

WHAT CORPORATE COUNSEL SHOULD KNOW
ABOUT SEC ENFORCEMENT

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The SEC Division of Enforcement has routinely investigates disclosures by public companies. In the wake of the collapse of Enron, the SEC Division of Enforcement is likely to intensify further its focus on public companies. The purpose of this article is to briefly respond to some of the questions that corporate counsel often pose upon learning that their Company is involved in an SEC investigation.

1. 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 and government agencies and referrals 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 from disappointed investors, disgruntled employees, and short sellers. It is more important to identify and address the Staff’s substantive concerns than to worry about the source of the concerns.

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2. *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 authorizing the SEC Staff to issue subpoenas requiring the production of documents and the provision of testimony.

This order is referred to as a, “Formal Order of Investigation,” or “Formal Order” and is 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 some information regarding the direction of the SEC investigation.

Both informal investigations and formal investigations can adversely impact a Company and its officers. Both should be taken seriously.

3. *Are we 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 a 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.

4. *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 Enforcement Staff has identified an issue that, in its opinion, warrants investigation. The SEC closes many enforcement investigations without any enforcement action.

5. *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.

6. *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.

7. *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 Company should 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 the Company’s performance and prospects; (2) the likelihood that the investigation will result in an enforcement action; (3) the impact of the potential enforcement action would likely have on the Company; and (4) the likelihood that news of the investigation will leak.

Typically, a Company does not disclose the existence of an SEC investigation at least 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. Companies hesitate to disclose the investigation earlier than necessary for several reasons. First, the investing public is likely to interpret the disclosure of an SEC investigation as evidence that there

is a serious problem at the Company. When Tyco International Ltd. announced in December 9, 1999 that it had been advised that the SEC Staff was conducting a “nonpublic, informal investigation” relating to Tyco’s financial statements, Tyco’s stock fell from a close of \$36.2371 on December 8, 1999 to a low of \$22.50 on December 9, 1999. Second, such an announcement can trigger the filing of numerous shareholder lawsuits. Third, 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. 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. In responding to these investigations, the Company should be aware that it might have to update its response if it later turns out that, unbeknownst to senior management, the response was inaccurate or materially misleading. 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.

8. *Should we retain outside counsel to assist us in this matter?*

Companies often hire outside counsel to assist in responding to 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.

9. *Should management notify the Board of Directors?*

In general, management should notify the Board of the SEC investigation if it appears that the Company or a senior officer is a target of the investigation or the Company otherwise has significant potential exposure.

10. *Should the Company refrain from taking remedial action for fear that it will be construed as an admission of wrongdoing?*

In general, the Company should take such 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 arguable engaged in violative conduct in the past, there is no 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. 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.

11. *Our CEO is well-connected to an influential senator. Should he 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.

12. *Who should the Company notify of the investigation?*

As set forth above, the Company might be required to disclose the existence of the investigation to the investing public if the investigation is material. It often is prudent to disclose the investigation to the Company's auditors. In addition, it might be appropriate for the Company to notify lenders.

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. In developing these steps, the Company should remain cognizant of Regulation FD.

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).

13. *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 Enforcement Division is conducting an investigation. 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. In addition, as a practical matter, underwriters may hesitate to proceed with a public offering if the Enforcement Division is actively conducting an investigation.

14. *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.

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

An SEC investigation can take less than two months or many years. An SEC investigation that results in an enforcement action involving financial disclosures typically takes at least a year. 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.

The SEC gathers information primarily by obtaining and reviewing documents and questioning witnesses. Counsel can supplement these sources with other information that defuses the Staff’s concerns, 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).

Most enforcement proceeds are settled before they are filed. All settlements must be approved by the Commissioners. 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.

16. *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.

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 on 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 bring. 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 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 willing to state that it 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. In appropriate circumstances, the Company can also 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.

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.

17. *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 who can advise the employee on those issues where the employee and the Company are potentially adverse. 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. Depending on the Company's indemnification provisions, the Company may be able or be obligated to bear the reasonable cost of separate counsel.

18. *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.² 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. In the fiscal year ended September 30, 2000, the SEC sought officer and director bars against seven chief executive officers. Furthermore, with respect to corporate officers of an 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.

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

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.

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 lawyer, a CPA, or securities professional) to earn a living in his or her chosen profession.

19. *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. Each year, criminal prosecutors obtain scores of convictions initially investigated by the SEC. As one senior enforcement official recently stated, “There is nothing like the involvement of criminal prosecutors to send a message to the financial reporting community.”³ 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 The average prison sentence from SEC referrals to U.S. Attorneys’ offices grew from ten months in 1992 to 44 months in 1998. “SEC’s Chief Accountant Reviews Current Areas of Staff Focus,” SEC Today (1/3/01)⁶

³ Remarks of Stephen Cutler, Deputy Director of Enforcement, D.C. Bar (April 12, 2001).

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

⁵ Berger, Id.

⁶ “SEC’s Chief Accountant Reviews Current Areas of Staff Focus,” SEC Today (1/3/01).