CHAPTER 3

SEC Investigations

The Heart of SEC Enforcement Practice

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CHAPTER 3

SEC Investigations

The Heart of SEC Enforcement Practice


A. The Importance of SEC Investigations

The SEC has extensive powers of investigation under the federal securities laws. These powers are exercised by the attorneys, accountants, and other professionals who constitute the Commission’s enforcement staff (the “staff”). The staff is located in the Enforcement Division’s Washington, D.C. headquarters and eleven regional offices in major cities throughout the continental United States. For several reasons, staff investigations are the heart of securities enforcement practice.

First, all SEC enforcement actions are instituted on the basis of a staff recommendation. Except in emergency situations, the staff typically conducts a comprehensive investigation before recommending enforcement action by the Commission. The investigation often involves extensive document production and the testimony of numerous witnesses. By the time the staff recommends an enforcement action, it usually has amassed a great deal of evidence and has developed a detailed theory of the alleged liability of the targets of the staff’s investigation. At the conclusion of its investigation, the staff will normally invite a potential target of its enforcement recommendation to file a Wells Submission, in which counsel can argue why the Commission ought not institute a public enforcement proceeding. The ability to prepare a persuasive Wells Submission will depend, in most cases, on the factual record developed during the staff’s investigation. Accordingly, the best opportunity to influence the outcome of an SEC investigation often occurs during the staff’s investigation, rather than after its completion.

Second, for most companies and persons who are confronted by an SEC enforcement action, the staff’s investigation will represent their only “day in court” because the vast majority of cases brought by the Commission are settled at the time or shortly after they are instituted. SEC investigations generally are confidential, whereas formal enforcement proceedings always are matters of public record. The publicity associated with the institution of a public enforcement proceeding can cause more reputational and business damage than the formal sanctions that may ultimately be imposed as a result of the proceeding. Thus, a primary focus of defense counsel during an SEC investigation is to persuade the Commission not to initiate a public enforcement proceeding against its client, to reduce the gravity of the charges made in any such proceeding, or to lay the foundation for a satisfactory settlement in which the client accepts certain findings and sanctions without admitting or denying any wrongdoing.

Third, the persons called to testify or produce documents in SEC investigations greatly exceed in number the defendants named in any enforcement action that may result from an investigation. Thus, the number of firms and individuals requiring representation will be greatest at the investigatory stage. The investigatory stage is also a time when many issues will arise regarding
joint representation, e.g., whether one law firm can represent both a securities firm and various of its individual officers or employees. Although separate representation of witnesses in SEC investigations is not as common as in criminal investigations, to avoid potential conflicts of interest, firms and individuals often will retain separate counsel during the investigatory stage.  

Finally, SEC enforcement actions are expensive and difficult to defend successfully. More often than not, the SEC prevails in litigated enforcement actions, not only in proceedings before the SEC’s own administrative law judges (“ALJs”), but also before federal district court judges. Accordingly, in most cases the subjects of an SEC investigation and their counsel make an extensive effort to develop a favorable record during the staff’s investigation. Notwithstanding concerns over discovery in related civil or criminal litigation, they frequently present a full defense at the investigative stage rather than rely on obtaining a successful result in a formal enforcement proceeding.

The SEC’s Rules Relating to Investigations do not explicitly provide for an active role for counsel representing the subjects of an investigation. Nevertheless, experienced counsel typically find ample opportunities to influence an investigation’s outcome. Through a proactive approach with the staff, counsel can often allay the staff’s suspicions and otherwise help to shape the staff’s investigative conclusions. Moreover, through negotiating reasonable accommodations and developing a professionally credible relationship with the staff, counsel can influence the scope and time frame for the production of documents as well as the number of witnesses and the timing and location of their testimony.

To have the maximum impact, counsel should be closely involved in an investigation as soon as possible. An investigation generally should not be treated like discovery in a civil case, in which the presumed strategy often is “the less said, the better.” Instead, in many cases the most effective strategy is to present the client’s defense at every stage of the investigation. Such an approach requires a thorough evaluation of the client’s case at an early stage. This evaluation will help determine whether to: (a) adopt a fully cooperative strategy by presenting the client’s defenses to the staff in an aggressive fashion by informally discussing the case with the staff at an early stage of the investigation and freely furnishing documents and written submissions even if not specifically requested, or (b) take a more defensive “sit back and wait” approach, furnishing to the staff only the minimum information necessary to comply with the staff’s subpoena or informal requests.

If the fully cooperative strategy is chosen, counsel will want to present the client’s affirmative defenses to the staff’s factual allegations and legal theories through discussions with the staff, document production, testimony and, if necessary, through Wells Submissions and post-Submission discussions with the staff. If, on the other hand, a “sit back and wait” strategy is appropriate, counsel may provide not only the minimum information required but also may rely heavily on privileges, such as the attorney-client privilege and the privilege against self-incrimination, to limit the evidence that might be used against the client in subsequent proceedings.

While the nature of each client’s defense will depend upon the particular circumstances of each investigation, any company or person with potential exposure should approach an SEC investigation with the same careful attention and preparation that would be devoted to the defense of civil litigation. Otherwise, counsel will not be in a position to counteract and dispel the staff’s prosecutorial suspicions—suspicions that may be assisted by the often misguided inclination of other potential targets to attempt to deflect the staff’s attention from themselves by pointing fingers at others.

Of course, each investigation varies in scope and tone, depending upon the severity of the potential violations being investigated, the regulatory climate, the reputation and notoriety of the parties under investigation, the impact on the financial markets, the interest of the press or the Congress in the subject matter of the investigation, the culture and priorities of the particular SEC office (i.e., headquarters or a regional office) in which the investigation originates, and the
personalities of the individual staff members actually conducting the investigation. Nevertheless, there are certain characteristics common to many staff investigations.

This chapter seeks to offer practical advice about how to protect potential targets at each stage of an SEC investigation. After discussing the breadth of the Commission’s authority to conduct investigations (section B), it discusses how investigations are initiated (section C), the various types of staff investigations (section D), and the importance of cooperation and remediation in enforcement investigations (section E). These subjects are followed by a discussion of counsel’s own inquiry into the facts (section F) and the advice to be given to a subject of a staff investigation (section G).

This chapter then provides an overview of the staff’s investigatory tools (section H), and explores the legal constraints on the staff’s use of its investigatory powers (section I). Next, this chapter focuses on the staff’s two primary techniques: subpoenas or requests for the production of documents and other information (section J) and for the testimony of witnesses (section K). After exploring disclosure issues related to pending investigations (section L), the chapter concludes with discussions regarding how an investigation can be closed without further action (section M) and how to prepare an effective Wells Submission if the staff gives notice of its intention to recommend Commission institution of a public enforcement proceeding (section N).

**B. The Commission’s Authority to Conduct Investigations**

Congress has delegated an enormous degree of discretion to federal administrative agencies in general, and to the Commission in particular, to conduct investigations. The Commission has a broad mandate to conduct investigations “as it deems necessary to determine whether any person has violated, is violating, or is about to violate” federal securities laws. Indeed, the Commission’s investigatory authority has been compared with the expansive power of a federal grand jury to investigate criminal violations.

Accordingly, with rare exceptions, the courts have refused to second-guess a decision by the Commission to initiate an investigation. Consistent with its broad investigatory powers, the Commission can probably commence an investigation solely on the basis of its “suspicion that the law is being violated, or even just because it wants assurance that it is not.” The courts have been similarly reluctant to interfere with the manner in which the SEC conducts its investigations. Deterred, in part, by the remote chance of succeeding in a judicial challenge against an SEC investigation, as well as by the publicity generated by an SEC subpoena enforcement action, targets of SEC investigations make such challenges only infrequently.

Because SEC decisions to initiate investigations are not final agency actions, they typically are not subject to judicial review under the Administrative Procedure Act. In rare cases, targets of SEC investigations have brought actions to enjoin them, alleging that in initiating or conducting its investigation, the SEC violated their rights by reason of improper motive, unlawful acquisition of information, or other inappropriate behavior. In a few instances, the courts have provided temporary relief by ordering discovery on the merits of plaintiff’s claims, temporarily enjoining an aspect of an investigation, or permitting a limited evidentiary hearing on the target’s claims.

Ultimately, however, the courts generally have refused to enjoin an investigation permanently as long as the Commission can articulate a rational basis for it, even when, as one court found, an
SEC employee engaged in apparent wrongdoing in connection with an investigation.22 As these decisions demonstrate, except in rare cases involving the most egregious staff misconduct, it usually serves little purpose to seek judicial assistance by initiating an action to enjoin an SEC investigation. Efforts to limit the burden of compliance with SEC investigative subpoenas have met with somewhat more, albeit limited, success.23 At best, judicial challenges, with rare exceptions, may temporarily delay an investigation but only at the cost of unwanted publicity and escalation of regulatory resolve to find a basis for taking enforcement action.

C. The Initiation of SEC Investigations

Investigations are initiated formally by the Commission or informally by the staff of the Enforcement Division either from the Commission headquarters in Washington, D.C., or from one of its eleven regional offices.24 The location of the investigation often depends on which office first received the information leading to the investigation. More recently, the Enforcement Division has sometimes concentrated multiple investigations involving similar conduct in a single regional office.

Investigations are triggered by information from a variety of sources, including the Enforcement Division’s “market surveillance” activities;25 staff review of filings made with the Commission; inspections and examinations, including “sweep” examinations of industry practices by the Office of Compliance Inspections and Examinations (“OCIE”). OCIE is responsible for compliance examinations of broker-dealers, investment companies, and investment advisers and referrals from other Commission offices or government agencies and from SROs, such as the NASD or New York Stock Exchange. Many other investigations are triggered by media stories, complaints by disappointed investors, or information provided by disgruntled employees or former employees who claim to have knowledge of alleged securities law violations. Tips, many of them anonymous, from such sources as short-sellers, market makers, adversaries in hostile tender offers, mergers, and other transactions or industry competitors also can trigger an investigation.26

The SEC generally seeks to conserve its relatively scarce enforcement resources by commencing an investigation only when it believes that a significant violation of the federal securities laws may have occurred. Nevertheless, investigations sometimes are undertaken into seemingly minor violations because they relate to activities that have received significant press or Congressional attention.27 The likelihood that a particular matter will lead to an investigation depends on a number of factors, including the priorities of the Commission at the time the information is received, the workload of the office receiving the information, the complexity of the issues, the magnitude of the investor harm resulting from the possible violation and whether the matter is appropriate for referral to an SRO, a state securities regulator, or another government agency.

ENDNOTES
*With appreciation to Richard Marshall, formerly of K&L Gates, for his assistance.

4. See Section 15A of the Exchange Act. See Chapter 9 infra for further information regarding SRO inspection programs. While an SRO as a non-government authority has inspection powers that are broader in some respects than those of the SEC, many aspects of the SEC’s inspection process described herein also apply to SRO inspections.


6. At present, the SEC has 11 regional offices, including six offices that until recently were designated district offices and reported to regional offices.


8. The SEC reported that in 2006 OCIE completed routine inspections of 650 advisers with higher risk profiles and 328 advisers with lower risk profiles. Such advisers accounted for approximately 40 percent of adviser assets under management as of the beginning of 2006. Examiners also conducted inspections of 368 advisers that appeared to have specific issues requiring additional scrutiny or that were part of a risk-targeted examination sweep. 2006 SEC Accountability Report at 11-12, supra note 3.


18. The Fourth Amendment provides in pertinent part: “The right of the people to be secure in their persons, houses, papers and effects against unreasonable searches and seizures, shall not be violated.”


20. SEC v. Olsen, 354 F.2d 166, 170 (2d Cir. 1965)

21. Id.


25. See e.g., SEC v. Sange, 513 F.2d 188 (7th Cir. 1975) (subpoena enforcement denied because it required “mass removal of business records”).
