

Introduction

By Robert Plotkin

As we all know, as a result of widespread accounting scandals in 2001-02, Congress passed the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 769 (2002) (SOX). SOX, signed into law on July 30, 2002, authorizes substantially increased funding for the United States Securities and Exchange Commission, creates broad new SEC enforcement powers, a greater range and magnitude of civil and criminal penalties, several new criminal prohibitions and more rigorous reporting requirements among other things.

Engineered to vastly expand federal regulators' authority to enforce the Federal Securities Laws, SOX presents new challenges and magnifies many pre-existing issues facing those under investigation or being actively prosecuted for securities law violations.

As a result, the Securities and Exchange Commission (SEC) has become increasingly active and influential in the regulation of public securities markets. To effectively defend entities and individuals facing federal investigations it is imperative to understand the federal agency involved, and its procedures.



SPECIAL ISSUE

DEFENSE AFTER SARBANES-OXLEY

Securities Enforcement Actions After SOX

By Robert Plotkin

SEC ENFORCEMENT ACTIVITIES: AN OVERVIEW

The Securities and Exchange Commission (SEC) was created by Congress in the aftermath of the 1929 stock market crash, the cause of which was widely attributed to fraudulent and deceptive practices on Wall Street. It is an independent regulatory agency whose five commissioners, including a Chairman, are appointed by the President. The SEC's Division of Enforcement is the "police force" of the Commission; it is responsible for the civil and administrative enforcement of the various federal securities laws. The Enforcement Division also typically works closely with U.S. Attorney's Offices throughout the country to assist with the criminal prosecution of securities violations.

SEC INVESTIGATIONS

The SEC receives complaints of securities violations from every imaginable source. No formalities are required, and the information need not be sworn to or provided in a particular format. Media reports, whistleblowers, information from state, federal or foreign agencies, Congressional inquiries, referrals from stock exchanges and other quasi-regulatory bodies, and simple letters from aggrieved investors have all initiated Enforcement Division investigations. The SEC has adopted Rules of Practice that establish procedures for the Enforcement staff to follow in the conduct of investigations. 17 C.F.R. § 202.5, § 203.1-8.

INFORMAL AND FORMAL INVESTIGATIONS

Upon receipt of information suggesting a possible violation, the Staff generally begins an informal, or preliminary, inquiry. At this stage, the Staff has no ability to issue subpoenas for documents or testimony. Rather, it must use information that is

continued on page 2

In This Issue

Enforcement Activities:
An Overview1

Federal Court Litigation
Proceedings4

already available to the public, and seek the voluntary cooperation of the persons or entities involved. The Staff may request access to certain documents or request that specific information be provided. Potential witnesses may be telephoned, and asked for information. Although witnesses cannot be compelled to appear and testify at this stage, frequently interviews are conducted on the record before a court reporter, or in an office interview. The witness may be represented by counsel if he or she desires. Regulated entities or persons, such as broker-dealers and investment advisors, have a legal duty to provide information and documents even during informal inquiries. *See, e.g.*, 15 U.S.C. § 78q(b); 15 U.S.C. §§ 80b-4 and 80a30(b).

While persons responding to requests for voluntary cooperation have no specific procedural rights, they can negotiate the terms and conditions of their cooperation, and reserve the ultimate right to refuse to provide any information. Although the inquiry is "informal" or "preliminary," defense counsel must be wary, as it is still illegal to obstruct, or to give false information in, "informal" investigations. Whether to cooperate, and the degree of any such cooperation, is a strategic decision that must be evaluated case by case. For most people, there is a natural desire to cooperate, because "I haven't done anything wrong," but that view must be tempered by the nature of the inquiry, by the fact that the SEC could choose to disclose publicly the information provided, and by the possibility that serious civil or criminal charges may flow directly from the information provided.

Based upon the information obtained by the Staff during its informal inquiry, it may decide to close the matter or to request the SEC Commissioners to authorize the initiation of a formal investigation.

If the Commission approves the Staff's request, it enters an order

Robert Plotkin, a member of this newsletter's Board of Editors, is a white-collar defense lawyer in the Washington, DC, office of McGuire Woods LLP.

known as a "Formal Order of Investigation." The Order grants the Staff the right to issue subpoenas for documents and witness testimony, and to administer testimonial oaths. The Order summarizes the factual and statutory basis for the investigation, but does so in vague, boilerplate language that usually does not provide a complete understanding of the nature and scope of the investigation. The existence of the Order is not made public by the SEC, although some public reporting companies choose to disclose such investigations in their filings.

The SEC has no obligation to provide notice or a hearing prior to commencing a formal investigation because it is "an administrative hearing [which] adjudicates no legal rights." *SEC v. O'Brien, Inc.*, 467 U.S. 735, 742 (1984). Nor does the Commission identify the primary party under investigation as its "target" or "subject." Rather, the SEC takes the position that the facts discovered during the course of its inquiry will determine what actions, if any, the SEC will take. However, persons who are subpoenaed pursuant to a Formal Order may obtain a copy of the Order to verify the subpoena's propriety, and this typically is defense counsel's initial request upon receipt of an SEC subpoena.

SUBPOENAS FOR DOCUMENTS

The first thing the SEC Enforcement Staff does upon issuance of an Order of Investigation is to draft and serve subpoenas. The first wave of subpoenas usually requests documents. These subpoenas are rarely drafted with precision. Rather they intentionally ask for virtually every document and file in a recipient's possession and leave it to the recipient and/or his or her counsel to negotiate narrower terms. The term "document" is defined broadly so as to include "electronic media," and "storage devices" in addition to paper records. Typically, the subpoena initially provides a very short time for a response, in order to get the recipient's immediate attention and set the response in motion.

continued on page 3

Business Crimes Bulletin®

PUBLISHER	Marjorie A. Weiner
ASSOCIATE PUBLISHER	Sofia Pables
CHAIRMAN OF THE BOARD	Richard M. Cooper Williams & Connolly LLP Washington, DC
EDITOR-IN-CHIEF	James Niss
ASSOCIATE EDITOR	Ellen E. Oberwetter
MANAGING EDITOR	Wendy Kaplan Ampolsk
MARKETING PROMOTIONS	
COORDINATOR	Rob Formica
MARKETING ANALYSIS	
COORDINATOR	Traci Footes
ART DIRECTOR	Claire C. O'Neill-Burke
GRAPHIC DESIGNER	Louis F. Bartella
BOARD OF EDITORS	
STANLEY S. ARKIN	Arkin Kaplan & Cohen LLP New York
TOBY J.F. BISHOP	Association of Certified Fraud Examiners Austin, TX
MICHAEL E. CLARK	Hamel, Bowers & Clark LLP Houston
ALAN M COHEN	O'Melveny & Myers New York
GERALD A. FEFFER	Williams & Connolly LLP Washington, DC
JONATHAN S. FELD	Katten Muchin Zavis Rosenman Chicago
ROBERT J. GIUFFRA JR.	Sullivan & Cromwell LLP New York
HOWARD W. GOLDSTEIN	Fried, Frank, Harris, Shriver & Jacobson New York
JAMES J. GRAHAM	Jones, Day, Reavis & Pogue Washington, DC
JEFFERSON M. GRAY	Assistant US Attorney Baltimore
JEFFREY T. GREEN	Sidley Austin Brown & Wood LLP Washington, DC
MICHAEL KENDALL	McDermott, Will & Emery Boston
DAVID J. LAING	Baker & McKenzie Washington, DC
RONALD H. LEVINE	Post & Schell, P.C. Philadelphia
IRVIN B. NATHAN	Arnold & Porter Washington, DC
ROBERT PLOTKIN	McGuire Woods Washington, DC
STEVEN F. REICH	Manatt, Phelps & Phillips New York
JOSEPH F. SAVAGE, JR.	Testa, Hurwitz & Thibault LLP Boston
ROBERT W. TARUN	Latham & Watkins LLP Chicago
JUSTIN A. THORNTON	(Private Practice) Washington, DC
STANLEY A. TWARDY, JR. ...	Day, Berry & Howard, LLP Stamford, CT
LAURENCE A. URGENSON	Kirkland & Ellis Washington, DC
GREGORY J. WALLANCE	Kaye, Scholer, Fierman, Hays & Handler, LLP New York
JACQUELINE C. WOLFF	Covington & Burling New York
MICHAEL E. ZELDIN	Deloitte Touche Washington, DC

Business Crimes Bulletin® (ISSN 1090-8447) is published by Law Journal Newsletters, a division of American Lawyer Media. © 2004 NLP IP Company. All rights reserved. No reproduction of any portion of this issue is allowed without written permission from the publisher. Telephone: (800) 999-1916
Editorial e-mail: wendya@palawnet.com
Circulation e-mail: subs@palawnet.com

Business Crimes Bulletin P0000-245
Periodicals Postage Pending at Philadelphia, PA
POSTMASTER: Send address changes to:
American Lawyer Media
1617 JFK Blvd., Suite 1750, Philadelphia, PA 19103
Annual Subscription: \$329

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, Pa 19103
www.ljonline.com

SEC subpoenas may be served in any state or territory. Indeed, receipt of the subpoena is often a surprise, as it may be the recipient's first notice of an investigation. Upon receipt, counsel for the recipient should contact the SEC attorney identified in the subpoena to negotiate a reasonable document return date, narrow the scope of documents requested and request a copy of the Formal Order of Investigation. In the vast majority of cases, corporate entities have little choice but to produce the required documents. Individuals, however, may avoid production by asserting a recognized legal or constitutional privilege. (Individuals may assert an "Act of Production" Fifth Amendment privilege, because the production establishes that the document exists and is in the person's custody. *Fisher v. U.S.*, 425 U.S. 391, 410-11 (1975).) The decision to assert a privilege or to otherwise refuse to comply must be evaluated carefully, which is difficult given the lack of information available to the recipient at the initial stage of the process.

If the recipient fails or refuses to comply with the subpoena, the Staff may go to federal district court for an order requiring compliance. Resisting an SEC subpoena in court is difficult because of the SEC's broad investigative authority. Courts rarely refuse to enforce subpoenas on grounds that the Commission exceeded its statutory jurisdiction in instituting the investigation, because the Commission's discretion is so broad. *RNR Enters., Inc. v. SEC*, 122 F.3d 93, 97-98 (2d Cir. 1997); *Kixmiller v. SEC*, 492 F.2d 641, 645-46 (D.C. Cir. 1974).

In situations where the recipient is willing to produce documents but wants to protect proprietary business information, trade secrets or other confidential data, the SEC regulations provide a modicum of protection. 17 C.F.R. § 200.83. There must be a letter from counsel requesting confidential treatment for certain information, and each document so produced must be stamped or coded as "confidential." However, if a public lawsuit subsequently ensues, or a request is made for the material under the Freedom of Information

Act, there remains a strong possibility that some or all of the material will be disclosed.

WITNESS TESTIMONY

Once the Enforcement Staff has obtained and reviewed documents, it may also issue subpoenas compelling individuals to appear to testify before Staff members. The witness is required to appear at an SEC office, take a sworn oath and answer questions from a staff member. The witness is advised of the right to be represented by, and consult with, counsel, warned that false testimony can be criminally prosecuted, and told of the Fifth Amendment privilege to refuse to answer questions that might be incriminating.

Testimony before the SEC is not, despite popular misconception, the equivalent of a deposition in a civil case. The Federal discovery rules do not apply, and the proceedings are completely controlled by the ranking SEC staff member. Witnesses may be asked to give opinions, speculate and provide hearsay information. They may be asked to review and comment upon documents they have never seen. Witnesses are commonly asked personal questions about their families, jobs and financial situation. While in theory the proceeding is non-adversarial, witnesses may be confronted with allegations made about them by others, badgered by repetitive questioning or asked if they believe their actions violated the securities laws.

For these reasons, witnesses should have the assistance of experienced counsel. Such assistance must begin prior to the examination, in one or more preparation sessions, where the witness is advised with regard to the nature and purpose of the testimony. To the extent that likely topics of examination can be anticipated, counsel should discuss these with the witness, and review documents that may be used in conjunction with the examination. During the testimony, the witness may consult privately with counsel. Despite the fact that this is not a deposition, counsel should treat it as one, and actively object to, or correct, unfair and irrelevant questions. When the staff has concluded its questions,

counsel may ask questions to clarify or explain previous testimony. Counsel should also obtain and review a copy of the testimony transcript, in order to correct errors and maintain a permanent record of the session for further reference. 17 C.F.R. § 203.6

The Fifth Amendment, which protects a witness from incrimination by his or her own compelled testimony, may be invoked during SEC testimony. *Kastigar v. United States*, 406 U.S. 441, 444-45 (1972). Prior to invoking the privilege, counsel and witness must carefully balance the risks inherent in testifying versus not testifying. The SEC believes that it may infer that a witness refused to testify because he or she would, in fact, give incriminating testimony. It uses such inferences both to justify initiating an enforcement action and as evidence against the individual in the subsequent enforcement action. On the other hand, should the witness testify, the statements made under oath properly could be used against the witness in a later criminal or civil proceeding, and they might stimulate an otherwise dormant criminal investigation.

The SEC staff ordinarily will require a witness planning to assert the privilege to attend the scheduled session. It will then ask the witness a series of leading questions intended to demonstrate the witnesses' culpability. Counsel must be careful to have the witness invoke the privilege early in the testimony, so as to prevent a waiver of the right. *Rogers v. United States*, 340 U.S. 367 (1951). A witness may also refuse to answer particular questions on grounds of attorney-client privilege and/or the work-product doctrine. Like the Fifth Amendment privilege, however, the Staff will require the witness to attend and answer questions about information that may be privileged to determine whether the privilege has been invoked properly, and to evaluate whether the witness has waived the privilege. *SEC v. Kingsley*, 510 F. Supp. 561, 563-64 (D.D.C. 1981).

WELLS LETTERS AND SUBMISSIONS

At the completion of an investigation, the Staff may, if it believes

continued on page 4

securities violations occurred, give notice to the suspected violators that it will recommend to the Commission that judicial or administrative proceedings be filed against them. This notice is known as the so-called "Wells" letter. (The term derives from a Committee created in the early 1970s to review fair practice rules before the Commission. See, 17 C.F.R. § 202.5; Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Release No. 5310 [1972-73 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 79,010 (Sept. 27, 1972).) The letter will summarize — but only in the most cursory fashion — the facts that the Staff believes justify the charges, and it will cite the legal violations alleged to have occurred. Often, the Staff will confer informally with counsel about the allegations and provide additional information, but this is entirely in the Staff's discretion.

The "Wells" letter invites the party, if it wishes, to make a "Wells Submission." This is essentially a written brief (or a videotaped statement) presented by counsel, arguing against the institution of formal charges, seeking to omit particular proposed defendants or to modify the severity of the proposed charges. The key to a persuasive Wells Submission lies in the strength of the legal and/or policy reasons opposing the filing of an enforcement action. The SEC Rules of Practice specifically discourage the party from arguing about factual disputes and/or witness credibility; the Commission believes that those issues are best litigated and decided by a judge.

Whether to make a Wells submission is another aspect of the investigation that must be evaluated carefully on the merits of each particular case. The submission may be treated by the SEC as admissions by the client and used against the client if an action is later filed. Unless the Staff has relied on clearly erroneous or incomplete facts, a factual argument is not usually recommended. In many circumstances, it is better to stand mute.

Once the Staff files its recommendation — accompanied by a Wells

submission if one is presented — the Commissioners meet in closed session to consider the matter. If the Commission authorizes the filing of judicial and/or administrative actions, the filing of the case is announced to the general and financial press, and it becomes a matter of public record.

SEC CIVIL ENFORCEMENT ACTIONS ***Federal Court Litigation Proceedings***

When the Commission authorizes a judicial action, the Staff files a civil complaint in the appropriate United States District Court. In practice, most of these cases are settled long before they are ready for trial. Indeed, the great majority settle simultaneously with the filing of the complaint in court.

Ordinarily, the SEC will make available to the defendant, as part of discovery, most of its investigative files. This includes the documents obtained by subpoenas, as well as the testimony procured throughout the investigation. It will not include the staff's privileged or work-product items, including the various memoranda recommending investigations or enforcement actions. Where the Commission seeks to impose a monetary penalty, Supreme Court precedent allows the defendant the right to a trial by jury. *Tull v. United States*, 481 U.S. 412, 420 (1987).

Remedies

Historically, the SEC has had a limited ability to impose significant consequences on violators. But throughout the past decade or so, Congress has provided the SEC with increasingly greater powers in an effort to deter violations and punish wrongdoers, so that today the SEC possesses a wider array of remedies it may seek to impose in court actions.

Injunctions

The most common form of judicial relief sought by the SEC is an injunction, or a court order prohibiting a person and/or an entity from taking particular types of action. The typical SEC injunction simply requires the defendant not to violate specific securities statutes and/or SEC regulations in the future. It is intended to prevent future violations rather than punish past misconduct, but in reality these concepts often merge.

Because an injunction is "equitable" there is no right to a jury trial. *Parklane Hosiery Co. v. Shore*, 439 U.S.

322 (1979). Even where the SEC seeks to disgorge "ill gotten gains," no right to a jury attaches because it is not a penalty but a curative action. *SEC v. Commonwealth Chemical Securities Inc.*, 574 F.2d 90, 95-97 (2d Cir. 1978). For this reason, there are no statutes of limitations for an SEC injunctive action, although a lengthy delay between the time of the violation and the SEC's request for an injunction may militate against issuing an injunction. *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1244 (S.D.N.Y. 1992); *SEC v. Willis*, 777 F. Supp. 1165, 1174 (S.D.N.Y. 1991) Indeed, the SEC is seen by the courts not as "an ordinary litigant, but as a statutory guardian [of] the public interest ... " *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 808 (2d Cir. 1975) and thus is not required to make the same evidentiary showing as private litigants.

Before issuing an injunction, a court must first make certain factual conclusions about the defendant's conduct. Most significantly, the court must find the defendant in fact violated the securities laws or is about to do so. *Aaron v. SEC*, 446 U.S. 680 (1980). Then the court must also decide, by a preponderance of the evidence, that there is a reasonable likelihood that, absent an injunction, the defendant will commit a future violation. This decision should be based upon more than simply the past violation, and a court often considers subjective factors, such as the severity of the past violation, the individual's past history, the explanation for the violation, and the time lapsed since the violation, to determine if it is likely the wrongdoer will sin again. *SEC v. Cavanaugh*, 155 F.3d 129, 135 (2d Cir. 1998); *SEC v. Lorin*, 76 F.3d 458, 461 (2d Cir. 1996); *Jones v. SEC*, 115 F.3d 1173, 1184 (4th Cir. 1997). Although in theory such predictions about someone's future behavior are virtually impossible to "prove," in practice courts frequently agree to the SEC's request for an injunction.

Needless to say, these injunctions are publicly reported by the SEC, and defendants' reputations may be harmed. Even a consensual order at least implicitly suggests that the entity or individual has violated the law, and cannot be trusted to comply in the

continued on page 5

future. The existence of such injunctions usually must be disclosed by the defendant in certain types of SEC filings, business contracts, transactional due diligence, financial statements, loan applications and other important documents, and may create a negative impact on current and future business opportunities.

From the SEC's standpoint, the most important element of the injunction is the Commission's ability to punish violations of the order through prompt contempt proceedings. By requesting the court to issue orders to enforce its original order, the SEC does not need to initiate a new action and thus avoids many of the procedural and discovery delays that otherwise accompany civil litigation. *SEC v. Bilzerian*, 131 F. Supp. 2d 10 (D.D.C. 2001); *SEC v. Diversified Growth Corp.*, 595 F. Supp 1159 (D.D.C. 1984). Failure to obey the injunction can lead to fines and/or incarceration until full compliance is achieved. *Id.* at 1172-73. A "willful" violation can be prosecuted as a criminal contempt, and so long as the individual is not sentenced to more than 6 months' incarceration, the defendant is not entitled to a jury trial. *Frank v. United States*, 395 U.S. 147, 150 (1969).

Penalties

From its earliest days, the SEC's primary enforcement weapon was the injunction, which many people perceived to be an insufficient deterrent to illegal conduct. In response to such concerns, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the Remedies Act) which, among other things, specifically allowed the SEC to seek court ordered penalties for violations of securities laws and regulations.

The Remedies Act permits a Court, "upon a proper showing," to penalize anyone who has violated the federal securities laws or SEC regulations. While the exact amount of the penalty is "determined by the court in light of the facts and circumstances ..." 15 U.S.C. § 77t(d)(1) and (2)(A) the Remedies Act sets the maximum penalties that may be imposed by the court. The maximums vary, depending upon the severity of the defendant's conduct, according to a three-tiered structure. The largest penalties are reserved for "fraud, deceit, manipulation, or deliberate or reckless disre-

gard of a regulatory requirement," that caused "substantial losses" or a risk thereof. 15 U.S.C. § 77t(d)(3). In such cases, the court can penalize "a natural person" up to \$100,000, a legal entity up to \$500,000, or "the gross amount of the pecuniary gain" obtained by the violator. *Id.* The Remedies Act does not define how to calculate "pecuniary gain," but this provision obviously allows a court to increase the penalty far beyond the ostensible statutory maximum.

Congress also created special penalty provisions for insider trading violations. For individuals who directly engage in the trading, the court may impose a penalty up to "three times the profit gained or loss avoided ..." In addition, penalties may be assessed against "controlling" persons who "knew or recklessly disregarded" that the direct violator under their control "was likely to engage in" insider trading. A controlling person may be penalized up to \$1 million or three times the profit gained or loss avoided, whichever is greater.

The Supreme Court has ruled that where the government seeks to impose a civil penalty for violations of regulatory statutes, the defendant is entitled to a jury trial. *Tull v. United States*, 481 U.S. 412, 420 (1987). Accordingly, a jury trial is required when the SEC seeks to impose a Remedies Act penalty.

Disgorgement

The law historically has permitted courts to exercise their equitable jurisdiction to grant broad relief necessary to provide justice to the parties. In cases where securities violators have obtained a personal gain, courts have long ordered such violators to "disgorge," or give back, such unjustly earned profits. *SEC v. Fischbach Corp.*, 133 F.3d 170 (2d Cir. 1997); *SEC v. Patel*, 61 F.3d 137, 139 (2d Cir. 1995). Because this is viewed as an equitable order and not as a "penalty," the violator is not entitled to a jury trial. *SEC v. Rind*, 991 F.2d 1486, 1493 (9th Cir. 1993).

The SEC invariably claims that interest must be paid on the amount disgorged in order to eliminate any financial benefit to the wrongdoer. The disgorged amount may be paid to the U.S. Treasury, or the SEC may also request that it be paid into a separate fund to reimburse victims of the wrongdoing.

Officer and Director Bars

The SEC has long sought to prevent certain individuals who violate the securities laws from holding future management jobs in public companies. This typically occurs where the behavior is believed to be particularly egregious. Prior to the 1990 Remedies Act, however, there was no specific statutory authority to impose such extraordinary relief. Consequently, the SEC often obtained such bars through a negotiated consent decree rather than by a court order.

The Remedies Act closed this loophole. The Act expressly authorizes federal courts to issue injunctions barring certain individuals from being officers or directors in a public reporting company. Such bars can be issued only against persons who have violated the anti-fraud provisions of the securities laws, and who are otherwise "unfit." The standard was recently eased from "substantial unfitness" to simply "unfitness" by § 305(a) of SOX, amending 15 U.S.C. § 78u(d)(2) and 15 U.S.C. § 77t(e). The court may impose a "permanent" bar or limit the bar to a specific period. *Id.*

Other Equitable Actions

As with disgorgement orders, courts have broad equitable authority to issue orders to do "justice" and further the purposes of the securities laws in particular cases. Depending upon the circumstances and notoriety of a particular case, the SEC may seek to impose additional specific requirements upon an enjoined party. To assure there is no doubt about the SEC's authority in this regard, SOX specifically provides that the SEC can seek any equitable relief that "may be appropriate or necessary for the benefit of investors." Sarbanes-Oxley § 305(b), amending 15 U.S.C. § 78u(d).

If the SEC believes there is an ongoing fraud and money is still being raised or has not yet been depleted, it may ask the federal court to issue an interlocutory order "freezing" the defendant's assets, in an effort to preserve the funds for possible restitution and/or penalties. *SEC v. Unifund SAL*, 910 F.2d 1028, 1041 (2d Cir. 1990); *SEC v. Interlink Data*

continued on page 6

Network of Los Angeles, Inc., 77 F.3d 1201, 1204(9th Cir. 1996). SOX added authority for the SEC to obtain a temporary asset freeze order for payments such as bonuses or severance, to insiders.

Courts have appointed “receivers” to take control of assets so that an accounting can be done, or hidden or lost items can be located. *SEC v. Am. Bd. of Trade, Inc.*, 830 F.2d 431, 435-36 (2d Cir. 1987). Such orders, however, are not common, and again are usually reserved for the most serious violations.

Settlement and Consent Decrees

The overwhelming majority of SEC civil enforcement actions result in a negotiated resolution. The cost of mounting a defense to these actions is substantial, and success cannot be accurately predicted. Most individuals do not have the financial ability — and often the time and intestinal fortitude — to join battle with the SEC. Even well-heeled companies, investment advisers and broker-dealers often are reluctant to litigate against their primary regulator. A settlement may also minimize negative publicity. Public companies must be aware, however, that they may temporarily lose their statutory “safe harbor” for forward-looking statements. (15 U.S.C. § 78u-5(b)(1)(A)(ii) provides that the safe harbor provision does not apply if, during the 3-year period preceding the statement, the company was the subject of a judicial or administrative injunction or cease-and-desist order.)

Negotiating the terms of an agreement with SEC staff can be a difficult process. As discussed below, there are numerous items that are routinely required by the Commission’s Rules, and these are rarely excluded through negotiations. Other matters must be negotiated based on the facts and circumstances of a particular case: the amount of disgorgement, if any; the length of a potential bar; whether the individual acted with scienter or simply was negligent. A defendant might propose to take actions to prevent future violations and/or to mitigate or correct past violations, in exchange for concessions by the SEC on other points. Defense counsel also must remember that they are initially negotiating with

staff attorneys who may be relatively junior. All of their “agreements” must be reviewed by a long chain of SEC command that culminates with the Commissioners, and thus are always subject to rejection or modification.

A settlement usually takes the form of a “consent decree,” meaning that the parties consent to having a judge adopt the agreement as the court’s own order, without need for full discovery and/or a trial. This format allows the SEC to enforce the agreement by seeking a contempt order from the judge who signed the judgment. From the defense standpoint, the key to the consent judgment is that it does not require a defendant to admit any legal violations. Without this provision, defendants might prejudice their ability to defend related lawsuits based on the same underlying facts.

SEC ADMINISTRATIVE HEARINGS

Where the SEC has regulatory jurisdiction over a suspected violator, it may choose to invoke its disciplinary authority through administrative proceedings in addition to, or instead of, a court action. Regulated parties include companies registered with the SEC to sell their shares to the public, broker-dealers, investment advisers, and professionals who practice before the Commission. For such regulated parties, upon completion of an investigation, the Staff may recommend that the Commissioners institute such disciplinary proceedings. If it approves, the Commission will issue an Order for Proceedings, which, like the complaint in a civil case, states the charges against the responding party and refers the matter to an Administrative Law Judge (ALJ). The Remedies Act broadened the SEC’s administrative authority to include non-regulated individuals and entities.

Historically, defense counsel preferred referral to administrative hearings than to federal court. It was thought that the consequences of, and publicity about, a court order were more serious than an administrative order. Moreover, the SEC had no power administratively to impose monetary sanctions or disgorgement. Since passage of both the Remedies Act in 1990, and SOX in 2002, however, the SEC’s administrative

enforcement authority has significantly expanded over regulated entities, and when combined with its ability to suspend or revoke registrations, this process today is viewed with far greater concern.

Nature of Proceeding

An administrative hearing is a quasi-judicial proceeding governed by the Administrative Procedures Act, 5 U.S.C. § 551, *et seq.* as supplemented by the SEC’s own Rules of Practice. 17 C.F.R. Part 201. The Enforcement Staff switches from its investigatory role to a prosecutorial role, and has the burden of proving its charges. The ALJ controls the proceeding and makes the initial ruling, but either party may appeal to the Commission itself, which then issues the final order.

Respondents in an administrative proceeding are entitled to a full hearing, where they may be represented by counsel, call and cross examine witnesses, issue subpoenas for relevant documents and witnesses, and file motions arguing rulings on evidence or points of law. Although the Rules of Practice allow for pre-hearing depositions and interrogatories, they typically are reserved for material witnesses who are unable to attend the actual hearing, so that in reality there is little true discovery permitted. The SEC must prove its case by a preponderance of the evidence, *Steadman v. SEC*, 450 U.S. 91(1981), and justify any remedy it seeks to impose as necessary to protect “the public interest.” 15 U.S.C. § 78o(b)(4). Upon completion of the hearing, the ALJ issues a written order, the “initial decision,” which the respondent may appeal to the Commission for review. The Commission’s final order may itself then be appealed to a federal appellate court for further review.

The administrative forum is perceived as a more friendly environment for the SEC. The prosecutor and ALJ, as well as the Commissioners who act as their final reviewer, are all employed by the bureaucratic machinery of the Commission. Additionally, the Rules governing the proceedings were all promulgated by the SEC, and generally tilt toward

continued on page 7

efficiency and speed rather than to protections for the respondents. But whether the administrative forum truly is more friendly than a federal court ultimately may depend upon the particular ALJ hearing the case.

REMEDIES IN

ADMINISTRATIVE HEARINGS

Depending upon the nature of the regulated activities, the SEC has a variety of administrative remedies it may pursue. For publicly registered issuers, the SEC may issue a "refusal order" prohibiting the issuance of a proposed registration statement believed to be defective, or a "stop order," where an already issued statement is alleged to contain fraudulent information. It may also summarily suspend trading of a company's stock for 10 days, although a hearing must be provided if the suspension is extended for successive 10-day periods. *SEC v. Sloan*, 436 U.S. 103 (1978).

Other remedies may be sought against entities or individuals who are registered broker-dealers. They may be censured or have their registrations suspended or revoked, and they may be barred from associating with any other broker-dealer. The SEC has similar authority over investment advisers and investment companies.

CEASE AND DESIST ORDERS

With the passage of the Remedies Act in 1990, the SEC's administrative remedies were greatly expanded. The new remedy most widely used is the authority to issue cease and desist (C&D) orders. Following a hearing establishing that the respondent has, or is about to, violate the securities law, the SEC may order the respondent to "cease and desist" from such actions. A C&D is similar to a court-ordered injunction in many respects, but the administrative process usually affords the SEC a faster method for obtaining relief than does a court action. As with injunctions, a C&D order can be fashioned broadly, based on the circumstances of the case.

The SEC also may enter temporary C&D orders against regulated parties in situations where there is likely to be a "significant dissipation or conversion of assets, significant harm to

investors, or substantial harm to the public interest ... " There is a right to petition the Commissioners for a hearing and review of such orders, as well as the right to seek prompt judicial review.

PENALTIES AND DISGORGEMENT

The Remedies Act also provided the SEC with two powerful administrative financial remedies, monetary penalties and disgorgement. However, these remedies may only be imposed on an SEC regulated party, such as a broker-dealer or investment adviser.

The administrative penalties are similar to the three-tier structure applicable in federal court, except that the maximum penalty cannot be exceeded based upon the amount of the wrongdoer's pecuniary gain. The statute requires the SEC to consider several factors in determining to impose a penalty: whether the offense involved fraud or deceit, the degree of harm caused to third parties, the unjust enrichment of the wrongdoer, and the wrongdoer's previous regulatory record.

The Remedies Act permits the SEC to order disgorgements administratively. Previously, there was no statutory provision for such orders, and the SEC was required to file court actions to obtain disgorgement. Administrative disgorgement is based on the same equitable principles applicable in civil court actions, and can be used in any case where the SEC would have authority to obtain a C&D or to impose monetary penalties.

Administrative Officer and Director Bars

Prior to 2002, the SEC lacked express authority to administratively issue officer and director bars. However, Section 1105 of SOX now enables the Commission, "in any cease and desist proceeding," to "prohibit [from acting as an officer or director], conditionally or unconditionally," any person violating the anti-fraud provisions if "that person demonstrates unfitness to serve as an officer or director ... " Sarbanes-Oxley, §§ 1105(a) and (b), amending 15 U.S.C. § 78u-3(f) and 15 U.S.C. § 7Th-1(f) respectively.

Professional Bars

One of the more controversial aspects of the SEC's administrative

authority is Rule 102, which regulates lawyers, accountants and other securities professionals who "appear" and "practice" before the Commission.

Rule 102 broadly defines "appearing or practicing" before the Commission so as to include not only physical "appearances" at hearings and so forth, but also the preparation of any documents that are, with the preparer's consent, filed with the Commission. It allows the SEC, after notice and a hearing, to deny professionals the "privilege" to appear before it. In addition to violations of the securities laws, they may also be barred for unethical behavior or being professionally unqualified. Professionals who have been suspended or disbarred by their own regulatory bodies, or who have been convicted of certain crimes, are likewise not permitted to appear and practice.

The SEC's authority to regulate professionals has been challenged, and upheld in court, because the Rule simply permits the Commission "to ensure that [those] professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence." *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979), upholding the SEC's regulatory authority to promulgate professional conduct rules. In order to clarify any possible ambiguity, SOX has codified the SEC appearance and practice rules. It now is beyond doubt that the Commission has authority to regulate professionals appearing before it. (Sarbanes-Oxley, §§ 307 and 602, which amends 15 U.S.C. § 78, *et seq.* by adding a new § 4C.) Section 307 of SOX also instructs the SEC to develop standards of professional conduct for lawyers appearing before it, including an obligation to report "evidence of a material violation" of securities laws to corporate officers and/or the audit committee.

Administrative Settlements

Most administrative proceedings, as with court actions, end in some type of negotiated settlement. A respondent can bargain for a consent

continued on page 8

C&D, a censure, or a short registration suspension. In exchange for more lenient treatment, respondents may offer “undertakings,” whereby they promise to take certain actions designed to correct the alleged misconduct in the future. Administrative settlements can also be written so that the respondent neither “admits or denies” the charges, thereby limiting any collateral consequences in parallel private litigation.

A major concern in administrative settlements is the SEC’s inclusion of factual “findings” in a consent agreement. Such regulatory-determined “facts” can be used by private litigants to prevent further litigation of those “facts” in court actions. Thus, it is important to omit or severely limit findings by the SEC in these documents. Several of the statutory provisions arguably require the SEC to make such findings, so defense counsel must pay special attention where these provisions are involved.

Voluntary Disclosures

Given the recent spate of financial reporting investigations by the SEC, many public companies are increasingly likely to be faced with internal complaints of irregularities. Passage of SOX created several specific disclosure requirements, including a mandated corporate self-evaluation and report of internal controls. The law also requires the SEC to implement regulations requiring lawyers to disclose “evidence of a material violation” to corporate officers and/or Board committees. In such circumstances, the Company could either disclose the potential problem to the SEC, or quietly correct the problem and respond to the SEC if and when it seeks information.

In years past, many companies took the quiet correction approach to this dilemma, because it was unclear whether companies would obtain any benefit from a voluntary self-disclosure to the SEC. While the SEC Enforcement Staff has, from time-to-time, used its prosecutorial discretion to reward cooperation by declining to take enforcement actions, there was no clear SEC policy identifying when, and how, such non-enforcement decisions should be reached. In an effort to encourage and reward

corporate self-reporting, the SEC issued such guidelines. The policy, while still too new to determine its practical effects, may afford reporting companies greater protection.

In Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Enforcement Release No. 1470 [Financial Reporting Binder], Fed. Sec. L. Rep. (CCH) ¶ 74,985 (October 23, 2001) (“Report of Investigation”), the SEC advised that it will reward cooperation for self-disclosure of misconduct in certain situations. This reward can range “from the extraordinary step of taking no enforcement action to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents [used] to announce and resolve enforcement actions.” *Id.* While the boundaries of this announcement can only be fleshed out as the SEC continues to apply the policy and decide what, if any, enforcement is appropriate in specific cases, it is safe to say that the policy shift will only apply in limited circumstances. The analysis employed by the SEC considers two components: first, “what is the nature of the conduct” that has been brought to the SEC’s attention? and, second, “what steps did the company take upon learning of the misconduct?” *Id.* Though the SEC does not specifically say so in its Report of Investigation, it appears to be embracing a sliding scale analysis in which the severity of the misconduct is measured against the speed and effectiveness of the company’s response to the discovery of the misconduct.

In determining the first element, the nature of the conduct, the SEC will consider such things as whether the conduct was intentional or inadvertent, the seniority of the company officials involved, the duration of the misconduct, and the harm caused to investors and to the public.

For the second element of the SEC’s evaluation, the company’s response to the discovery of the wrongdoing, the SEC will consider how long it took the company to discover, disclose and correct the misconduct. It will also evaluate the company’s cooperation with the Enforcement staff, review any new internal controls adopted to pre-

vent recurrences and scrutinize management changes designed to deter and correct misconduct. The existence of a meaningful company compliance plan — and evidence that it was actually in use — may also influence the SEC’s view of the company. An important element the SEC will also weigh is whether the Company voluntarily waived its attorney-client privilege as part of the cooperation, a difficult decision that could leave the corporation vulnerable in private litigation, such as shareholders’ class actions.

Whether to make a disclosure is a decision that can only be taken by balancing the various factors identified in the Report of Investigation against the known misconduct. At a minimum, however, a company should take certain prophylactic measures to better position itself in the event misconduct is identified. These steps should include a review of the company compliance program and its implementation, and strengthening the ability and competence of corporate compliance officers, who must effectively oversee and monitor these programs. The corporate Board should also include an effective audit committee, as well as directors who are truly independent of company management.

CONCLUSION

With increased public awareness, rising government funding and enhanced enforcement authority, SEC investigations are a common and constant concern for companies, their managers and their investors. A negative outcome to these investigations can have an enormous impact on both the entities and the individuals for years. The best defense is the creation of effective internal controls that will discourage and identify serious securities violations. But, if and when the SEC does come calling, it helps to know what to expect and how to minimize your exposure.



The publisher of this newsletter is not engaged in rendering legal, accounting, financial, investment advisory or other professional services, and this publication is not meant to constitute legal, accounting, financial, investment advisory or other professional advice. If legal, financial, investment advisory or other professional assistance is required, the services of a competent professional person should be sought.