SEC INVESTIGATIONS OF PUBLIC COMPANIES
What is the Securities and Exchange Commission?

The United States Securities and Exchange Commission ("SEC") is the law enforcement agency specifically charged by Congress with civil enforcement of the federal securities laws.¹

What does the SEC Investigate?

The SEC has authority to investigate all violations of the securities laws by any person or entity it believes may have committed a violation, including individuals, public companies, securities exchanges, broker dealers, investment advisers and mutual funds.²

The SEC will initiate an enforcement investigation of a public company when it has reason to suspect that the company has violated the federal securities laws.³ For instance, the SEC investigates potential securities fraud – that is, the making of false or misleading statements to the public through a company's financial statements, its periodic public disclosures (e.g., SEC Forms 10-Q and 10-K), or its press releases. Today, any public company that restates its financial statements can expect an enforcement inquiry.⁴ In recent years, some 25-30% of the SEC's enforcement investigations have concerned financial disclosures by public companies.⁵

The SEC also may investigate a public company suspected of violating various other federal securities statutes or SEC regulations (such as the registration requirements for the public issuance of new securities, the required disclosure of payments that violate the Foreign Corrupt

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² Violations of the federal securities laws may also constitute criminal offenses. See Securities Act, Section 24, 15 U.S.C. § 77x; Exchange Act, Section 32(a), 15 U.S.C. § 78ff. However, the SEC does not have statutory authority to bring criminal prosecutions; all criminal prosecutions for federal securities offenses are handled by the United States Department of Justice ("DOJ"). See Securities Act, Section 20(b), 15 U.S.C. § 77t(b); Exchange Act, Section 21(d), 15 U.S.C. § 78u(d).

³ The SEC's civil enforcement jurisdiction extends beyond public companies to any person or entity who violates the federal securities laws. For example, the SEC has authority to enforce the securities antifraud rules against all issuers of securities, including private companies, partnerships and individuals. The term "security" encompasses far more than stock; it also includes mutual funds, variable annuities, promissory notes and investment contracts. Similarly, the SEC may enforce the nation's securities laws against individuals, such as persons who engage in insider trading.

⁴ See, e.g., Exchange Act, Section 21(a), 15 U.S.C. § 78u(a) ("The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this chapter.").

⁵ If, following a financial restatement, the company experiences a drop in its stock price, it can also expect to become the target of a securities class action and, possibly, a shareholder derivative suit. Accordingly, companies planning to restate their financial statements often retain experienced securities class action and SEC enforcement defense counsel to manage the restatement process to minimize such exposures.

⁶ See SEC Annual Performance and Accountability Reports (available at http://www.sec.gov/about.shtml (under "Annual Reports and Statistics")).

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Practices Act, and the prohibition against the selective disclosure of material information to the marketplace).

An SEC investigation of a public company typically involves scrutiny of all persons involved in the conduct in question. For example, in an investigation related to a company's financial statements, the SEC will examine the officers involved in the underlying conduct, the officers responsible for the financial statements (such as the Controller and the CFO), and the CFO and CEO who certified those financial statements under Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 ("SOX").

Consistent with its view that attorneys are "gatekeepers" to our nation's financial markets, the SEC increasingly scrutinizes the role of corporate counsel. In a seminal speech in September 2004, the SEC's former Enforcement Director noted that:

> Consistent with SOX’s focus on the important role of lawyers as gatekeepers, we have stepped up our scrutiny of the role of lawyers in the corporate frauds we investigate.

**Who at the SEC is Responsible for Conducting Investigations?**

SEC investigations are conducted by its Division of Enforcement. The Enforcement Division has over 1,200 professional personnel (attorneys, accountants and other professional staff) in its Washington, D.C. headquarters and eleven regional offices across the country. Typically, the Enforcement Division office that begins an investigation sees it through to its conclusion, including the settlement or trial of any resulting enforcement action.

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8. Over 400 work in the SEC's Washington, D.C. headquarters and more than 800 work in the various regional offices around the country.
How Does The SEC's Division Of Enforcement Obtain Investigatory Leads?

The Division of Enforcement obtains investigatory leads from a wide variety of sources including electronic and traditional news media, investor complaints, tips and bounty requests,\(^9\) internal referrals from other SEC offices,\(^10\) and referrals from self-regulatory organizations and other state and federal law enforcement and regulatory authorities.

The SEC's 2007 budget request notes that it expects to receive and handle a combined total of 670,000 investor complaints, tips and forwarded email spams, and to open about 1,430 new matters under inquiry ("MUIs"). The majority of these MUIs will become enforcement investigations. The SEC's 2007 budget request states that it expects to open roughly 960 enforcement investigations. It is difficult to quantify what percentage of SEC investigations result in enforcement actions.\(^11\)

The Enforcement Division's scrutiny of public companies has increased due to the SEC's more frequent periodic review of their filings. Section 408 of SOX requires the SEC to review a public company's disclosures at least once every three years, which is considerably more frequent than in the past. In fiscal year 2006, the SEC reviewed the public filings of 4,485 (33%) public companies. These periodic reviews, performed by the Division of Corporation Finance, have led to an increased number of referrals to the Enforcement Division.

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9 The Enforcement Division operates a bounty program for insider trading (see http://www.sec.gov/divisions/enforce/insider.htm).

10 Internal SEC referrals most often come from the Division of Corporation Finance (which reviews corporate disclosures), the Division of Market Regulation (which regulates major market participants such as broker-dealers, self-regulatory organizations and transfer agents), the Division of Investment Management (which regulates investment companies such as mutual funds, closed-end funds, UITs, ETFs, and interval funds, as well as variable insurance products and federally registered investment advisers), and the Office of Compliance Inspections and Examinations ("OCIE") which conducts examinations of registered entities, including self-regulatory organizations, broker-dealers, transfer agents, investment companies and investment advisers).


11 The SEC does not publish this statistic and it cannot be derived from comparing the number of investigations with the number of enforcement actions in a given year for two reasons: First, investigations precede enforcement actions by a year or more; and, second, a single investigation can lead to multiple enforcement actions (e.g., a corporate investigation can lead to separate enforcement actions against the company, its employees, its auditors and its outside counsel). Nevertheless, one can get some feel for the matter by looking at recent data. In fiscal year 2006, the SEC initiated 914 enforcement investigations and 574 enforcement actions (consisting of 218 civil proceedings in federal court and 356 administrative proceedings). In fiscal year 2005, the SEC initiated 947 enforcement investigations and 629 enforcement actions (consisting of 335 civil proceedings in federal court and 294 administrative proceedings).
What Are A Company's Obligations To Preserve Relevant Documents?

After learning of a potential SEC investigation, a company's foremost obligation is to preserve, without alteration, all potentially-relevant documents, in both hard copy and electronic formats. The company must preserve all documents within its custody or control including, for instance, documents in the custody of its outside professionals, such as legal counsel.

A company must ensure that all documents potentially relevant to the SEC's investigation are preserved. In addition to preserving hard copies, the company and its employees must ensure that no copies of relevant electronic files, including emails, word processing and spreadsheet files, and back-ups are destroyed or overwritten, even inadvertently. Electronic documents are particularly problematic because they are easily altered or deleted, often through routine electronic data policies. For example, a company might routinely delete emails of a certain age or recycle backup media, either of which destroys potentially relevant data. Moreover, often it is not obvious where relevant electronic documents may reside (e.g., data may reside on file, email and voicemail servers; computer desktops and laptops; personal digital assistants; temporary storage devices such as portable hard drives and USB flash drives; and backup media).

Careful document preservation is critical for several reasons. First, SOX provides for serious criminal penalties for document destruction intended to interfere with a governmental investigation. Section 802 of SOX provides for criminal penalties of up to 20 years imprisonment and fines up to $10 million for anyone who:

knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation … of any matter within the jurisdiction of any department or agency of the United States ….

Importantly, Section 802 does not require that there be a pending investigation at the time of the conduct – a person can violate this section if he or she is aware of a potential governmental investigation. This prohibition applies to all persons – i.e., companies, their employees, their directors, their legal counsel, their accountants and other representatives.

Entirely apart from these criminal sanctions, the SEC penalizes companies that do not preserve and timely produce relevant documents. For instance, in a September 11, 2003 settlement with American Insurance Group, Inc., the SEC imposed a $10 million penalty, noting:

AIG failed to produce a large quantity of documents that were called for by the staff's various requests and subpoenas. In part, this failure resulted from a

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18 U.S.C. § 1519. Similarly, Section 1102 of SOX makes it punishable by up to 20 years imprisonment to "corruptly" alter, destroy, mutilate or conceal a record to impair its integrity or availability for use in an official proceeding. 18 U.S.C. § 1512.
woefully deficient document collection effort within AIG, in which AIG failed to search various locations in which responsive documents were likely to be found.\textsuperscript{13}

Similarly, in a March 10, 2004 settlement with Banc of America Securities LLC ("BAS"), the SEC imposed a $10 million penalty solely for failing to promptly furnish documents requested during an enforcement investigation – the SEC did not allege that BAS had committed any substantive violations of the securities laws.\textsuperscript{14} Further underscoring the seriousness with which the SEC approaches this subject, in a May 17, 2004 settlement with Lucent Technologies, Inc., the SEC imposed a $25 million penalty for various acts of "non-cooperation," including incomplete document preservation and production in an enforcement proceeding.\textsuperscript{15}

To discharge a company's preservation obligations, a senior company official (preferably the General Counsel) should instruct its information technology department to ensure that no potentially relevant electronic files, including backup media, are overwritten. These preservation efforts might well require alteration of the company's routine electronic data policies. Similarly, company employees should be instructed to preserve all relevant electronic files, regardless of whether they reside on their desktop or laptop computers, home computers, personal digital assistants, or temporary storage devices (such as portable hard drives, USB or flash drives).

These document preservation efforts should be broad and inclusive. Just because potentially relevant documents are being preserved does not mean they necessarily will be produced to the SEC. The company's SEC-enforcement-defense counsel will negotiate the scope of production with SEC Staff and will review the company's and its employees' documents for responsiveness and privilege before producing documents to the SEC.

What are a Company's Obligations to its SEC Defense Counsel?

The company must be entirely candid with its SEC defense counsel. Counsel cannot adequately defend the company's interests (or the interests of its directors, officers, or employees) without the benefit of the complete, unvarnished truth.

It is critical that counsel know all of the relevant facts from the very beginning. The company’s SEC defense counsel may need to make certain factual representations to the SEC early in the investigation. If these representations turn out to be less than 100% accurate, the company will lose credibility and possibly be branded as uncooperative or obstructive. Thus, the company should disclose the full and complete truth – including facts that may be inconvenient or embarrassing – to its SEC defense counsel.


What Role Does Cooperation Play in SEC Enforcement Investigations?

The SEC has stressed repeatedly the need for cooperation with its investigations. 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 its investigations in its enforcement decisions relating to corporate actors.

In the matter that gave rise to the Seaboard Report, the SEC refrained from taking any enforcement action against the company in light of its complete cooperation with the SEC investigation. As the SEC explained:

We are not taking action against the parent company, given the nature of the conduct and the company's responses. Within a week of learning about the apparent misconduct, the company's internal auditors had conducted a preliminary review and had advised company management who, in turn, advised the Board's audit committee, that Meredith had caused the company's books and records to be inaccurate and its financial reports to be misstated. The full Board was advised and authorized the company to hire an outside law firm to conduct a thorough inquiry. Four days later, Meredith was dismissed, as were two other employees who, in the company's view, had inadequately supervised Meredith; a day later, the company disclosed publicly and to us that its financial statements would be restated. The price of the company's shares did not decline after the announcement or after the restatement was published. The company pledged and gave complete cooperation to our staff. It provided the staff with all information relevant to the underlying violations. Among other things, the company produced the details of its internal investigation, including notes and transcripts of interviews of Meredith and others; and it did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation.

The company also strengthened its financial reporting processes to address Meredith's conduct -- developing a detailed closing process for the subsidiary's accounting personnel, consolidating subsidiary accounting functions under a parent company CPA, hiring three new CPAs for the accounting department responsible for preparing the subsidiary's financial statements, redesigning the subsidiary's minimum annual audit requirements, and requiring the parent company's controller to interview and approve all senior accounting personnel in its subsidiaries' reporting processes.17

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17 Id.
The Seaboard Report describes a level of self-policing, self-reporting, remediation and cooperation that only a few companies have been able to meet. The SEC has made clear that only the most complete cooperation will warrant a pass from any enforcement action.

For instance, in a 2002 investigation involving Homestore, Inc. and some of its senior executives, the SEC declined to pursue charges against the company, explaining that it

would not bring any enforcement action against Homestore because of its swift, extensive and extraordinary cooperation in the Commission's investigation. This cooperation included reporting its discovery of possible misconduct to the Commission immediately upon the audit committee's learning of it, conducting a thorough and independent internal investigation, sharing the results of that investigation with the government (including not asserting any applicable privileges and protections with respect to written materials furnished to the Commission staff), terminating responsible wrongdoers, and implementing remedial actions designed to prevent the recurrence of fraudulent conduct. These actions, among others, significantly facilitated the Commission's expeditious investigation of this matter.18

Similarly, on January 3, 2006, the SEC announced it was filing charges against six former officers of Putnam Fiduciary Trust Company ("PFTC"), but said that it would not pursue PFTC "because of its swift, extensive and extraordinary cooperation in the Commission's investigation of the transactions that are the subject of the Commission's complaint."

PFTC's cooperation consisted of prompt self-reporting, an independent internal investigation, sharing the results of that investigation with the government (including not asserting any applicable privileges and protections with respect to written materials furnished to the Commission staff), terminating and otherwise disciplining responsible wrongdoers, providing full restitution to its defrauded clients, paying for the attorneys' and consultants' fees of its defrauded clients, and implementing new controls designed to prevent the recurrence of fraudulent conduct.19

And on April 24, 2007, the SEC filed charges against two former officers of Apple, Inc. for backdating stock options, but specifically said that:

18 SEC Press Release No. 2002-141 (Sept. 25, 2002) (available at http://www.sec.gov/news/press/2002-141.htm). The Homestore investigation also illustrates the degree to which the SEC cooperates with other law enforcement authorities (discussed in detail, below). The Homestore press release noted that the case was "the product of an investigation by the SEC, the Federal Bureau of Investigation, and the U.S. Attorney's Office for the Central District of California." Id. By the conclusion of this joint investigation, the SEC sued a total of 16 individuals for their roles in the scheme, 11 of whom were criminally charged by the United States Attorney. See http://www.sec.gov/news/digest/dig050505.txt.

it would not bring any enforcement action against Apple based in part on its swift, extensive, and extraordinary cooperation in the Commission's investigation. Apple's cooperation consisted of, among other things, prompt self-reporting, an independent internal investigation, the sharing of the results of that investigation with the government, and the implementation of new controls designed to prevent the recurrence of fraudulent conduct.  

In many other instances, cooperation with an SEC investigation undoubtedly has mitigated what otherwise would have been a harsher outcome for the corporation. Of course, when the SEC believes that a corporate actor has been affirmatively uncooperative, it will mete out even harsher penalties than might otherwise be warranted by the underlying conduct.

The SEC continues to place heavy emphasis on cooperation. In an April 29, 2004 speech, the SEC’s Director of Enforcement explained how cooperation can lead to more favorable outcomes for companies:

The … core factor, which will often prove decisive in our analysis [regarding what, if any, penalty to seek], is the extent of a violator's cooperation, as measured by the standards set forth in the Commission's 21(a) Report. … [T]he provision of extraordinary cooperation … including self reporting a violation, being forthcoming during the investigation, and implementing appropriate remedial measures (including, in the case of an entity, appropriate disciplinary action against culpable individuals), can contribute significantly to a conclusion by the staff that a penalty recommendation should be more moderate in size or reduced to zero.

Finally, in a January 4, 2006 Statement Concerning Financial Penalties, the SEC reiterated that "[t]he degree to which a corporation has … cooperated with the investigation and remediation of the offense, is a factor that the Commission will consider in determining the propriety of a corporate penalty."

In order to give proper consideration to a company's cooperation or lack thereof, senior Enforcement Division Staff have publicly stated that the Division keeps a running "scorecard" of cooperation during an investigation.

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While cooperation undoubtedly plays a role in the Enforcement Division's exercise of prosecutorial discretion with respect to corporate actors, there is a considerable question as to whether cooperation with an SEC investigation benefits an individual. In the few cases that have acknowledged the individual's cooperation, legitimate questions can be raised as to whether that cooperation produced any discernable benefit for the individual.  

**Does the SEC Coordinate Investigations with Other Law Enforcement Authorities?**

In the post-Enron era, it has become commonplace for the SEC to coordinate its investigations with other law enforcement authorities, both civil and criminal. In recent years, there has been approximately a four-fold increase in the number of SEC investigations that are coordinated with criminal authorities. Indeed, most of the recent major securities fraud cases have been prosecuted both civilly and criminally including, to name a just a few: Worldcom, Enron, Qwest, HealthSouth, Adelphia Cable, Rite Aid, Imclone/Martha Stewart, AIG/GenRe, Tyco, Comverse, and Brocade. However, active coordination with enforcement authorities is not limited to major corporate fraud cases. For instance, in the spring of 2007, the SEC announced that it, the United States Attorney's Office, and the FBI had investigated and filed civil and criminal charges related to an alleged insider trading ring.

The SEC also coordinates its investigations with various civil authorities. For instance, in 2006, the SEC jointly announced with the Office of Federal Housing Enterprise Oversight ("OFHEO") that Fannie Mae had agreed to pay a $400 million penalty to settle fraud charges. The SEC acknowledged the assistance of OFHEO in the investigation. Similarly, in the spring of 2007, the SEC announced a trading suspension of 35 companies allegedly engaged in email spam campaigns. In that case, the SEC thanked the National Association of Securities Dealers, the

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**Notes:**


25 In the most recent pre-Enron years for which data is available, the SEC reported that criminal authorities brought 74 (fiscal year 1998) and 64 (fiscal year 1999) indictments or informations in "SEC-related" cases. The numbers of criminal prosecutions dramatically increased after Enron. In fiscal year 2002, criminal charges were filed against 259 individuals or entities; in fiscal year 2003, criminal charges were filed against 246 individuals or entities; in fiscal year 2004, criminal charges were filed against 302 individuals or entities. See 2006 SEC Performance and Accountability Report (available at http://www.sec.gov/about/secpar/secpar2006.pdf#secl).

While the SEC has not provided similar statistics for subsequent years, the SEC's 2006 annual report noted that during the past year it had enjoyed "an unprecedented high level of collaboration with our counterpart state and federal regulators and criminal authorities." See id. at 2.


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Royal Canadian Mounted Police, the British Columbia Securities Commission, and the Ontario Securities Commission for their assistance with the investigation.28 In short, the SEC can and will share investigative information and coordinate its efforts with any number of foreign, federal, state, and local criminal, civil, or regulatory agencies.29

Do Parallel Civil and Criminal Investigations Present Additional Risks?

The prospect of coordination between the SEC and other prosecutorial or regulatory authorities substantially increases the complexity of and risks attendant to an SEC investigation. The risks are often difficult to assess because, as a policy matter, the SEC will not confirm or deny whether parallel investigations are being conducted, but will direct counsel to inquire with whatever other prosecutorial authority she may be concerned about.30 Additionally, in many cases the SEC will conclude its investigation and resulting enforcement action before the first sign of any criminal interest in the matter becomes visible.

As a practical matter, if the circumstances might be attractive to a criminal prosecutor (e.g., intentionally fraudulent conduct and significant investor losses), a company's safest course is to assume that there is or will be a parallel criminal investigation. In these circumstances, SEC defense counsel will often bring white collar criminal defense counsel into the matter to help navigate the many difficult issues raised by parallel civil and criminal investigations.

For example, a witness who is asked to testify in a civil proceeding may assert her Fifth Amendment rights to protect herself from criminal exposure, but doing so risks that civil authorities will draw an "adverse inference" of wrongdoing from her refusal to testify.31 The

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29 Indeed, the standard form that the SEC provides to every individual and entity from whom it seeks either documents or testimony (Form 1662: "Supplemental Information for Persons Requested to Supply Information Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena") warns that "[t]here is a likelihood that information supplied by you will be made available to such agencies [federal and state prosecutors] where appropriate." The form goes on to list 23 categories of routine uses that the SEC might make of the supplied information. See also 17 C.F.R. § 240.24c-1 (2006) ("[t]he Commission may, in its discretion and upon a showing that such information is needed, provide nonpublic information in its possession to any of the following persons if the person receiving such nonpublic information provides such assurances of confidentiality as the Commission deems appropriate … federal, state, local or foreign government[s] or any political subdivision, authority, agency or instrumentality of such government …."). The securities statutes expressly authorize the SEC to share investigative information with the DOJ. See 15 U.S.C. §§ 77t(b) and 78u(d)(1).

30 In a recent amicus curiae brief to the United States Court of Appeals for the Ninth Circuit, the SEC advised that "[w]hen defendant Stringer's attorney asked whether the SEC was working in conjunction with the U.S. Attorney's Office of any jurisdiction, he was correctly advised that the SEC's policy was not to comment on such issues, but to direct the witness to inquire of the U.S. Attorney's Office if he chose to." Brief for SEC as Amicus Curiae Supporting Appellants at 12, United States v. Stringer, No. 06-30100 (9th Cir. Sept. 13, 2006).

31 Conversely, testifying holds risks for the witness. The witness may not be able to satisfactorily explain her conduct, thereby further exposing her to both civil and criminal charges for the underlying substantive offense. And, if the witness testifies inaccurately (even if due merely to faulty memory or inadequate preparation, rather than an intent to mislead), she may be exposed to criminal perjury or obstruction of justice charges.

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decision as to whether a witness should testify in the SEC's civil investigation often comes down to a choice between the lesser of two evils.

**Will both the Criminal and Civil Proceedings Proceed Simultaneously?**

Often, the government will announce joint civil and criminal prosecutions, only to then move to stay the civil case to prevent the defendant from using civil discovery to gain a purportedly unfair advantage in the criminal matter in which it would not otherwise have had broad discovery rights. Some federal courts have criticized this practice, holding that the usual rationales in favor of staying a civil case in favor of a pending criminal proceeding do not apply where the government has initiated both the civil and criminal proceedings.32 For instance, in *SEC v. Saad*, in denying the government's motion to stay the SEC's civil case, the Court observed that it was:

strange[] … that the U.S. Attorney's Office, having closely coordinated with the SEC in bringing simultaneous civil and criminal actions against some hapless defendant, should then wish to be relieved of the consequences that will flow if the two actions proceed simultaneously.33

**Are There Limits to Cooperation Between Criminal and Civil Authorities?**

It is well-accepted that the government may conduct parallel investigations of conduct that violates both civil and criminal laws.34 However, the courts have long held that the "[g]overnment may not bring a parallel civil proceeding and avail itself of civil discovery devices to obtain evidence for subsequent criminal production." *United States v. Parrott*, 248 F.

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34 *See, e.g., United States v. Kordel*, 397 U.S. 1 (1970) (no departure from proper administration of justice where defendant had to choose between either asserting Fifth Amendment rights or answering interrogatories, the responses to which were later used to convict him); *SEC v. First Fin. Group of Texas, Inc.*, 659 F.2d 660, 666-67 (5th Cir. 1981) ("There is no general federal constitutional, statutory, or common law rule barring the simultaneous prosecution of separate civil and criminal actions by different federal agencies against the same defendant involving the same transactions…. The simultaneous prosecution of civil and criminal actions is generally unobjectionable because the federal government is entitled to vindicate the different interests promoted by different regulatory provisions even though it attempts to vindicate several interests simultaneously in different forums."); *SEC v. Dresser Indus., Inc.*, 628 F.2d 1368 (D.C. Cir. 1980) (courts should not intervene in parallel investigations unless the nature of the proceedings prejudices substantial rights).
Supp. 196, 202 (D.D.C. 1965). Several recent cases have sharply criticized how the government has conducted certain related investigations. These cases hold that it is inappropriate for criminal authorities to direct aspects of an SEC investigation in order to advance their own investigations.

In *United States v. Scrushy*, criminal authorities had significant involvement in developing the strategy for both the defendant's deposition and the SEC's investigation. Specifically, the criminal prosecutors: directed the SEC to change the location of defendant's deposition to give any eventual criminal perjury prosecution a favorable venue, dictated the questions the SEC could ask, and shaped the questioning to conceal their interest in defendant. The defendant was never informed that he was the target of a criminal investigation. The Court granted the defendant's motion to suppress his SEC testimony in the criminal case, holding that the civil and criminal investigations had "improperly merged" and that "the Government [had] departed from the proper administration of criminal justice in procuring the Defendant's deposition testimony."

A more dramatic remedy was imposed in *United States v. Stringer*. There, the district court dismissed a securities fraud and conspiracy indictment against two individuals on findings that the SEC and DOJ had violated the defendants' due process rights. In *Stringer*, the criminal authorities essentially used the SEC to develop a criminal case, going so far as to explain to the SEC how to develop the best record for the perjury cases they were hoping to bring and requesting that the SEC conduct interviews in Oregon to establish criminal venue in that state. The Court ruled that this degree of collaboration was impermissible and violated the defendants' due process rights: "[a] government agency may not develop a criminal investigation under the auspices of a civil investigation." The Court also found that the government engaged in "deceit and trickery to keep the criminal investigation concealed." On these findings, the Court

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36 *Id.* at 1137.

37 408 F. Supp. 2d 1083 (D. Or. 2006). As of this writing, this decision is on appeal to the United States Court of Appeals for the Ninth Circuit.

38 *Id.* at 1089. Indeed, the Court noted that:

[T]hese were not parallel investigations. The USAO identified potential criminal liability and a few targets in the beginning of the investigation, and elected to gather information through the SEC instead of conducting its own investigation. The government was concerned that the presence of a criminal investigation would halt the successful discovery by the SEC, witnesses would be less cooperative and more likely to invoke their constitutional rights, and that the rules of criminal discovery would be invoked.

*Id.* at 1087-88.

39 Among other things, the government:

... went so far as to instruct court reporters to refrain from mentioning the U.S. Attorney's involvement and to have [the prosecutor] avoid being near certain

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dismissed the criminal indictment because the governmental conduct was "so grossly shocking and so outrageous as to violate the universal sense of justice."  

In light of Scrushy and Stringer, if there is reason to suspect that there may be criminal interest in a matter, counsel should consider making an on-the-record inquiry during SEC investigative testimony as to:

- Whether the SEC has been in contact with any criminal authorities regarding the matter under investigation;
- Whether there is an active criminal investigation of the matter; and
- Whether the witness is a target or subject of a criminal investigation.

While the SEC Staff likely will not provide meaningful responses to such inquiries, even an evasive response could serve the witness well in any subsequent criminal prosecution.

Similarly, in a civil enforcement proceeding, defense counsel should consider using discovery to investigate possible coordination with criminal authorities.

**How Does the SEC Conduct Its Investigations?**

Typically, SEC investigations follow a predictable course:

**Document requests**  Most SEC investigations of public companies begin with a request for documents. In an investigation of any consequence, the SEC likely will make several sets of document requests.

**Interviews**  Occasionally, the SEC's initial contact with a company will be a request for an explanation of certain events, such as a financial restatement. The company's response could be in the form of either a written submission or a personal meeting. It is critical that counsel thoroughly prepare the company's response to ensure that its representations will withstand further investigative scrutiny. If the company's initial representations are discredited, both the company and its counsel will have credibility problems with the Staff, which will make the investigation more protracted and costly.

*Id.* at 1089.

*Id.*

SEC Staff likely will respond that the Enforcement Division does not have "subjects" or "targets" and, as in Stringer, direct counsel to the generic possibility, noted in SEC Form 1662, that the Staff will share investigative information with criminal authorities.

Occasionally, the SEC's initial contact with a company will be a request for an explanation of certain events, such as a financial restatement. The company's response could be in the form of either a written submission or a personal meeting. It is critical that counsel thoroughly prepare the company's response to ensure that its representations will withstand further investigative scrutiny. If the company's initial representations are discredited, both the company and its counsel will have credibility problems with the Staff, which will make the investigation more protracted and costly.

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Witness testimony  If, after reviewing the company's document productions, the SEC continues to have an investigatory interest in the company, it will request sworn witness testimony. The SEC likely will take such testimony from current and former employees, contractual counterparties and outside professionals, such as auditors.

Wells Notice and Wells Submission  After witness testimony has been completed, the SEC's investigative Staff will review the evidentiary record to determine whether to recommend that the Commission institute charges. If the Staff is prepared to recommend charges to the Commission, it will issue a so-called "Wells Notice" to the subjects of the anticipated charges. The Wells Notice will advise the subject of the nature of the charges and will give the subject an opportunity to respond in the form of a "Wells Submission."

Settlement negotiations  If defense counsel does not succeed in convincing SEC Staff that no enforcement action is warranted, counsel typically will engage the Staff in settlement discussions to determine whether the matter can be resolved on mutually-agreeable terms.

These phases of the investigative process (and related considerations) are discussed in more detail, below.

What Are "Preliminary" and "Formal" Investigations?

The SEC may gather facts and make a charging decision through either a "preliminary" (or "informal") investigation or through a "formal" investigation. Both are serious. Indeed, preliminary investigations that never reach the formal stage still often result in an SEC Staff recommendation that the Commission initiate enforcement charges.

At the preliminary investigation stage, the Staff does not have the authority to subpoena documents and testimony; in preliminary investigations, requests for documents and testimony are voluntary. Of course, given the SEC's emphasis on "cooperation," a corporation is likely to conclude that it is in its interests to respond to the Staff's voluntary requests.

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 of Investigation; however, furnishing a copy of the formal Order rests in the discretion of senior enforcement personnel.

It is useful to request a copy of the formal Order, as it may give some insight into the Staff's concerns. However, while the formal Order indicates the Staff's concerns at the time it was

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43 Persons or entities regulated by the SEC, such as broker-dealer firms and investment advisers, however, must respond to preliminary requests for information.

44 See Exchange Act, Section 21(b), 15 U.S.C. § 78u(b); 17 C.F.R. § 202.5(a).

45 17 C.F.R. § 203.7(a).
issued, the Staff subsequently may develop investigatory concerns that are not reflected in the formal Order.

Regardless of whether they are preliminary or formal, all SEC investigations are "non-public," meaning that neither the Commission nor the Staff should acknowledge or comment on the investigation unless and until charges are brought. However, parties under investigation may, and are sometimes obligated to, disclose the pendency of the investigation. SEC disclosure counsel may advise disclosing the investigation in the company's SEC filings and companies may have to disclose the SEC investigation in response to other regulatory matters or in response to requests for proposals.

Do D&O Policies Cover the Costs of Responding to an SEC Investigation?

A company's D&O policy potentially could cover the costs of defending an SEC investigation that extends to an Insured Person. Whether such coverage exists will depend on the precise policy language and, possibly, the type of investigation at issue. Covered "claims" under some policies may not include government investigations and most policies exclude coverage for preliminary investigations. Because coverage might exist, the company should give timely notice to its D&O carriers, including all excess layer carriers.

Coverage questions can be complex. Even if, on the face of the policy, an SEC investigation does not appear to be covered, a company may have substantial arguments in favor of coverage. Thus, the company should engage an expert in D&O coverage issues to review its policies at the outset of the SEC investigation.

SEC investigations often proceed simultaneously with related shareholder litigation. When they do, both defenses become inextricably intertwined. For instance, the document productions will overlap and inadequate preparation of witnesses for SEC testimony can create an evidentiary record that could prejudice the defense of the shareholder litigation. In these circumstances, at least some of the expenses related to the SEC investigation might be covered under policy language that defines a claim to include "costs, charges and expenses incurred … in connection with any Claim."

D&O coverage might not extend to all of the relief that the SEC could seek in an enforcement action. For instance, many D&O policies do not cover penalties or disgorgement of ill-gotten gains. Likewise, many policies exclude coverage for intentional misconduct, fraud, dishonest or

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47 A company might consider requesting that the SEC proceed by formal process to trigger its D&O coverage. Of course, the desire for D&O coverage must be balanced against the concern that formal investigations may be more likely to result in enforcement action because they have received attention both at high levels within the Enforcement Division, as well as from the Commission.

48 In general, D&O policies do not cover fines and many policies do not cover punitive damages.
criminal acts or acts that were undertaken for personal profit. But because these exclusions do not apply unless there has been a final adjudication by a finder of fact (i.e., a judge or jury), defense costs incurred before a final adjudication should be covered.

The conduct underlying an SEC investigation can also give rise to a risk that the company's D&O coverage may be rescinded. D&O new policy applications often require the company's officers to make representations concerning their knowledge of wrongful acts. If the SEC's investigation uncovers evidence that the officer who signed the application committed (and, therefore, was aware of) wrongful acts that were not disclosed on the application, the carrier may have grounds to rescind the D&O policy.

There is also a rescissionary risk if the company restates its financial statements. The carrier will argue that it relied upon the company's financial statements (whether attached to the new policy application or filed with the SEC before a policy renewal) in determining whether to underwrite the risk. If the financials are restated, the carrier could argue that the original, but now admittedly incorrect, financial information was material to its underwriting decision, meaning that there was no "meeting of the minds" and, hence, no valid contract for insurance. The company should consider obtaining expert assistance to negotiate the policy with a view to minimizing these above-described exclusions and rescissionary risks.

Under the cooperation clause of most D&O policies, carriers can demand that their insureds turn over information relating to the SEC investigation. Such information potentially could give rise to grounds for rescission. Moreover, providing such information to the carrier could waive the attorney-client privilege or work-product immunity, potentially prejudicing the company's defense of both the SEC investigation as well as any shareholder or derivative action. With these competing considerations, the company must walk a fine line between sufficiently cooperating with its carrier to maintain coverage and not handing the carrier grounds to rescind the policy or prejudicing its defenses to the underlying action through a privilege waiver.

**Should Witnesses Speak Informally with SEC Enforcement 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. These conversations often take place before the witness understands what is at issue and has had an opportunity to refresh her memory. The witness also will not have the benefit of representation by defense counsel. Unfortunately, a witness' ill-advised comments made at this preliminary stage are not "off the record." Typically, several SEC Enforcement Staff will participate in the conversation and will make detailed notes of the witness' statements, essentially locking in her testimony.

Not only might a witness put herself into a damaging position, but any inaccurate responses could later be interpreted as uncooperative conduct. Inaccurate responses, even though unsworn, might also expose the witness to criminal charges under 18 U.S.C. § 1001. Therefore, when contacted by SEC Enforcement Staff, employees or corporate spokespersons should politely but firmly make clear that they will need to consult with counsel before speaking with the Staff.

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How Should Documents be Produced to the SEC?

In SEC investigations, the Staff routinely asks companies to produce a broad range of documents. The SEC typically requests production of electronic data, such as documents from the company's file and email servers, hard drives and other storage media. It may even request that the company restore certain backup media. Electronic data productions are usually complex, expensive and time-consuming.

An outside vendor expert in electronic discovery can provide invaluable assistance. The vendor can help the company identify and preserve relevant data sources, copy electronic data in a forensically sound manner (e.g., without altering metadata), eliminate duplicates, search the remaining document collection by key words, run preliminary privilege screens, host the electronic document collection on-line, provide a web-based review tool to facilitate attorney review and, finally, properly format the documents for production to the SEC.

Given the expense and time requirements for an electronic data production, it is important for counsel to work with the SEC Staff to establish a sensible production protocol that addresses which data sources and email boxes will be produced, which backup media will be restored, the search terms that will be used to screen the data for relevance, a timetable for producing documents from various data sources, and the format in which the SEC would like the data delivered.

Unless defense counsel and the Staff agree upon a reasonable protocol, all parties are likely to be disappointed with the process. The company will spend far too much for the production, while the SEC will be disappointed by the slow pace of the production and the large number of irrelevant documents produced. Indeed, without agreement on a reasonable electronic document production protocol, the SEC may believe that the company – despite an enormous investment of resources in and attention to the process – is being less than fully cooperative.

At the beginning of the production, it is very difficult to accurately project a reasonable schedule for the document production because there are many difficult-to-estimate variables to take into consideration, including the size of the document collection, the number of duplicates that will be eliminated, and the number of documents that will be responsive to key-word searches. If a company finds that it is falling behind its production schedule due to unforeseen circumstances (e.g., inaccurate estimates of the foregoing variables or difficulties in restoring backup tapes), it is important to notify the SEC to avoid appearing dilatory or uncooperative.

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49 The SEC’s technical data delivery standards are constantly evolving. If the Staff does not include its current data standards in its request for an electronic production, the responding party should request them.

50 One of the most efficient methods for managing e-discovery costs is to confine the number of sources, or custodians, to only those key individuals that are likely to have relevant electronic information.
It is vital that SEC Staff regard the producing party as making a timely and complete production of all non-privileged, responsive documents. In larger document productions, the Staff usually prefers to get the production started early, on a rolling basis. It is often easiest to begin the production with hard copy documents.

The SEC frequently will follow up its initial document requests with additional document requests directed to individual directors, officers, and third parties that it believes may have relevant information (e.g., auditors and parties to transactions that are under review), as well as with supplemental requests to the company. Additionally, the SEC Staff frequently requires producing parties to certify the adequacy of their searches for documents and the completeness of their productions.

Given the importance of complete document preservation and production, it is sound practice to document the steps that the company and its counsel have taken to preserve and produce responsive documents to the SEC.

Finally, 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.

Can Privileged Information be Selectively Disclosed to the SEC?

The question of whether a company can "selectively disclose" privileged information to governmental authorities without waiving the privilege with respect to all others has come to the fore in recent years.

This has been due to the confluence of two factors. First, Sarbanes-Oxley has put pressure on companies to uncover potential wrongdoing, resulting in an unprecedented number of internal investigations. At the same time, government enforcement authorities (such as DOJ and the SEC) have rewarded companies that "cooperate" by sharing their internal investigative findings. Indeed, in cases where the SEC has spared a company from any enforcement action, the company's cooperation included sharing the results of its internal investigation with SEC Staff.

While a company may choose to disclose certain privileged documents to SEC Staff in the interest of cooperating with the investigation, as discussed below, the case law has become increasingly hostile to selective disclosures, holding that a disclosure to the SEC waives the attorney-client privilege with respect to all third parties.


The SEC's Enforcement Director stated at a national securities conference on May 4, 2007, however, that the SEC does not request waivers of the attorney-client privilege:

First, we do not — indeed we cannot — require waiver of the attorney/client privilege. Second, waiver of a privilege or protection is not a pre-requisite to obtaining credit in a Commission investigation. The credit given is based on, among other things, the factual information given, the timeliness of the provision of information and the usefulness of the information. Waivers may be, and often are, a means to that end but are not an end in and of themselves.


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Companies have tried to maintain that they could "selectively disclose" such privileged information to governmental authorities, but not waive their privileges with respect to the rest of the world.

The DOJ and SEC have supported selective disclosure through various means. They have entered into confidentiality agreements with the disclosing company that purport to maintain the privilege with respect to third parties, they have accepted disclosures in forms that do not leave paper trails (such as oral disclosures or opportunities to review but not retain copies of documents), and they have supported the principle of selective disclosure in *amicus* briefs filed in private litigation.

The principle of selective disclosure garnered early support from the Eighth Circuit, which in 1978 held that the production of documents to the SEC did not result in a general waiver of the privilege despite the lack of a written confidentiality agreement. Following this decision, several other Courts of Appeal indicated that they might apply the selective waiver principle where the producing party had a written confidentiality agreement with the government.

However, by 2002, the Sixth Circuit described the law governing selective disclosure as being in a state of "hopeless confusion" and rejected the doctrine, refusing to limit waivers despite the existence of a written confidentiality agreement. Since then, the trend has been decidedly against allowing companies to selectively waive the privilege to governmental agencies, regardless of whether a written confidentiality agreement is in place.

A particularly notable rejection of selective disclosure is *United States v. Reyes*. Here, the court rejected the principle even though confidentiality agreements were in place and the

Nonetheless, it remains to be seen whether any company that does not share the work product of its internal investigation will get a complete pass from any enforcement action.

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54 See *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1978) (en banc).

55 See, e.g., *In re Sealed Case*, 676 F.2d 793, 824 (D.C. Cir. 1982); *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2d Cir. 1993); *United States v. Billmyer*, 57 F.3d 31, 37 (1st Cir. 1995); *Dellwood Farms, Inc. v. Cargill*, Inc., 128 F.3d 1122, 1127 (7th Cir. 1997); *In re Keeper of the Records*, 348 F.3d 16, 28 (1st Cir. 2003).


58 239 F.R.D. 591 (N.D. Cal. 2006).
disclosing party did not produce any documents to the government, but limited their disclosures to oral briefings concerning their witness interviews and investigative findings. The Court noted that its rejection of the principle was "[i]n accord with every appellate court that has considered the issue in the last twenty-five years ...." 59

Proponents of selective disclosure had hoped that the issue would be resolved by an amendment to the Federal Rules of Evidence. However, at its April 2007 meeting, the Advisory Committee on Evidence Rules to the United States Judicial Conference rejected an amendment to Rule 502 that would have protected selective disclosures to the government. The Committee's report noted that the selective disclosure proposal was "very controversial" and "raised questions that were essentially political in nature." 60 Accordingly, the Committee prepared language to assist Congress should it decide to proceed with independent legislation on selective disclosure, but refrained from recommending such an amendment.

Given the current state of the case law, the absence of rules or legislation that resolve the issue, and the fact that most companies can be subject to litigation in almost any jurisdiction in the country, companies should assume that any disclosure of privileged information to the government – regardless whether a confidentiality agreement is in place and regardless of the form of the disclosure – runs a severe risk of waiving the attorney-client privilege and work-product immunity.

How Should a Request for Sworn Witness Testimony be Handled?

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

SEC Staff often will begin with lower-level employees who can explain the organizational structure, the availability and location of documents, and basic information concerning the transactions or other matters under investigation. The Staff will then proceed up the corporate hierarchy to those witnesses whose actions can be imputed to the company and who themselves might be the subject of an enforcement action.

Preparing a witness for testimony is perhaps the most important aspect of defending an SEC investigation. Sworn testimony is invariably a witness' best opportunity to explain her and the company's side of the story to SEC Enforcement Staff. The testimony will be a strong consideration in the Staff's formulation of a charging decision and will lock in the witnesses' testimony in the event that charges eventually are brought.

Before holding preparation sessions with the witness, defense counsel will review all relevant documents that were written or received by the witness or which might help refresh the witness' memory. Experienced SEC defense counsel can anticipate the Staff's lines of inquiry and can help the witness put herself and the company in the best possible light, offering testimony that is

59 Id. at 603.
both inherently credible and consistent with the documents and other testimony the Staff is likely to hear.

Typically, several SEC Enforcement Staff participate in examining a witness. A Staff Attorney (the line-level investigator) usually leads the examination, with the Branch Chief (the first-level supervisor) and other Enforcement Staff (such as accountants) asking follow-up questions to ensure that a thorough record has been made.

SEC investigative testimony is given under oath and on the record.61

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.62

- See the formal order of investigation.63

- 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.64

Witnesses should be aware that their sworn testimony is subject to both the penalty for perjury as well as to the penalties for false statements to the government.65 A witness may refuse, under the Fifth Amendment to the United States Constitution, to give any information that may tend to incriminate her or subject her to a fine, penalty or forfeiture. Witnesses should be aware, however, that the government will draw an "adverse inference" of wrongdoing from a refusal to testify, which can prejudice the witness' ability to defend against SEC civil charges.

Because SEC investigations are fact-finding inquiries rather than evidentiary proceedings, the Staff takes the view that it has greater latitude in conducting the examination (particularly in calling for speculation and opinion) than would be permitted under the Federal Rules of Evidence.

61 See 17 C.F.R. § 203.6.
62 Id.
63 Id. § 203.7(a).
64 Id. §§ 203.7(b) & (c).
While a company may wish to cooperate with the Staff's investigation, allowing speculation and lay opinion to creep into the record creates a risk. While such testimony may well be inadmissible in court, it can be used to support the Staff's charging recommendation to the Commission. SEC defense counsel will minimize the amount of such inadmissible testimony through proper witness preparation and representation during the testimony.

**Should the Same Counsel Represent the Company and its Employees?**

A company will often want the same counsel to represent both it and its current and former employees.

In a corporate investigation of any complexity, it is expensive for counsel to become sufficiently familiar with the issues, relevant documents and witness testimony to be able to competently represent a single employee in SEC testimony. It would be unduly costly if the company were required to obtain separate counsel for each of its present or former employee witnesses. For this reason, the company typically will offer, at its expense, to have its defense counsel (in her capacity as the company’s counsel) represent each of its employee witnesses at her SEC testimony.

Multiple representations also have the advantage of making company counsel privy to the testimony of all commonly-represented employees. Because SEC investigations are confidential, only the counsel who represented the witness in testimony can order a copy of the witness' transcript. Indeed, if company counsel did not represent an employee during testimony, the Staff will not allow company counsel to review the witness' testimony unless and until a Wells Notice (discussed below) has been issued.

Counsel may represent multiple witnesses in testimony provided that there are no actual or potential conflicts of interest amongst the company and each commonly-represented employee witness. While the SEC will permit counsel, acting strictly in her capacity as company counsel, to represent present and former employees during their investigative testimony, the SEC typically notifies witnesses that they have a right to be represented during their testimony by their own personal counsel.

In the event that a present or former employee retains personal counsel, the company might partly secure the economic and informational advantages of a multiple representation through a joint defense agreement ("JDA"). Provided that the parties have a common interest in defending an SEC investigation, a JDA allows parties – even those who have potentially or actually conflicting interests – to share privileged communications and work product without fear of waiver. Thus, through a JDA, company counsel can help a separately-represented employee

67 Sometimes conflicts (or simply the advisability of having personal counsel) do not emerge until after the witness testifies or until after the SEC Staff issues a Wells Notice advising of its preliminary charging recommendation. For this reason, it is not uncommon for certain witnesses to obtain personal counsel after testifying.

68 Indeed, SEC Form 1662, shown to every witness at the start of testimony, warns that multiple representations present a potential conflict of interest if one client's interests are or may be adverse to another's.
more efficiently prepare for her SEC testimony by sharing work product with her counsel; company counsel can even participate in the preparation sessions. Likewise, through a JDA, company counsel may learn the substance of the testimony of a separately-represented witness.

Because the SEC may ask about the existence of a JDA, counsel will not want to enter such an agreement with any witness whom the company likely will want to portray as having acted as an unauthorized rogue.

**What Are the Opportunities for Informal Advocacy During the Investigation?**

During the investigation, SEC Enforcement Staff typically will not share its concerns with counsel. Nevertheless, there are numerous opportunities for informal advocacy during the course of the investigation.

Near the outset of the investigation, the company may ask its counsel to give the Staff an overview of the matter, possibly even providing the Staff with key documents. A presentation must be accurate and balanced if the company and counsel are to have credibility with the Staff. However, a presentation can demonstrate a company's cooperation and at the same time, present the company's views at an early date and to more senior SEC decision-makers than will be involved in the day-to-day conduct of the investigation.⁶⁹

As the investigation unfolds, counsel may find that the Staff is laboring under a misapprehension of law, fact, or expert knowledge (e.g., regarding an arcane facet of Generally Accepted Accounting Principles). Counsel might find it advantageous to correct this misapprehension.

If, at the conclusion of the testimonial phase of the investigation, SEC Staff makes a preliminary determination to recommend charges to the Commission, it will issue a so-called Wells Notice (discussed below) to the proposed subject of such charges. On the other hand, if the Staff does not issue a Wells Notice, a company may hear nothing about the status of the investigation for a long time, and can only guess the Staff’s intentions.⁷⁰

Typically, a company will simply await further contact from the Staff. However, in cases where the company believes that it has an especially strong position or where it is concerned that lower-level Staff might not accurately summarize the investigatory record to their superiors, a company may consider providing more senior Staff with its views on what the investigative record has established. This kind of "pre-Wells" submission must be approached cautiously because the Staff could re-open the record to fill any holes that the company has identified in the investigatory record.

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⁶⁹ While testimony typically is not attended by Staff above the Branch Chief (first level supervisor), overview presentations frequently will be attended by an Assistant Director (second level supervisor) or higher.

⁷⁰ If the Staff reaches a firm conclusion that it will not recommend enforcement charges, it has the discretion to advise the party that the investigation has been terminated. See 17 C.F.R. § 202.5(d). It is a matter of Enforcement Division policy to issue such letters, but the practice does not appear to be uniform. When they come at all, closing letters typically come long after (often more than a year) the conclusion of witness testimony.
Suffice it to say, although a Wells Submission is the only opportunity for advocacy formally identified in the SEC's rules, experienced defense counsel will find ample opportunities during the investigative process to advance the client's views.

**What are Wells Notices and Wells Submissions?**

If SEC 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. Although not required by the SEC's rules, the Staff will usually give the proposed subject of charges an opportunity to review all relevant testimony and exhibits.

The proposed defendant is given an opportunity, typically about three weeks, to submit a memorandum or video tape explaining its 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 proposed settlement.

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 ...." Additionally, they may be discoverable in civil litigation with third parties. The SEC generally refuses to accept Wells Submissions under claims of privilege or as settlement materials.

**What Kind of Charges can the SEC Bring?**

Broadly speaking, the SEC can bring two types of charges against a public company and its directors and officers with respect to the company’s financial reporting.

The more serious is a charge of financial fraud. To sustain a financial fraud charge, the SEC must show that the company, through its directors or officers, either knowingly issued materially misleading financial statements or was severely reckless as to whether its financial statements were materially misleading. A financial fraud charge is significant not only because of its greater stigma, but because it also serves as the predicate for heavier penalties (see below) and other sanctions, including director and officer bars.

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71 See 17 C.F.R. § 202.5(c).


73 SEC Form 1662. On the other hand, the SEC's Chief Administrative Law Judge, in a decision that may have continued vitality, held that Wells Submissions are inadmissible as protected settlement materials under Federal Rule of Evidence 408. See In re Allied Stores Corp., 52 SEC Docket (CCH) 451, 451-52 (1992).

The SEC can also charge a company with violating the so-called “books and records” and internal control provisions of the securities laws. These provisions require public companies to maintain accurate books and records and adequate internal control systems, and to file accurate periodic reports with the Commission. Unlike a financial fraud charge, generally these provisions do not require the SEC to prove that the company acted with intent or severe recklessness. When the SEC believes that it can prove financial fraud, it will invariably also charge books and records violations. However, where the evidence does not support a financial fraud charge, the SEC will limit the charges to books and records and internal control violations.

What Remedies Can the SEC Obtain Against a Company?

Regardless of the nature of the charges it brings, the SEC may seek two kinds of relief against a public company.

First, the SEC may seek a federal court injunction or an administrative cease-and-desist order obligating the company to obey the law in the future.

Second, the SEC may seek two forms of monetary relief: equitable disgorgement (including pre-judgment interest) and a civil money penalty. An order of equitable disgorgement requires a company to pay back any ill-gotten gains that it received as a result of its illegal conduct. Because it is usually difficult to quantify the company’s receipt of ill-gotten gain in a financial reporting case, disgorgement usually is not a significant factor in these kinds of cases.

Civil money penalties, however, have become a much more prominent feature of financial reporting enforcement cases. The securities laws provide a three-tiered penalty scheme, which is periodically increased to account for inflation). For violations occurring after February 14, 2005, the tiers are as follows:

<table>
<thead>
<tr>
<th>Tier</th>
<th>Penalty per violation</th>
<th>When available</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>Not to exceed greater of gain to defendant or $60,000</td>
<td>Any violation</td>
</tr>
<tr>
<td>2nd</td>
<td>Not to exceed greater of gain to defendant or $300,000</td>
<td>Violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement</td>
</tr>
<tr>
<td>3rd</td>
<td>Not to exceed greater of gain to defendant or $600,000</td>
<td>Same as 2nd tier and when such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses</td>
</tr>
</tbody>
</table>

75 17 C.F.R. § 201.1003.
Because these penalties apply to each "violation" (which is not defined in the securities statutes), the SEC can argue that any given financial fraud involved multiple violations (e.g., that each materially misstated financial statement entry constitutes a separate violation, and that each violation was repeated with every refiling or republication). Until recently, the SEC did not seek large penalties against public companies in financial fraud cases. For instance, a $10 million penalty imposed on Xerox on April 11, 2002, was then the largest penalty in the SEC’s almost 70-year history. Before Xerox, penalties rarely exceeded $1 million.

This has changed. Not only has the enforcement climate changed in the wake of this decade's corporate scandals, but SOX gives the SEC an incentive to obtain large penalties from public companies. The “fair funds” provision of SOX (§ 308(a)) allows the SEC to add any penalties that it collects to a disgorgement fund for the benefit of the “victims” of the violation. Since passage of this “fair funds” provision, the SEC has obtained a number of settlements in financial fraud cases that dwarf all prior penalties: e.g., $750 million against WorldCom, $50 million penalty against Vivendi, and penalties ranging from $37.5 million to $65 million against financial services firms for aiding and abetting or causing Enron's accounting fraud. In an April 29, 2004 speech, the SEC’s Enforcement Director signaled his intent to continue to demand large civil penalties against corporations:

Civil penalties against entities in the tens of millions of dollars are no longer rare; indeed, they seem to be expected by many . . . . I believe the ratcheting up of penalties is driven by both goals - increased accountability and enhanced deterrence.\footnote{Stephen M. Cutler, Remarks Before the 24\textsuperscript{th} Annual Ray Garrett, Jr. Corporate and Securities Law Institute (Apr. 29, 2004) (available at http://www.sec.gov/news/speech/spch042904smc.htm).}

In 2006, AIG agreed to pay $800 million in disgorgement and penalties, which will be returned to investors through a "fair fund." Also, Fannie Mae agreed to pay a $350 million penalty as well as an additional $50 million to the Office of Federal Housing Enterprise Oversight, with whom the SEC jointly brought the case. In 2006, the SEC's enforcement cases resulted in a total of more than $3.3 billion in disgorgement and penalties.\footnote{2006 SEC Performance and Accountability Report at 8 (available at www.sec.gov/about/secpar/secpar2006.pdf#sec1).}

In January 2006, the SEC issued guidance regarding civil penalties against corporations. The SEC acknowledged that:

The question of whether, and if so to what extent, to impose civil penalties against a corporation raises significant questions for our mission of investor protection. The authority to impose such penalties is relatively recent in the Commission's history, and the use of very large corporate penalties is more recent still. Recent cases have not produced a clear public view of when and how the Commission

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will use corporate penalties, and within the Commission itself a variety of views have heretofore been expressed, but not reconciled.\(^78\)

After reviewing the legislative history of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, which gave the Commission authority generally to seek civil money penalties in enforcement cases, the SEC announced that the appropriateness of a penalty on a corporation turns principally on two considerations:

1. *The presence or absence of a direct benefit to the corporation as a result of the violation.* The SEC explained that "the strongest case for the imposition of a corporate penalty is one in which the shareholders of the corporation have received an improper benefit as a result of the violation; the weakest case is one in which the current shareholders of the corporation are the principal victims of the securities law violation."\(^79\)

2. *The degree to which the penalty will recompense or further harm the injured shareholders.* The SEC explained that "[t]he presence of an opportunity to use the penalty as a meaningful source of compensation to injured shareholders is a factor in support of its imposition. The likelihood a corporate penalty will unfairly injure investors, the corporation, or third parties weighs against its use as a sanction."\(^80\)

In its Statement, the SEC identified the following additional factors that are properly considered in determining whether to impose a penalty on a corporation:

- The need to deter the particular type of offense;
- The extent of the injury to innocent parties;
- Whether complicity in the violation is widespread throughout the corporation;
- The level of intent on the part of the perpetrators;
- The degree of difficulty in detecting the particular type of offense;
- Presence or lack of remedial steps by the corporation; and
- Extent of cooperation with Commission or other law enforcement.\(^81\)


\(^79\) Id.

\(^80\) Id.

\(^81\) Id.
While the SEC is statutorily authorized to seek only the foregoing remedies against public companies, it frequently seeks other relief as a condition of settlement. For instance, the SEC may require a company to retain and follow the recommendations of an independent consultant charged with reviewing its accounting policies and procedures and internal control systems. The SEC will sometimes accept such undertakings in mitigation of the civil money penalty that it would otherwise require.

**What Remedies Can the SEC Seek Against Directors and Officers?**

The SEC can seek both injunctive and monetary relief against individual corporate actors, including directors and officers. However, the penalty amounts applicable to individuals are considerably lower. For violations occurring after February 14, 2005, the tiers are as follows:

<table>
<thead>
<tr>
<th>Tier</th>
<th>Penalty per violation</th>
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</tr>
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<tbody>
<tr>
<td>1&lt;sup&gt;st&lt;/sup&gt;</td>
<td>Not to exceed greater of gain to defendant or $6,500</td>
<td>Any violation</td>
</tr>
<tr>
<td>2&lt;sup&gt;nd&lt;/sup&gt;</td>
<td>Not to exceed greater of gain to defendant or $60,000</td>
<td>Violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement</td>
</tr>
<tr>
<td>3&lt;sup&gt;rd&lt;/sup&gt;</td>
<td>Not to exceed greater of gain to defendant or $120,000</td>
<td>Same as 2&lt;sup&gt;nd&lt;/sup&gt; tier and when such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses</td>
</tr>
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Where an individual has violated Section 10(b) of the Exchange Act or any of the rules thereunder, the SEC can bar the individual (temporarily or permanently) from serving as a director or officer of a public company (a “D&O bar”). Prior to SOX, D&O bars were sparingly used in only the most egregious cases. Section 305 of SOX reduced the standard for imposing D&O bars from “substantially unfit” to serve as a director or officer of a public company to merely “unfit.” Additionally, while the SEC previously could only seek a D&O bar in a federal court proceeding, Section 1105 of SOX empowers the SEC to impose this remedy in an

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82 A director or officer cannot be held liable merely as a result of his or her position. To be held liable as a principal, the director or officer must have personally acted with the requisite scienter (i.e., state of mind). Similarly, a director or officer cannot be held liable as a “control person” if he or she acted in good faith and did not directly or indirectly induce the violation.

83 17 C.F.R. § 201.1003.
administrative cease and desist proceeding. In a February 11, 2004 speech, the SEC’s Director of Enforcement warned “you can expect us to continue to use this remedy aggressively.”

Under Section 304 of SOX, if a company is required to restate its financials as a result of “misconduct,” the CEO and CFO can be required to reimburse the company for (1) all bonuses and incentive or equity-based compensation the officer received during the year following issuance of the restated document and (2) any profits from the sale of the issuer’s securities during that year. While there are many open questions regarding how this provision will be applied, the CEO and CFO need not have personally engaged in any misconduct to be liable. This provision does not apply to salary.

Under Section 1103 of SOX, the SEC is authorized during the course of an investigation to seek a 45-day freeze (which may be extended to 90 days) of any “extraordinary payments (whether compensation or otherwise)” to any of the company's directors, officers, partners, controlling persons, agents or employees. If such an order is entered, the company is required to escrow those payments into an interest-bearing account. If the company or person is charged with a securities violation, the freeze remains in effect during the pendency of that proceeding.

Finally, if the subject of an investigation is an individual and a CPA who “appeared or practiced before the Commission” (e.g., by preparing or signing the company's SEC filings), the individual could be subject to a proceeding under SEC Rule of Procedure 102(e) to censure the individual or deny her, temporarily or permanently, the privilege of appearing or practicing before the Commission. On rare and egregious occasions, Rule 102(e) proceedings have been brought against attorneys.

How Does the SEC Approach Settlements?

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 independent authority to accept a settlement. That said, settlement offers that do not have Staff support are rarely accepted by the Commission.


85 In an April 13, 2007 speech, Chairman Cox signaled a potential shift in how the SEC approaches negotiating penalties against public companies. (available at http://www.sec.gov/news/speech/2007/spch041207cc.htm). Heretofore, without prejudgment by the Commission, the Staff negotiated the entire settlement with the company, subject to the Commission's subsequent approval. In the interest of fairness and "horizontal equity," Chairman Cox stated that going forward the Staff may be required to obtain Commission approval prior to commencing settlement discussions. Under the new policy, if the Staff then negotiates a settlement within the range of "guidance" provided by the Commission, the settlement will be eligible for summary approval through the Commission's seriatum procedure. This new policy raises issues for defense counsel who wish to have their views considered by the Commission before it issues settlement "guidance" to the Staff. As of this writing the defense bar does not have sufficient
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, whereas 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 before an enforcement action is commenced there is a single press event. When a matter is settled post-commencement, there are two press events: first, when the matter is brought and second, 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 makes 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, but makes no factual findings. However, when a party settles an SEC administrative action, the settling 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. At the same time, the settling party is permitted to defend itself in litigation with parties other than the SEC. 86

experience with this new policy to understand precisely how it will be implemented or how it will affect the dynamics of settlement negotiations with the Staff.

86 17 C.F.R. § 202.5(e).