

# COMPLIANCE WEEK

## The ABCs Of SEC Probes: 20 Questions And Answers

By Derek M. Meisner — November 23, 2004

**T**he Securities and Exchange Commission is funded to take action; its budget for enforcement has increased exponentially in recent years, and as a result, it is opening more investigations and targeting new industries and companies. The mere existence of an SEC investigation, if revealed publicly, can damage business and personal reputations significantly.

Although each SEC investigation is unique, the following questions and answers are intended to provide the reader a basic familiarity with the SEC's investigative policies and procedures.

### 1. How does an SEC investigation begin?

An SEC investigation may result from complaints made by investors, referrals from state securities regulators or self-regulatory organizations (i.e., the New York Stock Exchange), press reports, or, as is more often the case, the initiative of the SEC staff. The SEC actively monitors unusual price movements on several securities markets, and conducts periodic inspections of investment advisers and broker-dealers, any of which can lead to an investigation.

The SEC does not need to demonstrate "probable" or "reasonable" cause to begin an investigation. <sup>1</sup>

### 2. How does the SEC conduct its investigations?

An SEC investigation is conducted by the Division of Enforcement and usually begins as an informal investigation. In informal investigations, the SEC does not have the power to issue subpoenas for documents or to compel testimony, and generally (except in the case of regulated entities such as broker-dealers and registered investment advisers) relies on companies and individuals to cooperate voluntarily with the

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Prior to joining Kirkpatrick & Lockhart, Meisner served as a branch chief in the SEC's Division of Enforcement in Washington, D.C., where he conducted and supervised prominent investigations and litigation relating to corporate financial reporting, broker-dealer/investment adviser practices, market manipulation, hedge fund trading, offerings of unregistered securities, and insider trading.

Jason N. Golub, an associate at Kirkpatrick & Lockhart, assisted in

investigation.<sup>2</sup> This sometimes puts defense counsel in a relatively good position to negotiate with the SEC regarding the volume and type of documents and/or testimony that will be provided. Defense counsel has every incentive to keep an investigation “informal” because the investigation is much more likely to be terminated quickly and without any adverse consequences to his or her client.

the preparation of this article.

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If the SEC staff feels that the investigation is progressing, or it is not receiving the level of cooperation it needs, the staff may request the Commission to enter a formal order. A formal order is necessary for the designated staff to issue subpoenas and compel testimony.

Formal investigations generally assume a higher profile at the SEC and require the commitment of additional staff resources. Compared to informal investigations, fewer formal investigations are terminated without adverse action being taken against the party being investigated.

### 3. **What areas does the SEC generally investigate?**

The majority of SEC investigations address alleged accounting deficiencies, insider trading, trading and/or sales practices of investment advisers, broker-dealers and mutual funds, regulatory failures to supervise, offerings of unregistered securities, "soft dollar" practices or disclosure problems. This list is by no means exhaustive, however.

### 4. **Is it possible to predict the onset of an SEC investigation?**

In the case of registered investment advisers and broker-dealers, an early warning sign of an SEC investigation includes the presence of an SEC enforcement staff attorney on a routine exam conducted by the SEC's Office of Compliance, Inspections and Examinations. In other instances, early warning signs are less obvious. For example, if a company receives adverse media attention relating to its securities or financial statements, or is named in a shareholder lawsuit pertaining to securities, the SEC may commence an investigation into the relevant activities. SEC counsel should carefully review all relevant company press releases and financial statements to ensure that they do not include material misrepresentations or omit to state material information.

### 5. **If the SEC initiates an investigation, does that mean that violations of the federal securities laws have occurred?**

No. The existence of an SEC investigation does not mean that any violation of law has occurred, nor does the SEC staff intend an investigation to be interpreted as an adverse reflection upon any person, entity or security.

### 6. **Do SEC investigations have “targets”?**

Technically, no. The SEC has instructed its staff to disclose only that it conducts non-public

fact finding investigations which do not have “targets.” Experienced defense counsel look past this routine disclosure, and attempt to ascertain the nature of the investigation and gage the disposition of the staff. With that information, counsel may be able to direct the investigation in a manner conducive to his or her client.

## **7. How long does an SEC investigation typically last?**

The length of an SEC investigation depends upon its subject matter and scope. The average SEC investigation lasts anywhere between six months and one year. However, sometimes SEC investigations can last several years and put a tremendous strain on the resources of the party being investigated.

## **8. What are the SEC’s enforcement remedies?**

The SEC can bring enforcement actions either in the U.S. federal courts or before an independent administrative law judge. The factors considered by the SEC in deciding in which forum to proceed include: the seriousness of the wrongdoing, the technical nature of the matter, tactical considerations, and the type of sanction or relief to obtain. Often, if the conduct warrants it, the SEC will bring both proceedings.<sup>3</sup> In federal courts, the SEC files a complaint that alleges the misconduct and identifies the sanction or remedial action that is sought. Typically, the SEC asks the court to issue an injunction that prohibits the acts or practices that violate the federal securities laws or Commission rules. A court's order can also require various corporate actions, such as audits, accountings, or special supervisory arrangements. In addition, the SEC often seeks civil monetary penalties and disgorgement (the return of illicit profits). The courts may also bar or suspend an individual from serving as an officer or director of a publicly-traded company.

The SEC can also seek a variety of sanctions in an administrative proceeding. Administrative remedies can include cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from serving as a corporate officer or director or associating with the securities industry, payment of civil monetary penalties, and disgorgement.

If not handled competently by defense counsel, either form of enforcement action has the potential to produce adverse collateral consequences for the defendant.

## **9. In what key areas has The Sarbanes-Oxley Act of 2002 expanded the SEC’s authority?**

The Sarbanes-Oxley Act of 2002 expands the SEC’s authority in several important areas. Specifically, Sarbanes-Oxley reduces the standard for the SEC to obtain an officer or director bar in an injunctive action from “substantial unfitness” to simple “unfitness.” Furthermore, Sarbanes-Oxley allows the SEC to obtain such a bar in an administrative proceeding pursuant to a cease-and-desist order without first instituting an enforcement action in federal court. In practice, this reduced standard has allowed to the SEC to seek officer and director bars for first time offenders, and in instances where the conduct at issue is relatively benign.

Prior to Sarbanes-Oxley, penalties sought by the SEC in an enforcement action were always

paid to the U.S. Treasury. However, Sarbanes-Oxley provides that where a disgorgement fund has been created as a result of an SEC enforcement action against any person, civil penalties paid in the action may be placed in the disgorgement fund for the benefit of victims of the violation. This provision has motivated the SEC to seek penalties in types of cases where it was previously reluctant to do so.

Sarbanes-Oxley also allows the SEC, while investigating possible securities law violations, to request a federal court to impose a 45-day freeze on extraordinary payments (i.e., corporate bonuses) to corporate executives or employees. The order may be extended for an additional 45 days upon a showing of good cause. And, if a company or an executive is then charged with a violation of federal securities laws, the Commission may obtain a freeze for the duration of the action (or extend a freeze already in place). To date, the SEC has used this provision sparingly and with limited success.

Sarbanes-Oxley also amends federal bankruptcy law to make non-dischargeable in bankruptcy certain debts that result from violations of the antifraud provisions of the federal securities laws. This amendment effectively makes it easier for the SEC to enforce a monetary judgment in obtains against an individual.<sup>4</sup>

**10. Can the SEC seek criminal penalties and sanctions?**

No. However, at any time during an investigation, the SEC may refer the matter to the Department of Justice with a recommendation that certain persons or entities be indicted and prosecuted. If the DOJ concurs in the recommendation—which is occurring more frequently—the matter will be referred to a grand jury and, assuming indictment, prosecuted by the U.S. Attorney.

**11. Does lying to the SEC during an investigation constitute a criminal offense?**

Yes. Under United States Code Title 18, Section 1001 (commonly referred to as "18 U.S.C. § 1001"), anyone who, "makes any materially false, fictitious or fraudulent statement or representation" to the SEC can be imprisoned for up to five years, and fined (see excerpt at right). In addition, a witness testifying falsely under oath before the SEC staff may be subject to a perjury conviction, whether the testimony is given in response to a direct question from the staff or is offered voluntarily by the witness.<sup>5</sup> The SEC has increasingly had success in convincing the DOJ to prosecute perjury cases based on false testimony before the staff.

18 U.S.C. § 1001
Below is an excerpt from United States Code Title 18, Section 1001:  <p style="text-align: center;">TITLE 18—CRIMES AND CRIMINAL PROCEDURE</p> <p style="text-align: center;">PART I—CRIMES</p> <p style="text-align: center;">CHAPTER 47—FRAUD AND FALSE STATEMENTS</p> <p>Sec. 1001. Statements or entries generally</p> <p>(a) Except as otherwise provided in this section, whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully</p> <p style="text-align: center;">—</p>

**12. Should a company utilize in-house counsel or retain outside counsel to help it in responding to an SEC investigation?**

Absent unusual circumstances or significant financial constraints, it is vastly preferable for a company to retain independent, outside counsel experienced in SEC investigations.

Experienced defense counsel have specific knowledge of securities enforcement laws and white collar

criminal laws, and understand the mechanics of an SEC investigation and type of information that the SEC is interested in. In addition, SEC staff may view independent, outside counsel as more cooperative and objective (particularly those lawyers with previous SEC experience) than in-house counsel, who are typically considered by SEC staff to be “aligned” with the company.

Given the need to retain outside counsel, it makes sense a company to conduct its due diligence on SEC defense counsel before the company experiences a problem. If a company waits until it receives an actual inquiry from the SEC, the company may not have enough time to select qualified counsel.

**13. Should a company notify its employees of the SEC’s investigation?**

Generally, a company (with the assistance of outside counsel) should take active steps to keep employees informed about the SEC’s investigation to mitigate their fears and to prevent potentially damaging internal and external rumors from spreading. If nothing else, if a company’s employees are aware of (and understand the scope of) the SEC’s investigation, they may be willing to help the company bring it to a successful conclusion. Employees should be instructed that they should not talk about the investigation to anyone unless counsel is present, and that they should inform counsel if they are contacted by anyone (including the press) for an interview. Furthermore, employees relevant to the investigation should be instructed to cooperate fully with any internal investigation that is being conducted by outside counsel, particularly those employees who may be called by the SEC to testify as witnesses.

For employees that may have interests adverse to the company, it is preferable to retain them separate counsel. In fact, the SEC has recently taken the position that a company’s failure to do so may be seen as a lack of cooperation.

**14. Should a company publicly disclose the existence of an SEC investigation?**

In the post Sarbanes-Oxley world, many companies should and do opt in favor of disclosing an SEC investigation. That being said, a number of factors should be considered when making the decision whether to disclose. A company should determine, among other things, whether the investigation will: (1) materially affect the company’s financial results, business dealings or reputation; (2) lead to the dismissal of senior employees or board members; or (3) lead to

1. falsifies, conceals, or covers up by any trick, scheme, or device a material fact;
2. makes any materially false, fictitious, or fraudulent statement or representation; or
3. makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry;

shall be fined under this title or imprisoned not more than 5 years, or both.

private litigation against the company, including class action lawsuits.<sup>6</sup>

Generally, the greater the likelihood of any of these factors occurring, the more likely it is that disclosure will be warranted. If the company decides to disclose the investigation, it is essential to consult with SEC counsel regarding the specific wording of the disclosure, and the timing of the disclosure. In addition, the company should consult with counsel about how the company will respond to press and investor inquiries, and who should speak on behalf of the company about the issue.

On the other hand, if the company decides not to disclose the investigation, it is imperative that company employees not deny the existence of the investigation in response to any press or investor inquiries.<sup>7</sup>

#### **15. Should a company take any remedial action in response an SEC investigation?**

A company seeking leniency from the SEC must consider taking appropriate remedial action. Prompt remedial action taken will strengthen the SEC's view of the company as eager to do the right thing. Remedial action may take several forms, including compensating investors, instituting new and improved internal controls and procedures, and disposing of members of management present during the wrongdoing, regardless of their culpability. If an internal investigation reveals that employees have committed wrongdoing, the company should consider suspending or terminate the responsible employees. The SEC has made it clear that remediation, including dismissing or appropriately disciplining wrongdoers, is a crucial step toward receiving credit for cooperation. Termination may also send a message to the SEC that the company is serious about rectifying past indiscretions.

#### **16. Should a company retain documents during an SEC investigation?**

Yes. Document retention is of the utmost importance. Immediately upon becoming aware that the SEC is conducting an investigation, counsel should direct a senior employee to immediately send a written instruction to all affected employees to preserve all relevant documents and computer files. Employees responsible for the wrongful conduct may attempt to destroy evidence of their involvement, which will impede the investigation and may raise criminal obstruction of justice concerns. Moreover, if the SEC learns that documents have been intentionally destroyed, the chances of an amicable resolution to the investigation decrease dramatically.

Counsel should immediately direct an employee to locate the most critical documents and files to be placed under counsel's control. The company's IT department should be engaged to ensure that proper backups of documents exist, and that those backups are protected. Once it is in possession of documents, outside counsel should create a detailed privilege log and ensure that privileged documents are segregated from other documents in order to prevent inadvertent disclosure and potential waiver of the attorney-client and work product privileges.

#### **17. How do I know if the SEC investigation has ended?**

If the investigation is completed without recommendation for an enforcement action, the staff

generally will give the target notice that the investigation has been terminated. If sufficient time has passed without any communication from the SEC staff, defense counsel (after consulting with his or her client) should consider contacting the staff to ascertain the status of the investigation.

#### **18. What is a Wells submission?**

If the SEC staff decides preliminarily to recommend an enforcement action, persons or entities that will be affected adversely by the recommendation are generally given an opportunity to make a Wells submission to the Commission. During a so-called "Wells call", the staff notifies a party that it has tentatively decided to recommend that the Commission bring an enforcement action for violations of various securities laws, and gives the party a specified period to make a written Wells submission. After receiving a Wells call, but prior to making any Wells submission, counsel for the affected party usually meets with the staff to learn more detail about the staff's recommendations. Experienced defense counsel use the meeting as an opportunity to convince the staff not to bring an action and/or to begin negotiating a favorable settlement.

If the staff ultimately decides to recommend an enforcement proceeding, the party's Wells submission (assuming it decides to submit one) is forwarded to the Commission in conjunction with the staff's enforcement memorandum. The Commission only authorizes proceedings after reviewing the staff's memorandum and any Wells submission, and considering any input from other SEC divisions.

In a Wells submission, counsel must be legally and factually persuasive and try to point out obvious weaknesses in the staff's case. Counsel must also avoid making statements that might be deemed an admission by their client or subsequently established to be false. In reality, while many Wells submissions convince the staff to recommend a less severe action, few Wells submissions actually succeed in convincing the staff not to recommend any action.

#### **19. What percentage of SEC actions result in settlements?**

The vast majority. The SEC simply does not have the resources to litigate and/or try all of the cases that it files. One benefit of settling with the SEC is that a party is not required to admit the underlying allegations in the SEC's complaint or administrative order. This "no admit or deny" policy allows many parties to avoid the consequences of admitting wrongful conduct, which can include an increased risk of private litigation, criminal exposure, and the loss of insurance coverage. However, SEC settlements do mandate that a party agree not to take any action or to make (or to permit to be made) any public statement denying, directly or indirectly, any allegations in the SEC's complaint or administrative order.

#### **20. Should a company settle or litigate with the SEC?**

The answer to this question depends on the specific facts and issues involved, including whether a settlement is in a party's best legal or financial interest. Many parties choose to litigate with the SEC, despite the risk of damage to their business or personal reputations and for publicly traded companies, shareholder flight. As the SEC staff continues to be stubborn and aggressive in its settlement demands and assertion of legal theories, this trend will

probably increase.<sup>8</sup>

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<sup>1</sup> Kenneth B. Winer et al., [SEC Enforcement](#), RealCorporateLawyer.com (2003)

<sup>2</sup> Id.

<sup>3</sup> See [The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity](#)

<sup>4</sup> David B. Bayless, [The New World of SEC Enforcement](#), MoFo Update (November 2003).

<sup>5</sup> See [Title 18 of the U.S. Code, Chapter 79, Section 1621](#).

<sup>6</sup> See Winer et al., *supra* note 2.

<sup>7</sup> Id.

<sup>8</sup> See Bayless, *supra* note 4.

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