

WHAT CORPORATE COUNSEL SHOULD KNOW
ABOUT SEC ENFORCEMENT

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The SEC Division of Enforcement routinely investigates disclosures by public companies. Since the collapse of Enron, the SEC Division of Enforcement has intensified its focus on accounting and other disclosures by public companies. In the first four months of 2002, the SEC opened 64 investigations into financial fraud and reporting compared to 31 for the same period in 2001, which itself was a record number.

The purpose of this article is twofold. The article addresses steps that your company can take before the initiation of an SEC investigation to make an investigation less likely or less intrusive. The article also addresses the questions that company officers often pose upon learning that their company is involved in an SEC investigation.

1. What can I do to make an SEC investigation less likely?

There are a limited number of steps that a company can take to make an SEC investigation less likely. Most SEC investigations involved revenue recognition. Your company should take steps to ensure that: (1) your company's revenue recognition clearly complies with GAAP; (2) your company has instituted and maintains a strong system of internal controls governing the recognition of revenue; (3) your company discloses business actions that will

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have the affect of accelerating into the current period revenue that, under your company's historic practices, would otherwise likely not have been recognized until a later period; and (4) your company is not engaging in swaps that lack a business purpose but result in additional revenue being reported. Your company should take measures to confirm that your company's sales force has not backdated sales contracts, engaged in bill-and-hold practices or entered into side agreements.

The SEC continues to be very concerned about "earnings management." Accordingly, your company should refrain from accounting actions designed to smooth earning or achieve analyst expectation. To the extent that accounting actions have such effects they should be disclosed. For example, if a company's true operating performance is obscured by a change in estimate (e.g., increasing the depreciable life of an asset), the SEC will expect the change in estimate to be disclosed.

The Commission takes the position that even a de minimis departure from GAAP is material if management intentionally departed from GAAP in order to manage earnings. Accordingly, your company should take steps to ensure that neither your accounting staff nor the accounting staff at your company's divisions or subsidiaries intentionally departs from GAAP to manage earnings.

The SEC is also very concerned about "cookie jar" reserves. A CFO should take steps to ensure that: (1) your company does not establish reserves in excess of the levels permitted by GAAP and (2) reserves and other estimates are not manipulated to manage earnings. To the extent a refinement in the estimation process have an arguable material impact on your company's financial statements, your company should consider disclosing that impact.

The SEC increasingly is focusing on quarterly disclosures, even where the issues were resolved by year-end. Accordingly, your company should redouble your efforts to get quarterly financial statements "right."

Perhaps most importantly, you can help establish a "tone at the top" that communicates to the company personnel that your company values accurate and full disclosure and that employees are expected to support those values.

2. *What else can I do to protect my company and me in the event that there is an SEC investigation?*

You should conduct yourself with an awareness that the SEC is showing less and less deference to accounting judgments made by company accountants and their auditors. It used to be that the SEC recognized the ambiguities inherent in GAAP and demonstrated considerable deference to the judgment of a company and its auditors that a company's accounting policy was aggressive, but compliant with GAAP. Increasingly, the SEC is likely to reach its own conclusion and view any contrary conclusion as a reckless or intentional violation of GAAP. As one senior SEC official has stated, the Staff thinks it is a good thing if companies are deterred from adopting applications of GAAP that, while aggressive, are arguably compliant with GAAP. Accordingly, the fact your auditors have concurred in good faith that a company accounting policy, while aggressive, is GAAP compliant will provide your company only limited protection if the SEC Staff reaches a contrary conclusion. Companies, therefore, should hesitate to adopt policies that they recognize as aggressive.

Company officers should document the actions taken in order to ensure that your company's financial statements are compliant with GAAP. Such documentation increases the likelihood that company personnel will recall the action one or two years later when questioned by the SEC. In addition, such documentation substantially increase the likelihood that the SEC Staff will credit their recollection.

The company should also be sensitive to language used in written materials, especially emails. People tend to use imprecise and casual language in emails. Taken out of context, such language can energize an SEC investigation. Accordingly, you should encourage company personnel to use temperate, business-like language in emails and other documents.

Your company should establish and maintain a financial controls compliance policy. The compliance policy should set forth the company's policy that all transactions be properly authorized, recorded accurately and in reasonable detail, and reflected in financial statements that comply with GAAP. The policy should also set forth the responsibilities of company personnel to ensure compliance with the policy. It is important that the compliance policy be realistic. For example, the compliance policy should not make the CFO of the parent company responsible for the internal controls of a subsidiary, if the finance and accounting staff of the subsidiary report to the president of the subsidiary and the CFO of the parent company has only limited input into the functioning of subsidiary; rather the policy (or associated documentation) should specify the relative responsibilities of the parent company personnel and the personnel at the subsidiary.

3. *Should my company document our reasoning when we make a difficult accounting decision?*

Documentation serves two salutary purposes. First, the documentation process often introduces a degree of rigor into the decision-making process that it improves the quality of decision making. Second, in the event that the SEC initiates an investigation, the company may be able to defuse the Commission's concerns if the company can provide documentation prepared at the time of the decision that details the company's reasoning and demonstrates the care that went into the decision. Accordingly, such documentation can greatly reduce the scope and intrusiveness of an SEC investigation.

It is, however, important that the documentation carefully reflect the best reasoning of the company. The documentation can make the defense of an SEC investigation more challenging if the documentation is not carefully reasoned. Our experience is that when accountants document their reasoning, the documentation often does not accurately reflect the reasoning that took place. This discrepancy is particularly likely when senior accounting personnel do not have the time to review the documentation carefully.

4. *What else can I do to prepare my company for an SEC investigation?*

You should also prepare your senior officers and members of the financial and accounting staff for the possibility of an SEC inquiry. Normally, you will learn that your company is the subject of an SEC investigation through a letter or subpoena from the SEC seeking documents or information. Less often, you will learn of an SEC investigation, when the SEC telephones a company officer and begins asking questions. If the SEC contacts your company, it will always identify itself. The optimal response to such a call is to listen carefully, take careful notes, promise prompt cooperation, and provide information to the Staff only after the information has been thoroughly vetted to confirm that it is accurate and has been framed in the most effective manner.

It is, however, dangerous for a company to instruct its personnel not to cooperate if contacted by law enforcement personnel; such instructions could expose the company to criminal charges of obstruction of justice or witness tampering. A company can, however, educate its officers regarding their rights if contacted by a government investigator who seeks to interview or otherwise question an employee. The employee has the right to decline to cooperate, to consult with an attorney before cooperating, and to set the time, place and

conditions for any interview (e.g., the employee's counsel will be present). The company can explain that the employee should not necessarily treat such contacts as "routine" and that anything the employee says to the government could later be used against the employee, other employees or the company. The company should explain that while it is within an employee's discretion to agree to answer voluntarily questions posed by a government investigator, the employee should not testify regarding the content of any communications with company counsel that are protected by the attorney-client privilege. The company should stress that if the employee provides information to a government investigator, it is imperative that this information be accurate. The company can also direct its employees to notify the company promptly after the employee is contacted by a government investigator. If an employee is questioned by a government investigator, the employee should be carefully and thoroughly debriefed by company counsel.

As discussed later in this paper, one important decision that a company has to make early in an investigation is whether to disclose publicly that the company is the subject of an SEC investigation. Especially for smaller companies, one factor that sometimes requires disclosure of the investigation is the likelihood that the costs of defending the investigation will be material to the company's performance results. While many D&O policies do not cover the cost of defending an SEC investigation, some policies do provide such coverage. In selecting coverage, you should consider whether the coverage might avoid the need for your company to disclose the existence of an investigation.

5. *I have just received information indicating that my company's financial reporting and disclosures may be misleading. What should I do?*

You should respond forcefully to allegations of possible misconduct. If you receive an allegation that your company's financial reporting and disclosures may be materially misleading, the company's chief executive officer, chief financial officer and chief accounting officer should be notified. Management should also seriously consider notifying the audit committee. It is appropriate to notify the audit committee of an allegation if the allegation appears to be credible based, for example, on the source, specificity and reasoning of the allegation and the allegation implicates senior financial or accounting personnel or is not clearly immaterial.

The company should take steps to look into the allegation. Under many circumstances, these steps can appropriately be taken under the direction of

management by company personnel (e.g., internal auditors or company counsel). Under some circumstances, it is appropriate for the investigation to be conducted by independent counsel under the direction of the audit committee. In determining the appropriate response to the allegation, consideration should be given to the nature of the allegation (including its source, specificity, and reasoning), whether the allegation implicates senior financial or accounting personnel, and the potential materiality of the misstatement.

Taking this proactive approach offers a number of advantages to you and your company. By responding forcefully, you might be able to address a potential problem before it materializes. You demonstrate that you are part of the solution, not part of the problem. In addition, you protect yourself from later criticisms that you were attempting to cover up the alleged misconduct.

6. *My company has launched an internal investigation relating to its financial reporting and disclosures. What should I do?*

If your company launches an internal review or investigation into possible violations of the federal securities laws, you should prepare carefully before you provide information or submit to an interview. While you will want to be forthcoming to demonstrate that you have nothing to hide, you should appreciate that the importance of providing accurate and effective answers. You should be aware that company counsel represents the company, not you. You should also be aware that the SEC views skeptically any internal investigation that does not identify at least one member of senior management as having engaged in wrongdoing. Accordingly, you should, at a minimum, carefully review your files before providing information. Often, you would be well served by retaining as personal counsel an attorney experienced in accounting matters and SEC investigations.

7. *Why did the SEC begin this investigation?*

There are many reasons why the SEC Staff might begin an investigation. The SEC Staff conducts surveillance activities with respect to the stock market and the internet and reviews news stories in the media. The Staff obtains referrals from other divisions, other government agencies, and from self-regulatory organizations such as the National Association of Securities Dealers, Inc. (the “NASD”) and the New York Stock Exchange (the “NYSE”). They also receive communications, often via the Internet, from disappointed investors, disgruntled employees, and short sellers. It usually is more important to identify

and address the Staff's substantive concerns than to worry about the source of the concerns.

8. *What should I do if the SEC Enforcement Staff telephones me and asks questions?*

You should listen to the Staff's questions and promise to cooperate. In this circumstance, it is important to learn what the Staff's concerns are and communicate that the company will be responsive. You should promptly collect the information the Staff requested. Before you or the company provide the requested information, company counsel should conduct due diligence testing the information collected.

9. *What type of SEC investigation is this?*

Broadly speaking, the SEC conducts two types of investigations. In informal investigations, the SEC Staff does not have the power to subpoena persons to produce documents or provide testimony and relies primarily on voluntary cooperation of witnesses. In formal investigations, the Commissioners have issued an order, known as a "Formal Order," authorizing the SEC Staff to issue subpoenas requiring the production of documents and the provision of testimony. Once the Commission has issued a Formal Order, the Staff does not need to obtain further authorization from the Commission before issuing subpoenas.

It is not difficult for the Staff to obtain a Formal Order from the Commissioners. The Formal Orders are not available to the general public. However, any person asked to testify before the Commission or produce documents to the Commission can request and obtain a copy of the Formal Order from the SEC. This Formal Order will generally provide limited information regarding the direction of the SEC investigation.

Both informal investigations and formal investigations can adversely impact your company and its officers. You should take both seriously.

10. *Is my company a target of the SEC investigation?*

Unlike the Department of Justice, the SEC does not identify its targets and subjects. Accordingly, the Staff will not formally disclose to your company whether it is a target of the SEC investigation. Nevertheless, it is often possible to assess the direction of the SEC investigation. For example, the Formal Order (if any), the circumstances surrounding the investigation, the

caption on correspondence from the SEC, the nature of the questions posed by the SEC, and conversations with the SEC may reveal the likely direction of the investigation.

11. Am I a target of the investigation?

The SEC is intent on pursuing senior management of companies that made false or misleading disclosures. Accordingly, if the investigation involves your company's financial reporting or disclosures, you should assume that you are a target of the investigation. The SEC has recently brought a number of enforcement actions against corporate counsel.

Does the existence of the investigation mean that the SEC Staff expects the Commission to bring an enforcement proceeding?

The fact that the SEC Staff is conducting an investigation does not mean that the SEC Staff expects to recommend an enforcement action; it simply means that the Staff has identified an issue that, in its opinion, warrants investigation. The SEC closes many enforcement investigations without any enforcement action.

12. What type of team should the company consider assembling in response to the SEC investigation?

The company should consider assembling a multi-disciplinary team consisting of its general counsel, the chief financial officer, the chief accounting officer, public relations advisers,² outside counsel representing the company in the SEC investigation, an accounting expert retained by outside counsel, a securities law disclosure adviser, and the officer responsible for investor relations. The company should assign to one person responsibility for coordinating the efforts of the team.

In addition, the audit committee should consider retaining separate independent counsel to assist the committee in meeting its obligations. This counsel would gather information on behalf of the committee and advise the committee.

² The company should be aware that provision of otherwise privileged information to a public relations advisor could result in a waiver of the privilege. Calvin Klein Trademark Trust v. Wachner, 198 F.R.D. 53 (S.D.N.Y. 2000).

13. *We have done nothing wrong and believe there is no probable cause. Can we challenge the Formal Order?*

In general, the issuance of a Formal Order is not subject to judicial view. The Commission does not need “probable” or even “reasonable” cause to suspect a violation of the federal securities laws in order to conduct an investigation. It is rarely possible to halt an investigation on the ground that the SEC has exceeded its statutory powers. In addition, the Staff is likely to view an unsuccessful challenge as a strong indicator that the company and its current management have something to hide.

14. *Is the SEC going to disclose the existence of this investigation to the public?*

While the SEC sometimes announces the existence of an investigation (e.g., the September 11 investigation and the Enron investigation), the SEC usually conducts its investigations on a non-public basis and refuses to confirm or deny publicly that it is investigating a specific company or individual. In the course of conducting its investigation, however, the Staff might contact individuals and companies who have relevant information, and the persons contacted might discuss the investigation with others, including the media.

If the investigation results in an enforcement action, the SEC will make that action public. Securities enforcement actions often receive substantial press coverage.

15. *Does the company have to disclose the existence of the SEC investigation to the investing public?*

There is no specific requirement that an issuer disclose the existence of an SEC investigation. The question of whether a publicly owned company is legally obligated to disclose the existence of an SEC investigation turns primarily on determining whether the existence of such an investigation is material information. This determination depends on a number of factors including: (1) whether the investigation will materially affect your company’s performance and prospects; (2) the likelihood that the investigation will result in an enforcement action; and (3) the impact the potential enforcement action would likely have on your company. In addition, companies consider (1) the likelihood that news of the investigation will leak and (2) the likelihood that analysts or others will ask whether the company is the subject of an investigation.

At least until recently, companies often did not disclose the existence of an SEC investigation unless or until the Staff has formally notified the company that the SEC Staff has tentatively decided to recommend that the Commission authorize an enforcement action against the company and/or its officers. This notification is commonly referred to as a “Wells” notice. In the current environment, however, early disclosure is often unavoidable.

There are several reasons why companies hesitate to disclose the investigation earlier than necessary for several reasons. The announcement of a SEC investigation will likely generate considerable adverse publicity. This publicity often causes and attracts the attention of the plaintiffs’ bar (resulting in a shareholders class action or a derivative action). In addition, some SEC defense lawyers fear that the disclosure of the SEC investigation might make the SEC more reluctant to terminate its investigation without an enforcement action.

It is important, however, that company officials not falsely deny the existence of an SEC investigation. Accordingly, senior management should contact the individuals authorized to deal with the press and media on behalf of the company and ensure that they do not deny the existence of the SEC investigation.

Even if the investigation is material, the company typically is not required to make disclosure unless it is filing a periodic report or the company is selling securities. A company might make earlier disclosure if, among other things, it appeared likely that the existence of the investigation could not be kept confidential.

If the company decides to disclose the existence of the investigation, counsel should work with company officers to help prepare them to respond to questions posed by the media, analysts and shareholders. The analysts, shareholders, and the media will press company officials for details. The company will have to balance competing demands. There will be a public relations desire to make extensive disclosure to address demands by the media analysts, and investors. From the perspective of limiting the company’s potential legal exposure, there will be a desire to limit disclosures because of the potential liabilities if released information proves arguably inaccurate, the danger that the company might have to update its response if it latter turns out that, unbeknownst to senior management, the initial response was inaccurate or materially misleading and the danger that any public disclosure could waive privileges that might otherwise apply. Company officials will have to set the company’s priorities.

The company should consider consulting with public relations advisers. All public statements relating to the investigation should be reviewed by counsel. In addition, the company should be cognizant of Regulation FD.

16. *Should the company retain outside counsel to assist us in this matter?*

Companies often hire outside counsel to assist in responding to SEC investigations. The company should consult outside counsel immediately if it appears that the company is a target of the investigation, particularly if the investigation might involve the company's disclosures or other conduct. Even if the investigation does not appear to be focused on the company, it is often prudent to consult with outside counsel experienced in dealing with SEC investigations.

A number of law firms have substantial experience representing companies and their employees in SEC investigations. These law firms offer a number of advantages. They are alert to the issues that are of interest to the SEC and are experienced in quickly gathering the information in response to an SEC investigation. They know SEC procedures and are sensitive to the important respects in which responding to an SEC investigation differs from litigation. They have experience with issues that recur in defending SEC investigations. They are experienced in dealing with the SEC Staff. They can assist management in developing the strategy that best fits the circumstances of the matter.

17. *Should I retain separate counsel for the SEC investigation?*

There are advantages to being represented by company counsel. Company counsel is likely to gain an unparalleled mastery of the evidence. In addition, while your company will likely advance the reasonable fees and costs associated with your retaining separate counsel, the retention of separate counsel can impose a substantial financial burden on your company. Nevertheless, it often is in the interest of a corporate executive to retain separate counsel to ensure that the executive's interests are being fully protected.

18. *Should management notify the Board of Directors regarding the SEC investigation?*

Management should promptly notify the Board of Directors, if it appears likely that the company or a senior officer is a target of the investigation or the company otherwise has significant potential exposure.

19. *Should my company refrain from taking remedial action for fear that it will be construed as an admission of wrongdoing?*

In general, the companies should take remedial action if such steps are appropriate in light of the circumstances. The institution of remedial action addresses the obligations of the Board and senior management to shareholders. In addition, the institution of remedial action enables the Board and senior management to demonstrate to the public and to the SEC that the company takes seriously the matter under investigation and that even if the company arguably engaged in violative conduct in the past, there is little likelihood of future violations. Moreover, to the extent that prior disclosures were materially false or misleading when made, books and records were inaccurate, or internal controls were deficient, failure to take corrective action could expose the company, senior management, and the Board to further liability.

Accordingly, throughout an investigation, the company should periodically consider whether remedial action is appropriate. At the onset of the investigation, the company should consider implementing increased oversight or restrictions on certain activities or personnel until additional information has been gathered and reviewed. The Audit Committee should consider an internal investigation or a special review of the company's internal controls and books and records. Senior management and the Board should consider whether prior disclosures should be corrected or supplemented, whether internal controls and training should be enhanced, whether books and records should be corrected or supplemented, and whether personnel should be disciplined and/or reassigned.

20. *I am well-connected to an influential senator. Should I contact the senator and seek relief?*

Such contacts are usually counterproductive. In the current environment, political figures are reluctant to interfere with law enforcement investigation. In addition, the SEC Staff is proud of its political independence and would likely redouble its efforts in response to any political pressure.

21. *Which employees should be notified of a SEC investigation?*

Even if the company decides not to disclose the investigation publicly, the company should notify employees who interact with analysts and the media so that they do not inadvertently deny the existence of the investigation. The company should consider also notifying company employees who are potential witnesses and might therefore be contacted by government investigators. Because the company does not want to be accused of obstructing justice, the

company should refrain from instructing employees not to talk to government investigators. The company may, however, inform these employees that they are not obligated to talk to government investigators and have a right to consult with counsel, should tell the truth if they decide to provide information to the government, and should notify the company promptly after being contacted by the government. Unless and until the company announces the existence of the SEC investigation, all employees notified of the existence of the investigation should be told to keep the investigation's existence confidential.

22. *Should the company notify anyone else of the investigation?*

The assistance of the auditors is often crucial to developing an informed response to the SEC investigation. In addition, failure to inform the auditors can adversely impact the company's relationship with the auditors.

In addition, while the SEC does not publicly disclose the existence of investigations, in the course of an investigation, the Staff might contact the company's customers or other persons who do business with the company. Such contacts can have an adverse impact on the company's business relationships. If it appears likely that the SEC Staff will contact customers or other persons who do business with the company, the company should consider taking pro-active steps to mitigate the impact of these contacts.

The cost of defending an SEC investigation often is not covered by insurance unless the defense of the SEC investigation assists in the defense of a claim that is covered by insurance. Nevertheless, an SEC investigation might constitute a circumstance giving rise to a claim. Accordingly, the company should consider providing prompt notice to the appropriate insurance carrier(s).

23. *When might the SEC contact the company's independent auditors?*

The Staff could contact the company's auditors at any time and without prior notice to the company. If the investigation involves the company's financial statements, the SEC likely will request that the auditors produce workpapers and other materials. If the SEC investigation is informal, the ethical rules governing auditors call upon them to obtain the consent of the company before voluntarily producing workpapers to the SEC. Companies ordinarily provide such consent, in part because the Staff is virtually certain to obtain a Formal Order if the auditor does not voluntarily produce the workpapers.

24. *Will the pendency of the SEC enforcement action prevent the company from proceeding with the sale of securities to the public?*

The SEC Division of Corporation Finance will typically permit a registration statement to go effective even though the SEC Division of Enforcement is conducting an investigation. Before taking affirmative action (such as accelerating the effective date of a registration statement) the Division of Corporation Finance will ask a company to provide a Tandy letter. In the Tandy letter, a Company will represent that

- the disclosure in the filing is the company's responsibility;
- the company acknowledges that the SEC's action does not relieve the company from its responsibility for the disclosure in the filing; and
- if the SEC takes action, the company will not assert this action as a defense in any proceeding initiated by the SEC or any person under the federal securities laws.

If, however, the SEC believes that the registration statement is materially misleading, the Commission can institute administrative proceedings to issue a stop order suspending the effectiveness of the registration statement.

Companies should hesitate to proceed with a securities offering in the midst of an SEC investigation regarding the company's accounting or other disclosures. If the investigation results in an enforcement action or restatement, there will likely be litigation pursuant to Sections 11 and 23 of the Securities Act if the price of the securities declined compared to the offering price. The company, its senior officers (including its CFO and principal accounting officers) are likely to be named as defendants in this litigation. In addition, as a practical matter, underwriters sometimes hesitate to proceed with a public offering if the Enforcement Division is actively conducting an investigation.

25. *What else should I brace the company for?*

As set forth above, disclosure of an SEC investigation is likely to trigger an onslaught of questions from analysts, shareholders, customers, suppliers, creditors and the media, and the company should carefully prepare a response to all these inquiries.

In addition, SEC investigations often result in restatements. Given the pressure that the Enforcement Division asserts on companies and their auditors even companies that firmly believe in the accuracy of their financial statements often end up restating their financial statements. Accordingly, you should prepare your company for the possibility that it will ultimately restate its financial statements.

An SEC investigation can cause a liquidity crisis. For example, a restatement might result in a violation of a debt covenant. Even if the investigation does not result in a restatement, the uncertainty associated with an SEC investigation could impair the ability of your company to raise or borrow capital, lead a rating agency to downgrade your company's credit rating or prompt vendors to tighten their credit terms. Thus, you should consider whether to begin preparing your company for a possible liquidity crisis.

26. *How long does an SEC investigation typically last?*

An SEC investigation can take less than two months or two or more years. An SEC investigation that results in an enforcement action involving financial disclosures typically takes at least one year and often two or more years. However, Chairman Pitt has emphasized the importance of "real time" enforcement. Accordingly, it is possible that the average duration of an investigation will shorten under his leadership. In addition, a company might be able to expedite the rapid resolution of an SEC investigation by responding proactively to the investigation.

27. *How does an SEC investigation typically proceed?*

The SEC gathers information primarily by obtaining and reviewing documents and questioning witnesses. Counsel can supplement the information the Staff obtains from these sources with other information that defuses the Staff's concerns and places troubling evidence in context or assists the Staff in conducting the investigation more efficiently.

The Staff sometimes issues document requests that are extremely broad and have unrealistic deadlines. Accordingly, the Staff is usually receptive to efforts to negotiate the scope and timing of the production. The Staff will often agree to extend deadlines or to accept a rolling production as the company locates and reviews documents. The Staff is less likely to be receptive if the company waits until after the deadline before contacting the Staff.

The process of collecting, reviewing and producing documents is inherently time-consuming. The company and counsel should strive to produce documents in a timely fashion. Counsel should keep the Staff informed regarding the status and expected timing of the production.

Great care should be taken to search thoroughly for responsive documents. The credibility of the company can be impaired if subsequent

discovery reveals that the company did not timely produce significant responsive documents.

The testimony of key witnesses is among the most crucial events in an SEC investigation. In order to prepare a witness properly, counsel should attempt to learn about the events underlying the investigation and the concerns of the Staff and should become familiar with the relevant documents. In preparing a witness, counsel helps a witness to testify accurately and effectively. The Staff sometimes asks questions that are confusing or that address facts out of context. Counsel teaches the witness how to handle such questions. In complex matters, the preparation of a witness often requires several sessions.

Under the SEC rules, a witness has the right to be accompanied by counsel during testimony. The role of counsel during testimony is largely to assist the witness in testifying accurately and to defuse potential, tense situations. Counsel also asks questions that clarify testimony, place purportedly harmful facts into an exculpatory context, and present exculpatory information to the Staff. During breaks, counsel confers with the witness and the Staff. In general, counsel experienced in defending SEC investigations will tend to be less aggressive during testimony than litigators are during depositions.

The Staff does not have authority to institute an enforcement proceeding. If the Staff tentatively decides to recommend that the Commissioners authorize the institution of an enforcement proceeding, the Staff usually will notify counsel to the perspective defendant. This notification is referred to as a “Wells Call.”

Upon receiving a Wells Call, counsel should meet with the Staff to learn the basis for the Staff’s tentative decision. Counsel can then prepare a document, referred to as a “Wells Submission,” to persuade the Staff not to recommend the action or to recommend a less severe action. In addition, counsel can meet with the Staff and attempt to dissuade the Staff from proceeding with the proposed recommendation.

If the Staff decides to proceed with the recommendation, the Staff submits to the Commission a memorandum setting forth its recommendation and the basis for its recommendation. Defense counsel does not have an opportunity to see this recommendation memorandum. At a meeting that is open to the Staff but closed to the public (including the proposed defendants and their counsel), the Commission decides whether to authorize the institution of the enforcement action based on the recommendation of the enforcement Staff, the Wells

Submissions filed by proposed defendants, and input from other interested Divisions (e.g., the Office of the Chief Accountant, the Division of Corporation Finance, and the Office of General Counsel).

28. *The investigation appears to be focused on insider trading, and not on the timeliness or accuracy of the company's disclosure. What exposure does the company have?*

The company has little direct exposure as long as the investigation remains focused on insider trading and the company had previously instituted and maintained a reasonable set of procedures to address the danger of insider trading. The investigation could, however, extend to encompass the timeliness and accuracy of disclosures.

29. *How does the SEC investigate suspected insider trading?*

Investigations into possible insider trading are launched in a number of ways. Often, an investigation will be triggered when the SEC, NASD or NYSE identifies market activity that is suspicious in light of subsequent events (e.g., the price of a company's stock increases dramatically in advance of a positive announcement). The investigators (sometimes at the SEC, sometimes at the NASD or NYSE) will then ask each relevant company for a chronology of events leading to the announcement and a list of individuals (both company personnel and others) who knew the critical information before it was announced. The investigators will also ask broker dealers to identify the customers who made timely trades in the securities. Often, the investigators will ask if anyone with advanced knowledge of the critical information knows any of the individuals who made timely trades. The SEC will then proceed by questioning witnesses (sometimes through telephone interviews, sometimes by taking testimony) and obtaining documents (including telephone and bank records). The SEC looks for circumstances that indicate that the timely trade was suspicious, evidence linking the trader to persons with advanced knowledge, and evidence linking an individual who made timely trades to other individuals who made timely trades. In trades involving foreign accounts the SEC will often seek a court order freezing funds.

30. *Do many SEC actions result in settlements?*

Most enforcement actions are settled before they are filed. Notwithstanding SEC rules suggesting that the Staff can negotiate settlements only if the Commission has authorized such negotiations, if the target initiates settlement discussions earlier, the Staff often will respond. Settlements are

sometimes negotiated before or during the Wells process. Sometimes, the proposed defendant does not negotiate a settlement until the Commission has authorized the action. All settlements must be approved by the Commissioners.

Counsel should negotiate the remedy (e.g., cease-and-desist order v. injunction), the language of the charging document, the amount of any disgorgement or penalty, and (if appropriate) exemptions from certain collateral consequences of the settlement. In almost all cases, the settlement documents will specify that the defendant will specify that the defendant neither admits nor denies the substantive allegations in the complaint.

31. *What defense strategy should the company adopt?*

The development of a defense strategy requires delicate judgments based on numerous factors. A protracted SEC investigation is costly and disruptive. Accordingly, there are a number of pro-active measures that a company should consider taking in response to an SEC investigation.

At the onset of the investigation, the company should take steps to preserve relevant documents, including computer documents. These steps should include suspension of document destruction routines.

Counsel often arranges to meet with the Staff early in the investigation. Through these meetings and subsequent communications, counsel can attempt to gain a better understanding regarding the Staff's view of the case and to provide information that might help defuse those concerns or put troubling evidence into context.

It sometimes is in a company's interest to respond to an SEC investigation by instituting an internal investigation, asking the Staff to defer its investigation pending the completion of the internal investigation, and promising to provide to the Staff the results of the investigation. There can be a number of benefits to this approach, especially if the company is prepared to take strong remedial measures. An internal investigation can expedite the resolution of the SEC investigation. This is beneficial to the company both because shorter SEC investigations are, in general, less disruptive and less costly than long internal investigations and because the Staff is more likely to close a matter without recommending an enforcement action if the Staff has only invested limited time and resources in the investigation.

In addition, the SEC sometimes gives credit for cooperation. The fact that the company undertook the internal investigation and provided the

results to the SEC is a factor that the Commission and the Staff will consider in determining what remedy, if any, to impose. Indeed, under the Commission's Rule 21(a) report regarding Seaboard Corporation, such extraordinary cooperation, in conjunction with other factors such as the remedial measures taken and the size of the loss to the investing public, might cause the Commission to refrain from an enforcement action against the company. More likely, the Commission will simply bring an enforcement action that arguably is less onerous than the action the Commission might otherwise have brought. For example, the Commission might bring a cease-and-desist proceeding instead of an injunctive action and might include exculpatory language in the order.

More often, the company and its counsel will make presentations addressing specific topics, such as the company's system of internal controls, the lack of materiality of the disclosure at issue, the accounting principles at issue, how that particular industry operates, and remedial measures taken by the company. In addition, the company and its counsel can attempt to assist the Staff in efficiently locating the sources of the information the Staff desires. For example, if the Staff is interested in learning how and when certain software was designed and written, the company might assist the Staff by identifying the witnesses who could provide the most information on that topic or by offering to provide a chronology on that topic.

The vast majority of SEC enforcement actions are settled simultaneously with being filed. Often, company counsel will attempt to negotiate a settlement upon receiving a Wells Call. Sometimes, company counsel will wait to see if the Commission has authorized an enforcement action before attempting to negotiate a settlement. Deciding when to initiate settlement discussions is a matter of delicate judgment. In appropriate circumstances, the company can consider making an early settlement proposal. The Staff will often be reluctant to accept an early settlement proposal without at least conducting confirmatory discovery. An early settlement proposal might, nevertheless, prompt the Staff to focus and therefore expedite the resolution of the investigation, at least as to the company and the company personnel, if any, who are participating in the offer. Even after the settlement has been accepted, the investigation might continue in order to develop evidence with respect to the auditors or other potential defendants who are not covered by the settlement offer.

32. *Can the law firm representing the company also defend the testimonies of each of the company employees called to testify in the investigation?*

The Staff will usually not permit company counsel to attend the testimony of a company employee unless the company counsel also represents the individual employee. There are often substantial benefits to both the company and the individual employees if company counsel can also represent individual employees. Ethical rules may limit the ability of company counsel to represent individual employees. Often, however, company counsel will be able to represent the company and one or more employees simultaneously if counsel obtains the informed consent after full disclosure.

When company counsel also represents individual employees, the company should ensure that the engagement letters contain appropriate provisions. The letters should address how the simultaneous representation will work and what will happen if a conflict arises or counsel otherwise ceases to represent one of the clients.

Sometimes company counsel will be able to represent the individual employee if the employee is also represented by separate counsel. Separate counsel can advise the employee on those issues where the employee and the company are potentially adverse and mitigate the adverse consequences of company counsel later withdrawing from representation of the individual if a conflict arises between the company and the individual.

In situations where the ethical rules appear to preclude company counsel from simultaneously representing one or more of the company employees called to testify, the company can still obtain some of the efficiencies of simultaneous representation by having the company counsel perform a major coordinating role. In many circumstances, for example, it will be appropriate for company counsel to participate in one or more preparation sessions with the individual employee.

33. *Can the company pay the reasonable cost of counsel representing company personnel?*

The company should review the indemnification provisions in the company's charter and by-laws and in employment contracts. Generally, companies may indemnify corporate officers who satisfy a specified standard of care. For example, Delaware corporations may indemnify company personnel who "acted in good faith, in a manner he reasonably believed to be in or not opposed to the best interests of the corporation and, with respect to a criminal action or proceeding, had no reason to believe his conduct was unlawful." Some companies have charters or by-laws that specifically provide for mandatory

advancement of legal fees and expenses. Other companies leave the advancement of fees and expenses to the discretion of the Board of Directors. If the company advances fees and expenses on behalf of an individual, the company usually should obtain an undertaking from the individual that the individual will repay the company if it is determined that indemnification was inappropriate.

34. *What type of enforcement action can the SEC bring?*

The SEC has the ability to bring a wide variety of enforcement actions. The SEC's fundamental enforcement tool is a civil action in federal court seeking an injunction against future violations of certain provisions of the federal securities laws. The SEC brings these actions against both companies and individuals. The SEC often brings enforcement actions against senior corporate executives. For example, in the fiscal year ended September 30, 2000, the SEC brought enforcement actions against 19 chief executive officers.³ The SEC also brings actions against members of middle management.

The SEC can also ask a court to order defendants to disgorge unjust enrichment and to impose monetary penalties on defendants. In addition, the SEC has become more aggressive in seeking to bar individuals from serving as officers or directors of public companies. Furthermore, with respect to officers of a corporate issuer, the Commission may seek disgorgement of bonuses that arguably were earned as a result of the misstatement of financials as well as any proceeds from stock sales that arguably occurred as a result of stock sales at prices that were inflated because of a misstatement in the issuer's financial statements.

The SEC can also bring an enforcement proceeding before an administrative law judge. In such proceedings, the SEC can seek an order that the respondent cease and desist from certain violations of the federal securities laws and take corrective action. With respect to an accountant, a lawyer, or other professional, the SEC can seek an order limiting the ability of the professional to practice before the Commission. If the company is selling securities pursuant to a registration statement, the SEC can seek an order suspending the effectiveness of the Registration Statement. The SEC also has the ability to obtain orders suspending for ten days trading in the securities of a public traded company.

³ Floyd Norris, "U.S. Accuses Top Cendant Executives of Fraud," at p. 2, [The New York Times on the Web](http://www.nytimes.com/2001/03/01/business01FRAU.html) (March 1, 2001), <http://www.nytimes.com/2001/03/01/business01FRAU.html>.

An SEC enforcement action often has substantial collateral consequences for a company including: adverse publicity; private damage actions by shareholders; loss of certain safe harbors; and exemptions provided under the federal securities laws. An enforcement action against an individual can, as a practical matter, severely impair the ability of an individual (especially a corporate financial or accounting official, a lawyer, an auditor, or a securities professional) to earn a living in his or her chosen profession.

35. *Can the SEC criminally prosecute the company or its officers?*

The SEC does not have the power to bring criminal actions. The SEC refers appropriate cases to the Department of Justice or to state and local authorities for prosecution. The SEC considers a number of factors in deciding whether to make a criminal referral, including its view on: (1) the quality of the evidence; (2) whether the witness lied during testimony, destroyed documents or otherwise obstructed justice; (3) the perceived egregiousness of the defendant's conduct; (4) whether the prospective defendant has previously violated the federal securities laws; and (5) the loss to the investigating public and the profits reaped by the prospective defendant.

Each year, criminal prosecutors obtain convictions in matters initially investigated by the SEC. In 2000, criminal authorities obtained 64 indictments and 62 convictions from cases referred by the Commission.⁴ In the period 1998-2000, eighteen CFOs were sentenced to jail or were awaiting sentencing.⁵ In the wake of Enron, the SEC is pushing even harder for criminal prosecutions.⁶

⁴ Associate Director Paul R. Berger, Remarks Before the AICPA National Conference on Current SEC Developments (December 5, 2000).

⁵ Berger, *Id.*

⁶ Remarks of Thomas Newkirk at *SEC Speaks* (March 5, 2002). See "Enforcement Division Reviews Recent Developments at Conference," *SEC Today* (March 8, 2002).