National Association of Bond Lawyers Presents
Fourth Annual Tax & Securities Law Institute

SEC Practice and Procedure: What to Do When the SEC Comes Knocking

February 23, 2006
The Peabody Orlando
Orlando, Florida

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I. <u>The SEC Enforcement Environment for Bond Lawyers</u>

Bond lawyers are at an unprecedented risk of being named in SEC enforcement actions for the manner in which they discharge their professional duties.

A. The SEC is Targeting "Gatekeepers"

"Pursuing gatekeepers [is] the most targeted and effective way of using the agency's limited enforcement resources." Former SEC Enforcement Director Steve Cutler, September 2004.

B. Several Recent Cases Based on Lawyers' Performance of Professional Duties

Historically, the SEC has rarely used its enforcement mechanisms to challenge lawyers' performance of their professional duties.

This is changing:

> "Consistent with SOX's focus on the important role of lawyers as gatekeepers, we have stepped up our scrutiny of the role of lawyers * * * . We have named lawyers as respondents or defendants in more than 30 of our enforcement actions in the past two years." Former SEC Enforcement Director Cutler, September 2004.

In most of these cases, the fact that the defendant/respondent had a law degree was merely incidental. However, several recent enforcement cases were based on the SEC's view that the lawyer did not properly perform her professional obligations.

1. <u>In re David C. Drummond</u>, AP No. 3-11795 (1/13/05) (attachment A), in this settled administrative proceeding, the SEC charged Google's General Counsel with causing Google to violate the registration provisions of the federal securities laws (Sections 5(a) & 5(c) of the Securities Act of 1933 ("'33 Act")) by failing to give his client complete advice regarding the legal basis for and risks of issuing unregistered stock options. The SEC ordered Drummond to cease and desist from violating these registration provisions; no other sanctions were imposed.

This action was predicated on how Google's General Counsel performed his professional duties:

> "[I]f a lawyer … fails to inform anyone else at the company of the potential legal risks [as did Drummond] … it will be much more difficult to argue that the lawyer played a purely advisory role. [T]he lawyer's continuing participation in the activity without providing advice to others may … constitute part of a course of conduct that effectively makes the ultimate business decision for the company." Former SEC General Counsel Prezioso, April 2005.

2. In re Isselmann, AP No. 3-11678 (9/23/04) (attachment B), in this settled administrative proceeding, the SEC charged a General Counsel with causing his client to file an inaccurate quarterly report. The SEC charged that Isselmann did not fulfill his "gatekeeper role" by failing to bring written legal advice to the attention of his client's Audit Committee, Disclosure Committee or independent auditors. The SEC ordered Isselmann to cease and desist from violating the books and records provisions of the federal securities laws; no other sanctions were imposed.

C. One Recent Case Involved Bond Counsel

The SEC recently charged a bond counsel for how he performed his professional duties. In In re Ira Weiss, the SEC's charges were based on bond counsel's unqualified legal opinion regarding the tax-exempt status of municipal General Obligation Notes and his representation that the proceeds would be used to fund capital improvement projects. The SEC squarely took issue with how Mr. Weiss performed his professional duties.

1. The SEC Originally Charged Bond Counsel with Fraud

The SEC originally charged bond counsel with committing fraud in violation of Section 17(a) of the '33 Act, Section 10(b) of the Securities Exchange Act of 1934 ("'34 Act") and Rule 10b-5 thereunder, and with "causing" the issuer to commit these violations; the SEC sought a cease-and-desist order from bond counsel, as well as disgorgement and prejudgment interest. See AP No. 3-11462 (4/22/04) (attachment C).

2. The Commission's December 2, 2005 Decision

The ALJ originally dismissed all charges against Mr. Weiss. See Initial Decision Rel. No. 275 (2/25/05) (attachment D). However, on December 2, 2005, in a 4-1 decision (Commissioner Glassman dissenting), the Commission reversed and held that Mr. Weiss had committed a primary violation of Sections 17(a)(2) and 17(a)(3) of the '33 Act, to which a negligence standard applies. See Ira Weiss, Commission Opinion, '33 Act Rel. No. 8641 (12/2/05) (attachment E). Mr. Weiss was ordered to cease and desist from committing or causing any violations or future violations of Sections 17(a)(2) or 17(a)(3) of the '33 Act and to disgorge his fee ($9,509.63), plus prejudgment interest.

3. Critical points about Ira Weiss

a. Mr. Weiss was charged for the manner in which he performed his *professional duties* (i.e., his unqualified tax opinion and representation that bond proceeds would be used to fund capital projects).

b. Mr. Weiss' performance of his professional duties was assessed under a *mere negligence standard*: "His conduct departed from the standard of reasonable prudence and was at least negligent." Commission Opinion at 23.

Contrast the mere negligence standard that the SEC applied in Ira Weiss to the standard that the SEC applies under the improper professional conduct prong of Rule of Practice 102(e) (other prongs include violations of the federal securities laws). With respect to licensed accountants, the SEC has defined "improper professional conduct" as either: (1) a single instance of "highly unreasonable conduct" or (2) "repeated instances of unreasonable conduct." Under the Ira Weiss standard, however, bond counsel may be found to have violated the federal securities laws for having engaged in a single instance of merely unreasonable conduct.

c. The Commission made clear that it *will not be bound by industry custom*. Although both Mr. Weiss and the Division of Enforcement pointed to the NABL Model Bond Opinion Report as the industry standard of care, the Commission cautioned:

> "'[w]hile compliance with industry standards is a consideration, it is only one factor to be weighed' in determining liability under the federal securities laws."

Commission Opinion at n.16 (citing SEC v. Piper Capital Mgmt., Inc., Exchange Act Rel. No. 48409 (Aug. 26, 2003), 80 SEC Docket 3594, 3607 & n.28, petition for review denied, No. 03-1349 (D.C. cir. 2004) (unpublished order).

D. Commissioner Campos Views Bond Counsel's Duties Broadly

At his September 2005 keynote address to NABL's 30th Bond Attorney's Workshop, SEC Commissioner Campos made clear that he views the responsibilities of bond counsel broadly:

First, Commissioner Campos made clear that bond counsel's primary duty should be to the ultimate investor.

Second, he suggested that it is incumbent on bond counsel to not view her responsibilities narrowly, but she should at least point out problems that she notices to the issuer and other transaction participants. As Commissioner Campos put it, "[t]he avoidance of fraud is everyone's job."

Third, the Commissioner urged bond lawyers to be pro-active in policing themselves to avoid further regulation.

E. Many SEC Municipal Enforcement Investigations Are Pending

The December 23, 2005 edition of Bond Buyer quotes Martha Haines, Chief of the SEC's Office of Municipal Securities, as saying that there are almost 15 municipal enforcement investigations pending at the SEC. Given the SEC's targeting of gatekeepers, it is reasonably certain that the SEC will examine the conduct of counsel in these matters, putting bond lawyers at risk.

II. SEC Remedies Available Against Bond Lawyers

A. Injunctive/Cease and Desist Relief

The SEC can seek injunctive relief in federal court (see Section 20(b) of the '33 Act and Section 21(d)(1) of the '34 Act) and cease-and-desist orders through administrative proceedings (see Section 8A of the '33 Act and Section 21C of the '34 Act). Both forms of relief order the defendant/respondent not to violate the law in the future.

1. The SEC May Charge Both Primary and Secondary Liability

The SEC may charge a defendant both with primary liability for committing the violation in question, and also for secondary liability for aiding and abetting (used in federal injunctive actions) or causing (used in cease-and-desist proceedings) the violation.

The limitation on aiding and abetting liability established by the Supreme Court in Central Bank, 511 U.S. 164 (1994), does not apply to SEC enforcement actions.

2. The SEC May Charge Both Fraud and Mere Negligence

a. Fraud must be supported by at least recklessness

The SEC may proceed on a fraud basis (e.g., Section 17(a)(1) of the '33 Act and Section 10(b) of the '34 Act and Rule 10b-5 thereunder), which requires proof that defendant/respondent acted with scienter.

The minimum degree of scienter necessary to support a fraud charge is recklessness, defined as "an extreme departure from the standards of ordinary care … present[ing] a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the defendant must have been aware of it." Sundstram Corp. v. Sun Chem. Corp., 553 F.2d 1033, 104-54 (7th Cir. 1977) (citation omitted), cert. denied, 434 U.S. 875 (1977).

b. Negligence is a departure from ordinary standards of care

When the SEC proceeds under Section 17(a)(2) and 17(a)(3) of the '33 Act, however, it need not establish scienter; mere negligence suffices. Aaron v. SEC, 446 U.S. 680, 697 & 701-02 (1980).

Negligence is defined as a failure to exercise ordinary care (see, e.g., SEC v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3rd Cir. 1997)). Ira Weiss makes clear that the SEC can find a failure to exercise ordinary care even when counsel follows industry custom.

B. Civil Money Penalties

In federal court proceedings, the SEC may seek a civil money penalty from any person (the SEC can only seek penalties administratively from regulated persons).

The SEC may impose three tiers of penalties against an individual person:

Tier	Penalty per violation	When available
1	Not to exceed greater of gain to defendant or $5,000	Any violation
2	Not to exceed greater of gain to defendant or $50,000	Violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement
3	Not to exceed greater of gain to defendant or $100,000	Same as 2nd tier *and* such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses

Section 20(d) of the '33 Act; Section 21(d) of the '34 Act. Periodically, by regulation, these amounts are increased to account for inflation.

Thus, only a first-tier penalty can be imposed for negligence charges under Section 17(a)(2) and 17(a)(3) of the '33 Act, while second and third-tier penalties can be imposed for fraud charges under Section 17(a)(1) of the '33 Act and Section 10(b) of the '34 Act, and Rule 10b-5 thereunder.

C. Disgorgement

In addition, or as an alternative, to a civil money penalty, the SEC may seek disgorgement of ill-gotten gains, plus pre judgment interest. For instance, the SEC may require counsel to disgorge a fee received in connection with a violative offering. The SEC pursued this form of relief against Ira Weiss. The SEC may seek disgorgement in both federal injunctive and administrative proceedings.

D. Suspension or Bar From Appearing Before the Commission

Under both SEC Rule of Practice 102(e) and Section 602(a) of the Sarbanes-Oxley Act, the SEC may suspend or bar from appearing or practicing before the Commission a person who engaged in improper professional conduct or willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws.

Although municipal securities are exempt from registration with the SEC, the SEC appears to believe that it may bring an action to bar a bond attorney from appearing or practicing before the Commission. In dictum, the Commission recently noted that:

> "[d]enying the person the privilege of appearing or practicing before the Commission is the remedy once the Commission makes one of the findings specified in Rule 102(e)(1)(i)-(iii); appearing or practicing before the Commission at the time of the misconduct is not the precondition to imposing that remedy."

In re Robert W. Armstrong, III, Opinion of the Commission (6/24/05) at 24. See also In re Ferguson, 5 SEC Docket 37 (1974) (settled Rule 2(e) proceeding against municipal bond counsel).

III. Overview of the SEC Enforcement Process

A. The Division of Enforcement

Investigations and prosecutions of municipal issuers and counsel involved in the issuance of municipal securities are conducted by the SEC's Division of Enforcement.

According to its 2006 budget request, the Division of Enforcement will have approximately 1,338 attorneys and other professional staff. Less than half are located in the SEC's headquarters in Washington, D.C., and the remainder are located in five regional offices and six district offices around the country.

B. Informal Inquiry vs. Formal Investigation

The SEC may gather facts and make a charging decision through either an informal inquiry or through a formal investigation. Both are serious. Informal inquires often result in the SEC Staff recommending that the Commission initiate enforcement charges.

When the Staff proceeds through an informal inquiry, the Staff does not have the authority to subpoena documents and testimony; in an informal inquiry, requests for documents and testimony from unregulated entities and persons are voluntary.

When the Staff wants authority to subpoena documents and testimony, it obtains a formal Order of Investigation from the Commission. Under the Commission's Rules Relating to Investigations, a person who is compelled to produce documents or give testimony has the right to be shown the formal order; whether the person will be furnished a copy of the formal order rests in the discretion of senior enforcement personnel. 17 C.F.R. § 203.7(a).

The formal Order of Investigation indicates the Staff's concerns at the time that the Order is issued; however, the Staff subsequently may develop investigatory concerns that are not reflected in the formal Order.

Whether or not formal, SEC investigations are "non-public," meaning that neither the Commission nor the Staff should acknowledge or comment on the investigation unless and until public charges are brought. Parties under investigation may, and are sometimes obligated to, disclose the pendency of the investigation.

C. Initial Contact With SEC Staff

SEC Enforcement Staff occasionally try to engage witnesses in substantive discussions very early in the investigative process, often by telephone.

Witnesses should be wary of engaging in any such discussion. The SEC Enforcement Staff will make detailed notes of the conversation, which often takes place before the witness understands what is at issue and has had an opportunity to refresh her memory.

Not only might the witness lock herself into a damaging position, but inaccurate responses might later appear to have constituted obstruction of justice. Additionally, inaccurate responses, even though unsworn, might expose the witness to criminal charges under 18 U.S.C. § 1001.

Witnesses should politely but firmly make clear to the Staff that they would like to consult with counsel before speaking with the Staff.

D. Document Preservation, Especially Electronic

Upon learning of SEC investigatory interest in a matter, it is critical to immediately take all necessary steps to preserve all potentially relevant documents within the custody or control of both client and counsel.

A failure to preserve relevant documents could result in the SEC seeking far more severe sanctions than otherwise, and might result in a criminal referral for obstruction of justice.

Electronic documents are particularly problematic because they are easily altered or deleted. Moreover, often it is not obvious where relevant electronic documents may reside (e.g., computer servers including file servers, email servers and voicemail servers; computer desktops and laptops; personal digital assistants; and back up media). It is important to communicate clearly with IT personnel to ensure that back up media are not overwritten.

E. The SEC Does Not Have "Subjects" or "Targets"

Unlike criminal prosecutors, the SEC's Enforcement Division does not have "subjects" or "targets."

If asked, the Staff will simply say that it is conducting a fact-finding investigation, and that the witness should not infer that the Staff believes that a violation of the securities laws has occurred.

F. The SEC's Routine Uses of Information and FOIA Confidentiality

The SEC advises all parties producing documents and testimony, whether on a voluntary or compulsory basis, of the SEC's routine uses of information.

In essence, the SEC may use the documents and testimony in its investigation and any resulting enforcement proceeding, and also may share the information widely, including with federal, state, local and foreign governmental authorities and self-regulatory organizations. See SEC Form 1662 (attachment F).

Pursuant to Rule 83 of the Commission's Rules on Information and Requests, 17 C.F.R. § 200.83, a person or entity submitting information to the SEC can make a written request that the information not be disclosed to third parties under the Freedom of Information Act.

G. Producing Documents to the SEC

In SEC investigations, the Staff routinely asks witnesses to produce a broad range of documents. It is often possible to negotiate the scope of the Staff's document requests and the time allowed for such production. Particularly in larger productions, the Staff prefers to get production started early, even if it means that production must be completed on a rolling basis.

Whatever scope and production schedule are agreed upon, it is vital that the Staff regard the producing party as making a timely and complete production of all non-privileged responsive documents (in some investigations, a party will choose to waive privileges in the interest of "cooperating" with the Staff's investigation). If the Staff regards the producing party as dilatory or reluctant to make a complete production, the Staff will view that party as "uncooperative," which can result in more severe sanctions.

In larger document productions, the SEC Staff now routinely requires that documents be produced in electronic form, which necessitates the use of an electronic discovery vendor and increases the cost and time required for such productions.

Additionally, the SEC Staff frequently requires producing parties to certify the adequacy of their search for documents, and the completeness of their production.

It is sound practice to document the steps that counsel and client have taken to preserve and produce responsive documents to the SEC's Staff.

H. Sworn Testimony Before the Division of Enforcement

The Division of Enforcement frequently requires witnesses to give sworn investigative testimony.

Thorough preparation for SEC testimony is absolutely critical. Sworn testimony is invariably the witness's primary – and often only – opportunity to explain his side of the story to SEC Enforcement Staff. The testimony will both form the basis for the Staff's charging decision and lock the witness in to a position in the event that charges eventually are brought.

Experienced SEC enforcement defense counsel can anticipate the Staff's lines of inquiry and can help the witness put herself in the best possible light, offering testimony that is both

inherently credible and consistent with the documents and other credible testimony the Staff is likely to hear.

Typically, several SEC Enforcement Staff attend and participate in the witness' examination; the staff attorney usually takes the lead in conducting the examination, with the Branch Chief and other Enforcement Staff asking follow-up questions to ensure that a thorough record has been made.

Investigative testimony is sworn and a verbatim record is made (only the SEC may make a verbatim record). 17 C.F.R. § 203.6.

Witnesses have the right to:

- Obtain a copy of their transcript on payment of the appropriate fee, unless the Commission denies the request for good cause; in any event, witnesses have the right to inspect the official transcript of their own testimony. 17 C.F.R. § 203.6.

- Be shown the formal order of investigation. 17 C.F.R. § 203.7(a).

- Be accompanied, represented and advised by counsel; counsel may (1) advise the witness "before, during and after the conclusion of such examination," (2) briefly ask clarifying questions of the witness at the conclusion of the examination, and (3) make summary notes during the examination. 17 C.F.R. §§ 203.7(b) & (c).

I. The Wells Process

If the Staff decides at the conclusion of the investigation, not to make an enforcement recommendation to the Commission, typically the Staff does not give notice of its decision to the subjects of the investigation and it is difficult for the subjects to obtain comfort that they no longer face the possibility of an enforcement action.

However, if the Staff tentatively decides to make an enforcement recommendation to the Commission, in non-emergency cases it issues (typically by telephone and follow-up letter) a so-called "Wells Notice" to the proposed defendant. The Wells Notice outlines the legal charges that the Staff is prepared to recommend to the Commission and, sometimes, the factual basis for those charges. The proposed defendant is given an opportunity, typically about three weeks, to submit a memorandum (or video tape) explaining her position. 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. See Herr, "SEC Enforcement: A Better Wells Process," 32 Sec. Reg. L.J. No. 1 at 56 (Spring 2004) (attachment G).

While Wells Submissions can be effective defense tools, they must be approached with care: the SEC warns that "[t]he staff of the Commission routinely seeks to introduce [Wells] submissions * * * as evidence in Commission enforcement proceedings * * * ." SEC Form 1662 (attachment F).

J. Settlements with the SEC

At appropriate points in the enforcement process (e.g., during the fact-gathering stage, in connection with or following a Wells Submission, and even after an enforcement action has been commenced), a party can discuss settlement with the SEC Staff.

The Staff does not have authority to accept a settlement. The Staff must obtain authority to settle from the Commission; settlement offers that do not have Staff support are rarely accepted by the Commission.

While a settlement reached prior to the commencement of an enforcement action often results in a reduction of the charges or relief that the Staff would otherwise seek, the range of compromise available post-commencement is usually more circumscribed.

The SEC routinely issues press releases when it brings and settles enforcement actions. Thus, when a matter is settled prior to commencement there is a single press event; however, when a matter is settled post-commencement, there are two press events: first, when the matter is commenced and again when it is settled.

In any settlement with the SEC, the settling party neither admits nor denies the SEC's allegations. When a party settles a federal injunctive action, neither the court nor the SEC make any factual finding: the SEC files a complaint making its allegations, and the court enters a final judgment that enjoins the defendant and may order other relief. However, when a party settles an SEC administrative action, the party (albeit without admitting or denying the SEC's charges) allows the SEC to make certain factual findings and conclusions of law.

Although all settlements are without admitting or denying the SEC's allegations, the SEC has a "no denial" policy that prohibits a settling party from denying the SEC's charges, but permits the party to defend itself in litigation with parties other than the SEC. 17 C.F.R. § 202.5(e).

K. The Role of Cooperation in SEC Enforcement Proceedings

In its October 23, 2001 "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions" (the "Seaboard Report"), the SEC articulated the role of self-policing, self-reporting, remediation and cooperation with the investigation in its enforcement decisions relating to corporate actors.

Following this report, there was considerable question as to whether "cooperation" with an SEC investigation could benefit an individual "gatekeeper" whom the SEC believes should be held accountable for violations that she commits or allows to occur.

It is noteworthy that in the Google and Drummond settlement, the Commission noted that "[i]n determining to accept Google and Drummond's offer of settlement, the Commission took

into account their cooperation during the Commission staff's investigation." In re David C. Drummond, AP No. 3-11795 (1/13/05) (attachment A).

Nevertheless, because an individual cannot distance herself from her own conduct as a corporation can distance itself from the conduct of former employees, the benefits of cooperation will not be as fully available to individuals as they are to corporations.

IV. Conclusion

In light of the SEC's increased focus on attorneys as "gatekeepers," bond lawyers will more frequently find themselves involved in SEC investigations. Given the SEC's ability to base charges against lawyers on mere negligence in the performance of their professional duties and given the adverse career impact of an SEC enforcement charge, bond lawyers should take seriously any SEC enforcement interest in their transactions.

Mitchell E. Herr concentrates his practice on the defense of SEC enforcement matters.

Mr. Herr joined Holland & Knight in December 2000, after serving for over 5 years as the chief trial counsel for the SEC's Southeast Regional Office where he was responsible for its litigation in 8 states and 2 territories. Mr. Herr successfully handled many significant and complex cases at the SEC, including several of first impression including the successful trial of *In re the City of Miami, Init. Dec. Rel. No. 185 (6/22/01), 2001 SEC LEXIS 1250,* the SEC's first trial against a municipal issuer; Mr. Herr obtained cease-and-desist order and a finding that the City engaged in "systemic" fraud in its sale of $116.5 million of bonds.

Since joining Holland & Knight, Mr. Herr has handled numerous SEC investigations and enforcement actions involving municipal issuers and their counsel, broker-dealers, registered investment advisers and associated persons, public companies, accountants, and other individuals concerning a variety of subjects, including tax-exempt status, revenue recognition, disclosure of insurance broker compensation arrangements, loss reserves, aged and obsolescent inventory, insider trading, secondary liability for contra-party accounting treatment, mutual fund market timing, prime bank investments, and unregistered offerings.

On the SEC's nomination, Mr. Herr was recently appointed by a federal court to serve as Equity Receiver in *SEC v. KS Advisors, Inc. et. al.,* Civil Action No. 2:04-CV-105-FtM-29 (M.D. FLA.), an action concerning two failed hedge funds and an investment advisor that had raised $10 million from over 100 investors located nationwide and overseas.

Mr. Herr was elected by his peers to *"The Best Lawyers in America"* (2006 ed.). Additionally, in both 2006 and 2005 he was recognized as a "Top Lawyer" in the field of Securities Litigation in the South Florida Legal Guide and also was named by *Florida Trend* magazine in 2005 as a member of Florida's Legal Elite. Mr. Herr is a member of The Florida and District of Columbia bars.

Mr. Herr earned his B.A. *summa cum laude* from Dickinson College, Carlisle, Pa., in 1978, where he was elected to *Phi Beta Kappa* in his jr. year and was awarded a 3-year Army ROTC scholarship. In 1981, Mr. Herr received his J.D. *cum laude* from the Univ. of Chicago Law School, where he was Assoc. Editor of the Law Review and elected to Order of the Coif.

Publications

"Does the SEC Demand More in Settlement Than It Can Get at Trial?" originally published in *Securities Regulation & Law Report* (BNA), Vol. 33, No. 16 (April 23, 2001) and republished in *U.S. Law Week* (BNA), Vol. 69, No. 42 (May 8, 2001) and *Corporate Counsel Weekly* (BNA), Vol. 16, No. 19 (May 9, 2001).

"SEC Resolves Long-Standing Questions About Its Cease-and Desist Remedy," originally published in *Securities Regulation & Law Report (BNA), Vol. 33, No. 29 (July 23, 2001).*

"SEC Enforcement: A Better Wells Process," originally published in *Washington Legal Foundation, Critical Legal Issues, Working Paper Series No. 119 (October 2003)* and republished in the Spring 2004 edition of *Securities Regulation Law Journal.* "