Sec Enforcement: A Better Wells Process*

By Mitchell E. Herr**

INTRODUCTION

Securities and Exchange Commission (SEC) enforcement actions recently have become a far more visible feature of American business life, and will remain so. Systemic changes in the SEC's budget,[1] staffing[2] and internal processes[3] ensure that its enforcement program will continue to play a larger role than ever. This Working Paper suggests improvements to a critical aspect of the SEC's enforcement program, the Wells Process,[4] which would further enhance both the program's efficiency and fairness.

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The views expressed in this article are the author's alone, and they do not necessarily reflect the views of his law firm or its clients.

[1]From 2001 to 2004, the SEC's budget has doubled from just under $413 million to almost $842 million. Http://www.sec.gov/foia/docs/budgetact. htm.

[2]The SEC expects to add more than 800 lawyers, accountants, economists and examiners to its staff. Http://www.sec.gov/news/press/2003–80.htm.

[3]Section 408 of the Sarbanes-Oxley Act now requires the SEC to review periodic filings by public companies at least once every three years. This is a substantial increase. As of last year, the SEC only had reviewed only 53% of America's 17,300 public companies in the previous 3 years. See Senate Committee on Governmental Affairs Report on Financial Oversight of Enron (10/8/02).

[4]In 1972, the SEC appointed an advisory committee consisting of John A. Wells (founder of the former Rogers & Wells law firm) and two former SEC Chairmen, Manuel F. Cohen and Ralph H. Demmler, to evaluate its enforcement program. The so-called Wells Committee made 43 recommendations to the SEC, several of which form the basis for the Wells Process.

I. THE WELLS PROCESS CONTRIBUTES TO THE SEC'S EFFICIENCY AND FAIRNESS

The Wells Process gives a party under investigation a formal opportunity to present its side of the story before the SEC decides whether to charge it with a violation of the securities laws. When the SEC's staff has tentatively decided to recommend that the Commission bring an enforcement action, the staff notifies the party's counsel of its tentative charging recommendation and gives it an opportunity to make a written ''Wells Submission.'' Wells Submissions may argue that no enforcement action is warranted or that lower level charges and less severe relief are appropriate; they may also argue in favor of a settlement. If, after receiving the Wells Submission, the staff still believes that enforcement action is warranted, the Wells Submission accompanies the staff's Action Memorandum (which recommends the enforcement action) to the five Commissioners who head the SEC.

A. The Wells Process Helps the SEC Efficiently Allocate Enforcement Resources

The Wells Process helps ensure that the SEC's limited enforcement resources are allocated efficiently. Even with its recent budget and staffing increases, the SEC will remain a relatively small agency faced with a massive policing job. The Wells Process helps ensure that SEC's resources are not wasted litigating cases that do not warrant enforcement action or are doomed from the outset. The Wells Process also helps the SEC identify the appropriate relief to seek; making settlement more likely, which further enhances the SEC's efficiency.[5]

B. The Wells Process is a Critical Component of Fairness

The SEC wields considerable power over lives and businesses. A 1987 ABA Task Force on the SEC's investigatory process noted that:

> ''[D]ue to the fragility of reputation in the financial community and the volatility of the financial markets, the [SEC's] investigative process can be devastating to business entities or individuals under scrutiny. ***

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[5] The SEC's most recent Annual Report notes that ''[m]ost of the SEC's enforcement actions were resolved by settlement ***.'' Http://www.sec.gov/pdf/annrep02/ar02full.pdf.

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> For these reasons, the Commission's Rules Relating to Investigations, while promoting speed and efficiency in the investigative process, must be designed to furnish prospective defendants and respondents a meaningful opportunity to present their side of the case prior to the institution of any enforcement action.''[6]

Indeed, the SEC's Canon of Ethics acknowledges that ''[t]he power to investigate carries with it the power to defame and destroy.''[7]

The Wells Process is the primary formal opportunity to present one's case to the Commission before it decides whether to level charges. As such, a meaningful Wells opportunity is both a matter of fundamental fairness,[8] and a check on the SEC's considerable prosecutorial discretion.[9]

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[6]Report of the ABA Task Force on SEC Rules Relating to Investigations, 42 Bus. Law. 789, 790–791 (1987).

Similarly, an earlier commentator noted that:

> ''To the person who is the subject of a Commission investigation, perhaps the most important thing that will ever happen to him in his life, perhaps the most disturbing thing, is that the Commission will bring or contemplate bringing a civil proceeding against him.''

Milton V. Freeman, Administrative Procedures, 22 Bus. Law. 891, 892 (1967).

[7]17 C.F.R. §200.66.

[8]The 1987 ABA Task Force stressed the need for fairness in the SEC's investigative processes:

> ''[I]n practice, SEC investigations are sufficiently adversarial that due process concerns are appropriate. But the concern for fairness in investigative practices is broader than the need to assure compliance with the minimum constitutional requirements of due process. Many of the most significant restraints on the abuse of prosecutorial authority are not requirements of due process, but rather procedures voluntarily adopted by the government in recognition of the need for moderation in the exercise of its powers. ***''

42 Bus. Law. at 791, n.4.

[9]A former Associate Director of the SEC's Enforcement Division noted in his letter to the Wells Committee that

> ''[I]t [would be] an arbitrary and capricious use of governmental power to publicly level serious fraud charges against an individual ... without first according an opportunity to tell his side of the story in the investigatory phase of the case.''

II. SUGGESTED IMPROVEMENTS TO THE WELLS PROCESS

The present Wells Process has a number of shortcomings, all of which can be corrected without hamstringing the SEC from taking fast, flexible enforcement action. These improvements will enhance both the efficiency and fairness of the SEC's enforcement program.

The courts have held that the Wells Process does not confer enforceable procedural or substantive rights.[10] Understandably, the SEC would prefer to improve its Wells Process by amending its policies, rather than by enacting new rules that might give rise to collateral litigation over a submitter's supposed Wells rights. This should not be problematic, provided that the policy changes are publicly promulgated.

A. The Staff Should Grant Access to its Entire File

The primary shortcoming of the present Wells Process is that the submitter often does not know what evidence the SEC's staff is relying on for its tentative charging recommendation. The 1987 ABA Task Force noted that ''defense counsel frequently have difficulty in obtaining sufficient information about the staff's view of the factual and legal bases of the case to prepare a meaningful response. This is not only unfair to the proposed defendant but also not in the best interests of the Commission.''[11] This deficiency persists.

Presently, the staff is not required to disclose any minimum amount of evidence supporting its proposed charges. Rather, the SEC's policy provides only that ''the staff, in its discretion, may advise such persons of the general nature of the investigation, including the indicated violations as they pertain to them ***.''[12] A leading treatise notes that ''[m]uch of the information necessary to

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Letter from Arthur F. Mathews, to the SEC Advisory Committee on Enforcement Policies and Practices at 5–6 (May 23, 1972), reprinted in Mathews et al., Enforcement and Litigation Under the Federal Securities Laws 1973, at 362–364 (PLI Corp. L. & Practice Course, Handbook Series No. 116 (1973)).

[10] See SEC v. National Student Marketing Corp., 538 F.2d 404, 407 (D.C. Cir. 1976), cert. denied, 429 U.S. 1073 (1977); Wellman v. Dickinson, 79 F.R.D. 341, 351–354 (S.D.N.Y. 1978).

[11] 42 Bus. Law. at 819.

[12] 17 C.F.R. §202.5(c).

write a Wells submission has to be wheedled out of the staff ***.''[13] Additionally, staff practices about providing supporting factual information are inconsistent.[14]

If the SEC decides to bring an enforcement action, during the litigation the staff will be required by applicable procedural rules to turn over its entire non-privileged investigatory file (including sworn testimony and exhibits thereto) relating to the subject of the enforcement action.[15] Given the importance of the Wells Process, the SEC generally should grant that same degree of access at the Wells stage. Because Wells Submissions often focus on the weight of the evidence and the inferences that properly should be drawn from conflicting evidence, their quality is directly related to the completeness of the submitter's access to relevant evidence.[16]

Of course, there will be those rare investigations where it is important for the staff to withhold certain information at the Wells stage. Accordingly, the staff should be allowed to limit access to its investigatory file at the Wells stage, provided that its Action Memorandum identify for the Commission what has been withheld, and the justification therefore.

B. The SEC Should Remove all Obstacles to Candor

Despite the value of Wells Submissions, there are a number of obstacles that unnecessarily tend to discourage parties from making candid Wells Submissions, or any submission at all. In the interest of ensuring that it has the benefit of candid Wells Submissions, the SEC should remove these obstacles.

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[13] 4 A. Bromberg & L. Lowenfels, Bromberg and Lowenfels on Securities Fraud & Commodities Fraud 2d ed., Sec. 13.2(1820) at 13:159 (1995).

[14] ''There is a significant range of practices regarding the extent to which the Staff will provide details regarding the theory and evidence underlying its tentative decision.'' K. Winer & S. Winer, ''Effective Representation in the SEC Wells Process,'' The Review of Securities & Commodities Regulation (Mar. 28, 2001).

[15] An SEC investigatory file may also contain information concerning third parties that is irrelevant to the Wells submitter. To protect the privacy interests of such third parties, the staff should only be required to produce those portions of its file relating to the Wells submitter.

[16] It is important that a submitter have access to *all* information in the staff's investigatory file, not just those documents that the staff has chosen to make exhibits to investigative testimony. Documents that the staff has ignored might well be critical in tipping the evidentiary scales back in favor of the Wells submitter.

1. Wells Submissions Should Not be Used Against Submitters

The SEC warns submitters that it may use their Wells Submissions against them at trial: ''The staff of the Commission routinely seeks to introduce submissions made pursuant to Rule 5(c) as evidence in Commission enforcement proceedings, when the staff deems appropriate.''[17]

This prospect undoubtedly has a chilling effect on the making of Wells Submissions. However, it appears that Wells Submissions are *very* rarely actually admitted in SEC enforcement proceedings.[18]

2. Wells Submissions Should be Confidential to the SEC

Wells Submissions lay out the submitter's evidence and legal arguments, providing a road map to trial strategy, which the submitter is reluctant to risk sharing with third parties. However, under the present practice, a potential submitter must balance the utility of making a Wells Submission against the risk that it will fall into the hands of a potential adversary. Wells Submissions can fall into third party hands via various means: pursuant to law enforcement referrals by the SEC or an ''access requests'' by another federal or state agency, through freedom of information act (''FOIA'') requests, or through discovery requests or subpoenas under applicable rules of procedure. The SEC should try to ensure that Wells Submissions remain confidential to the SEC.

a. Criminal Referrals/Access Requests

Undoubtedly, the SEC needs to be free to share the testimonial and documentary fruits of its investigation with other law enforce-

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[17] SEC Forms 1661 and 1662.

[18] A decade ago, the SEC's then Chief Administrative Law Judge (''ALJ'') held that Wells Submissions are inadmissible as protected settlement materials under Federal Rule of Evidence 408. In re Allied Stores Corp., 52 SEC Docket (CCH) 451, 451–452 (1992). This decision appears to have continued vitality.

Earlier this year, an SEC ALJ asked the Division of Enforcement to explain the basis for its proposed admission of a Wells Submission, asking it in particular to address the reasoning of Allied Stores Corp. The ALJ directed that ''If the Division is aware of any Commission opinions addressing the admissibility of Wells Submissions, it should bring the relevant authority to my attention.'' In re Oxford Capital Management, Inc., 2003 SEC LEXIS 95 (Jan. 14, 2003). This matter was ultimately settled, without deciding the admissibility of Wells Submissions.

ment authorities. However, there is little need for the SEC to share Wells Submissions. As with SEC enforcement actions, Wells Submissions play virtually no role in criminal prosecutions, yet the prospect that the SEC may provide them to law enforcement authorities likely chills their submission. The SEC should consider changing its policy to ensure that Wells Submissions remain confidential to the SEC and are not furnished to any law enforcement agencies, except where the submission itself contains a false statement in violation of 18 U.S.C. §1001[19] or similar statute. In the current climate, however, it might not be politically feasible for the SEC to take any action that appears to lessen its cooperation with criminal authorities.

b. FOIA Requests

Wells Submissions are not generally obtainable through FOIA requests during the course of the staff's investigation and any subsequent SEC enforcement proceeding. However, they generally do become subject to FOIA requests following the conclusion of the enforcement proceeding. A submitter cannot shield a Wells Submission from production by requesting that it be accorded confidential treatment under FOIA. While allowing third parties to obtain Wells Submissions through FOIA chills their submission, such access does not materially advance the SEC's enforcement program. The SEC should consider curing this problem by sponsoring legislation to exempt Wells Submissions from production under FOIA.

c. Discovery Requests

Until recently, there has been little case law addressing the discoverability of Wells Submission in civil litigation. However, in a landmark decision issued December 24, 2003, the United States District Court for the Southern District of New York held that Wells Submissions generally are discoverable in private civil litigation, even if they contain settlement offers.[20] In re Public Offering Securities Litigation, 2003 U.S. Dist. LEXIS 23102 (Dec. 24, 2003). The

[19]This statute provides, in pertinent part: ''whoever, in any matter within the jurisdiction of the *** Government of the United States, knowingly and willfully *** (2) makes any materially false, fictitious, or fraudulent statement or representation *** shall be fined under this title or imprisoned not more than 5 years, or both.''

[20]The Court indicated that any offer of settlement that might be contained in a Wells Submission would ''easily be severable from the remainder of the

Court held that Wells Submissions are discoverable by third parties, provided that they meet only the low threshold of relevance to the claims or defenses at issue in the civil litigation. Moreover, the Court reiterated the Second Circuit's holding in In re Steinhardt Partners, L.P., 9 F.3d 230 (2d Cir. 1993), that the voluntary submission of a Wells Submission to the SEC resulted in a *complete* waiver of the work product protection.[21]

In light of this decision, all SEC investigatory subjects who face the possibility of related private civil actions must carefully weigh the benefits of making a Wells Submission against the risk that the Submission will be used against them in private litigation. Many will choose to forego making a Submission, or will substantially curtail what they would have otherwise said. Given the contribution of the Wells Process to the efficiency and fairness of the SEC's enforcement program, and the lack of public benefit from allowing private litigants to obtain discovery of Wells Submissions,[22] the SEC should sponsor legislation to immunize Wells Submissions from third-party discovery.

C. The SEC Should Allow 45 Days For Wells Submissions

The SEC has not established any minimum time period in which to make Wells Submissions, leaving it to the discretion of individ-

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submission.'' Id. at n.23; but see J. Naftalis, '' 'Wells Submissions' to the SEC as Offers of Settlement Under Federal Rule of Evidence 408 and Their Protection From Third-Party Discovery,'' 102 Colum. L. Rev. 1912 (Nov. 2002), arguing that Wells Submissions are not discoverable under Fed. R. Civ. P. 26 because they qualify as settlement vehicles under Fed. R. Evid. 408.

[21] Other courts have held that a voluntary disclosure to a government agency made under a confidentiality agreement can result in only a limited waiver that preserves applicable privileges with respect to third parties. See Saito v. McKesson HBOC, Inc., 2002 WL 31657622 (Del. Ch. 2002) (voluntary disclosure to SEC resulted in only *limited* waiver); In re Subpoenas Duces Tecum, 738 F.2d 1367 (D.C. Cir. 1984) (voluntary disclosure to SEC under confidentiality agreement could *avoid* waiver); Diversified Indus., Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1977) (en banc) (voluntary disclosure to SEC resulted in only *limited* waiver, protecting the privilege). However, even in those jurisdictions where the limited waiver doctrine is viable, it is unlikely to help a submitter avoid a complete waiver because the SEC generally refuses to accept Wells Submissions under claims of privilege (or as settlement materials).

[22] Private litigants can independently discover the facts on which the Wells Submission is based. They simply have no need also to invade the thought processes of legal counsel who prepared the Wells Submission.

ual staff members. At the time of a Wells call, the staff is often subject to intense pressure to conclude its investigation. As a result, the staff frequently requests Wells Submissions within two weeks, and is often unwilling to grant more than another week's extension. Very simply, three weeks is usually an insufficient amount of time in which to prepare a thorough Wells Submission.

The 1987 ABA Task Force urged the SEC to adopt a rule establishing a presumptive minimum time for Wells Submissions:

> ''when counsel is denied sufficient time to prepare an adequate submission, the Commission itself suffers because it is then deprived of the opportunity to receive the kind of factual and legal analysis that may well persuade it, in particular cases, either that enforcement activity is unwarranted or that a particular remedy is inappropriate.''[23]

The ABA recommended that in the ordinary course counsel should have at least thirty days to prepare a Wells Submission.

However, the ABA Task Force did not propose, as does this Working Paper, that a Wells submitter be given access to the staff's entire non-privileged investigatory file relating to the proposed charges. While such access is important to the process, it will give the submitter more to digest, making it more appropriate to allow the submitter forty-five days to review the staff's investigative file and make a Wells Submission.

While the SEC has recently made commendable efforts to speed up its enforcement practice[24] , the slight delay occasioned by allowing forty-five days will not prejudice the public interest. Since an opportunity to make a Wells Submission will only be granted when the staff does not intend to seek emergency relief, this modest delay is a small price to pay for the enhanced quality of submissions that the SEC would receive. Finally, the Commission also should require the staff to note in the Action Memorandum if a lesser period was provided, and the reasons therefore.

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[23]1987 ABA Task Force Report, 42 Bus. Lawyer at 820.

[24]In recent years, the SEC has emphasized the importance of expedition in its enforcement processes under the banner of ''real-time enforcement.'' Additionally, earlier this year the SEC amended its rules to provide that administrative enforcement proceedings must be completed in a maximum of ten months, from institution of the proceeding to issuance of the Initial Decision. See 17 C.F.R. 201.360.

D. Absent an Emergency, A Wells Opportunity Should Always be Provided

The 1987 ABA Task Force proposed that an opportunity to make a Wells Submission be provided, ''except where a temporary restraining order is sought'' and ''time, therefore, is of the essence.''[25] In essence, this is the SEC's practice today. Under the present practice, the staff generally does provide an opportunity to make a Wells Submission, except when it needs to seek emergency relief, in which case it so advises the Commission in its Action Memorandum. However, the SEC does not have an articulated policy to this effect. To ensure that the staff continues – on a consistent and even-handed basis – to provide an opportunity to make Wells Submissions in the absence of exigent circumstances, the SEC should formalize this policy.

E. The SEC Should Clarify That Factual Arguments are Appropriate

Securities Act Release No. 5310, which publicly announced the Wells Process in 1972, gives the misimpression that the SEC will only consider policy and legal arguments, but that it will not entertain factual arguments:

> ''submissions *** will normally prove most useful in connection with questions of policy, and on occasion, questions of law, bearing on the question of whether a proceeding should be initiated, together with considerations relevant to a particular prospective defendant or respondent which might not otherwise be brought clearly to the Commission's attention.''

However, rather than discouraging them, the SEC should welcome an early presentation of defense factual arguments, which will assist it in weeding out both weak cases and inappropriately harsh charges. Moreover, despite Release 5310, experienced securities practitioners know that a thorough and persuasive explication of the factual issues is the most important part of a Wells Submission.[26]

Eliminating the dissonance between the SEC's public guidance

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[25] 1987 ABA Task Force Report, proposed Rule 8(a), 42 Bus. Lawyer at 819.

[26] Former SEC Director of Enforcement Gary G. Lynch has noted that the

> ''recommendation [of Release No. 5310 not to argue factual matters] should not be followed by counsel. While it is always helpful to discuss

on Wells Submissions and its actual practice will enhance the transparency of the SEC's enforcement process and foster the public's confidence in the fairness of that process. Accordingly, the SEC should publicly clarify that defense counsel should feel free to argue the facts in their Wells Submissions.[27]

III. CONCLUSION

Wells Submissions are a critically important part of the SEC's enforcement process. They both increase the efficiency of and are a critical component of the fairness of the SEC's enforcement program. However, the present Wells Process has several serious shortcomings that deprive the SEC of the benefit of full and candid Wells Submissions. All of these shortcomings can be remedied while preserving the staff's ability to act quickly and flexibly, and with minimal additional burden or delay. Specifically, the SEC should amend its Wells policies to ensure that (1) submitters generally have access to the entire relevant non-privileged investigatory

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policy or law if there are sound arguments which can be asserted, generally the prospective defendant's or respondent's version of the facts should be set forth and, where appropriate, the evidence supporting the asserted version of the facts should be discussed.''

G. Lynch & K. Choo, ''Wells Submissions: Effective Representation Following the Completion of the Staff's Investigation,'' PLI Advanced Securities Workshop 1990.

Similarly, other former SEC Enforcement attorneys note that although Release No. 5310 advises that factual disagreements can rarely be resolved through the Wells Process, ''[d]efense counsel should largely disregard this advice. *** While legal and policy arguments are often important, in most instances the facts will be decisive.'' K. Winer & S. Winer, ''Effective Representation in the SEC Wells Process,'' The Review of Securities & Commodities Regulation (Mar. 28, 2001).

[27]The SEC originally discouraged factual arguments because it ''wish[ed] to avoid the possible danger of apparent prejudgment ***.'' Securities Act Release No. 5310. This concern, however, is illusory. The Wells Committee itself noted that ''[s]ince a prospective defendant or respondent would not be required to present a submission, we do not foresee any substantial question of prejudgment arising from the Commission's adoption and implementation of the suggested procedure.'' Wells Committee Report at 32–33.

In exercising its prosecutorial discretion, the Commission necessarily must determine whether there is sufficient evidence to justify a proceeding. There is no greater danger of prejudgment when the Commission has both the subject's and the staff's factual contentions before it, than when it only has the staff's views. Indeed, the risk of prejudgment is arguably *lessened* when the Commission has both sets of views before it, instead of just the staff's views.

file, (2) Wells Submissions are not used against submitters at trial and will remain confidential to the SEC, (3) submitters generally have 45 days to prepare Wells Submissions, (4) a Wells opportunity is always provided, absent exigent circumstances, and (5) practitioners have notice that the SEC welcomes factual as well as policy arguments.