SEC INVESTIGATIONS OF PUBLIC COMPANIES:

a Primer for Directors and Officers

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You have learned that an SEC enforcement inquiry concerning your public company’s financial reporting is pending or likely. Naturally, you have questions concerning the company’s and your obligations, the likely course of the investigation and the remedies the SEC can obtain against you and your company. This brief memorandum will attempt to answer your most likely questions.

The Company’s and Your Obligations

Document Retention

You and your company must ensure that all documents potentially relevant to the investigation are preserved. In addition to preserving hard copies, you and your company must ensure that you do not destroy (even inadvertently) copies of relevant electronic files, including emails, word processing and spreadsheet files, and back-ups. Your company’s IT department will be instructed to ensure that these electronic files are not overwritten. Similarly, you should preserve relevant electronic files on your home computer or laptop. Your company’s defense counsel will instruct you regarding which documents will need to be produced to the SEC.

Cooperation

The SEC stresses 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 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 whom the SEC believes should be held accountable for violations that she commits or allows to occur. It is noteworthy that in its January 13, 2005 settlement with Google and its General Counsel, 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).

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.
If the SEC believes that a company has not been fully cooperative, the SEC will treat it more harshly. For instance, on May 17, 2004, the SEC announced a $25 million penalty against Lucent for failing to cooperate in an investigation. In an April 29, 2004 speech, the SEC’s Director of Enforcement spoke of the importance of cooperation:

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.

In its 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."

Accordingly, your company’s counsel will attempt to create a record of complete cooperation at every step of the SEC’s investigation.

Truth and Candor

Your company’s defense counsel cannot adequately defend its 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. Your company’s 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. For this reason, all directors, officers and employees must disclose the full and complete truth – including facts that may be inconvenient or even embarrassing – to the company’s counsel.

The Course of the Investigation

SEC investigations are conducted by attorneys and accountants within its Division of Enforcement, which has staff located both in Washington, D.C., and in
offices nationwide. 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.

The SEC's investigation will follow a predictable pattern.

Informal and Formal Investigations

The SEC may gather facts and make a charging decision through either an informal inquiry or through a formal investigation. Both are serious. Informal inquiries 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.

Regardless of whether the investigation is informal or formal, it will proceed similarly.

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.

**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.

**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.

**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.
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.

**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. To avoid being regarded as "uncooperative," the company and its employees must make every effort to meet this production schedule.

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.

The SEC frequently will follow up its initial document requests with requests directed to individual directors, officers and third parties likely to have relevant information (e.g., auditors and parties to transactions that are under review), as well as with follow-up requests to the company.

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.
Sworn Testimony

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).

Wells Submissions

During the investigation, the SEC’s enforcement staff typically will not share its concerns with company’s counsel. As a result, after the conclusion of testimony there may be long periods during which counsel and the company can only guess as
to whether the staff believes that an enforcement action is warranted. Notwithstanding the staff’s disinclination to discuss the merits of a pending investigation, experienced SEC enforcement defense counsel will attempt to engage the staff in a productive dialogue throughout the course of the investigation.

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).

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.

**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, but must obtain authority to settle from the Commission; however, 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).

**Remedies Available to the SEC**

**Categories of Charges**

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 the financial statements were materially misleading. A financial fraud charge is significant not only for its greater stigma, but it also serves as the predicate for heavier penalties (see below) and other sanctions, including director and officer bars.

The SEC can also charge a company with violating the so-called "books and records" provisions of the securities laws. These provisions require public companies to maintain accurate books and records and adequate internal controls

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2 Violations of the federal securities law can also be prosecuted criminally by the Department of Justice. Criminal prosecution is usually reserved for the most egregious cases. A discussion of criminal sanctions is beyond the scope of this brief paper.
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 either knew that its financial statements were materially misleading or was severely reckless with regard to their accuracy. 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 violations, which carry far less severe consequences.

Remedies Against Public Companies

Regardless of the nature of the charge, 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 enforcement case, disgorgement usually is not a significant factor.

Civil money penalties, however, have become a much more prominent feature in financial reporting enforcement cases. The securities laws provide a three-tiered penalty scheme (the following amounts are increased by regulation periodically to account for inflation).

<table>
<thead>
<tr>
<th>Tier</th>
<th>Penalty per violation</th>
<th>When available</th>
</tr>
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<tbody>
<tr>
<td>1st</td>
<td>Not to exceed greater of gain to defendant or $50,000</td>
<td>Any violation</td>
</tr>
<tr>
<td>2nd</td>
<td>Not to exceed greater of gain to defendant or $250,000</td>
<td>Violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement</td>
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<tr>
<td>3rd</td>
<td>Not to exceed greater of gain to defendant or $500,000</td>
<td>Same as 2nd tier and such violation directly or indirectly resulted in substantial losses or created a significant risk of</td>
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substantial losses

Because these penalties are available for 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 entry constitutes a separate violation, and that each violation was repeated with every republication). Until recently, the SEC did not seek large penalties against issuers in financial fraud cases. For instance, the $10 million penalty imposed on Xerox on April 11, 2002, was the largest such penalty in the SEC’s almost 70-year history. Prior to Xerox, such penalties rarely exceeded $1 million.

This has changed. Not only has the enforcement climate changed in the wake of recent corporate scandals, but new legislation gives the SEC an incentive to obtain large penalties from corporate issuers. The “fair funds” provision of the Sarbanes-Oxley Act of 2002 (§ 308(a)) allows the SEC to add penalties 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.

While the SEC is statutorily authorized to seek only the foregoing remedies against corporate issuers, it frequently seeks other relief as a condition of settlement. For instance, the SEC may require an issuer to retain and follow the recommendations of an independent consultant charged with reviewing its accounting practices and internal control systems. The SEC will sometimes accept such undertakings in mitigation of the civil money penalty that it would otherwise require.

Remedies Against Directors and Officers

The SEC can seek both injunctive and monetary relief against corporate actors, including directors and officers. However, the penalty amounts applicable

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3 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
to individuals are considerably lower (the following amounts are increased by regulation periodically to account for inflation):

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<td>1st</td>
<td>Not to exceed greater of gain to defendant or $5,000</td>
<td>Any violation</td>
</tr>
<tr>
<td>2nd</td>
<td>Not to exceed greater of gain to defendant or $50,000</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 $100,000</td>
<td>Same as 2nd tier and such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses</td>
</tr>
</tbody>
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The SEC can seek an order barring an individual from serving as a director or officer of a public company (a “D&O bar”). Prior to Sarbanes-Oxley, D&O bars were sparingly used in only the most egregious cases. Section 305 of Sarbanes-Oxley 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.” Consistent with this change, the number of D&O bars rose from 38 in fiscal year 2000 to 170 in 2003. 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 Sarbanes-Oxley, if an issuer is required to restate its financials as a result of “misconduct,” the CEO and CFO are required to reimburse the issuer for (1) all bonuses and incentive or equity based compensation 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, please note that the CEO and CFO need not have personally engaged in any misconduct to be liable. This provision does not apply to salary.

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.
Under Section 1103 of Sarbanes Oxley, 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 issuer’s directors, officers, partners, controlling persons, agents or employees. If such an order is entered, the issuer is required to escrow those payments into an interest-bearing account; if the issuer or person is charged with a securities violation, the freeze remains in effect during the pendency of that proceeding.

Finally, if the individual is a CPA and “appeared or practiced before the Commission” (e.g., by preparing or signing the issuer’s SEC filings), the individual could be subject to a proceeding under SEC Rule of Procedure 102(e) to censure the person or deny him or 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.