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SEC ENFORCEMENT

Responses and Strategies In Dealing With a Changed SEC

It has come under considerable public criticism over the past few years, but the U.S. Securities and Exchange Commission remains one of the most important civil law enforcement authorities for the U.S. financial services industry and for U.S. public companies. Developments during 2007 and 2008, including problems related to mortgage-backed securities and other financial products and the revelation of the Madoff fraud and the SEC's failure to detect it, caused some to question the overall effectiveness of the agency and even to call for its demise or a reduction in its powers. It appears, however, that the SEC has weathered the storm and emerged in 2009 not merely intact, but stronger.

For example, the appointment of former Department of Justice prosecutor Robert Khuzami as director of the SEC's Division of Enforcement, coupled with his appointment of two former DOJ colleagues to senior positions, signals that the Enforcement Division will strive to operate with the speed and rigor that have long been the hallmark of federal prosecutors. This message has been conveyed in Mr. Khuzami's public statements, where he has spoken of requiring "swift[ness]" and "urgency" in his staff's work and the preparation of cases based on "compelling evidence."¹

Procedural changes, including the "streamlining" of the division's internal processes and the discouragement of tolling agreements, further underscore the message that the SEC intends to move quickly and to avoid prolonged investigations.² The creation

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of specialized units, particularly those focused on derivatives and structured products and on hedge funds and other investment vehicles, signal that the SEC is trying to stay abreast of complex financial transactions and the activities of a broad array of market participants.³

And external factors, including the continuing impact of financial-industry investigations by the New York Attorney General and the recent ruling of Judge Jed Rakoff rejecting the SEC's proposed settlement of its proxy-

disclosure case against Bank of America,⁴ have undoubtedly put additional pressure on the SEC to be aggressive in its investigations of both companies and individuals.

All of these developments make this a propitious time for counsel at financial firms and public companies to consider their approach to dealing with an SEC enforcement investigation—both because companies and executives need to be prepared to deal effectively with a formidable and active investigatory agency and because changes in approach within the SEC could provide opportunities for constructive dialogue and reasonable resolutions.

Specific responses and strategies will obviously vary depending on the case, but there are some generally applicable guidelines for dealing effectively with the SEC Staff in an enforcement investigation. The suggestions below are presented from the perspective of companies and their counsel, but they also apply, in varying degrees, to individual employees and their counsel.

1. Begin your own investigation right away. When the SEC comes calling, it is imperative that counsel do its own thorough investigation of the relevant facts and law at the same time that the Staff is conducting its investigation. In most cases, it will be in the client's interest for counsel to convey the results and conclusions of its investigation to the Staff at an appropriate juncture, so counsel should strive to make its investigation as thorough and persuasive as possible.

While counsel's investigation will be guided by specific statements and informational requests from the Staff and will inevitably continue and evolve over a period of months

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or years, it is critical that counsel begin its work right away—as soon as possible after it understands generally the areas under investigation—and with a high degree of depth and breadth.

Whether the work is accomplished by inside counsel or outside counsel or both, it is particularly important for counsel to gain an understanding of the key facts as quickly as possible. This factual investigation will almost always require, at a minimum, the collection and review of critical documents and prompt interviews of key personnel. The optimal timing for engaging the Staff in substantive discussions may vary from case to case, but counsel's prompt, and continuing, investigation will put it in the best position to answer the Staff's questions and, where appropriate, to articulate defenses and arguments in the most persuasive manner. (The importance of counsel's early presentation of defenses and arguments is addressed further below.)

In addition, to the extent that counsel's investigation reveals misconduct, or potential misconduct, that goes beyond what the Staff has investigated to that point, counsel must give serious consideration to self-reporting such misconduct to the Staff. For a variety of reasons, self-reporting of particular facts may be the most prudent course, and in some circumstances could be legally required. Significantly, the SEC has made clear, in its oft-cited "Seaboard" Report and elsewhere, that self-reporting of misconduct is an important factor in its consideration of whether and how to charge a company.⁵

2. Focus on conflict issues right away. Often the factual and legal investigation can properly be conducted by counsel acting on behalf of company management. But in cases where management has an actual or potential conflict of interest—where there are allegations of wrongdoing by the chief executive or other influential members of senior management, for example—the investigation may need to be overseen by an independent body, such as the audit committee or special independent committee of the board of directors.

This threshold issue needs to be sorted out right away as it will impact both the manner in which the investigation is conducted and the credibility of the information and conclusions that are ultimately conveyed to the Staff. If there are any doubts on this score, the issue should be promptly reviewed by a lawyer independent of senior management—typically independent outside counsel, though in some cases internal counsel can perform this function—who can

reach a conclusion, at least preliminarily, as to whether the investigation can be properly overseen by management or whether the more prudent course is to have it supervised by the audit committee or other independent body.

Separately, counsel conducting the investigation must consider which, if any, employees of the company have an actual or potential conflict with the organization's interests and therefore should have independent counsel. The precise manner and timing of obtaining independent counsel for employees is often a delicate issue, but counsel conducting the investigation should keep certain principles in mind.

Except in very unusual circumstances employees are obliged to cooperate with company counsel, including providing information in interviews, as a condition of their continued employment, regardless of whether they might have a conflict with the company's interests or whether they have obtained or will retain independent counsel.

Companies and executives need to be prepared to deal effectively with a formidable and active investigatory agency, and changes in approach within the SEC could provide opportunities for constructive dialogue and reasonable resolutions.

Whether an employee's independent counsel is present during an interview of the employee is a separate issue and is usually within the discretion of company counsel.

Also, when interviewing employees, it is critical that company counsel provide each employee with a clear and complete explanation and warning about whom counsel represents and the implications of such representation. In the typical case, counsel will need to explain, among other things, that counsel represents the company and does not represent the employee and that the company controls all decisions regarding potential privilege waiver and/or disclosure, to the SEC or otherwise, regarding the information provided by the employee.

3. Be responsive and cooperative with the SEC Staff. Although often counsel may strongly disagree with the Staff's positions, and may view some of its behavior as obnoxious and unreasonable, it is rarely helpful for counsel or the client to court the ire of the investigators. But more to point, notwithstanding that the Staff has often seemed to minimize a company's

efforts in this regard, cooperation and responsiveness with the Staff's investigation can create opportunities to present the company or the executive in the best light and, if needed, argue for more favorable treatment.⁶ Indeed, Mr. Khuzami has made clear that the SEC intends to consider cooperation by both companies and individuals in making its charging decisions.⁷

Counsel should naturally make efforts to push back on onerous requests for documents, information or witnesses, and particular circumstances may dictate a different course, but, as a general matter, the ability of counsel and the client to provide a substantial amount of the requested information in a timely manner creates good will, signals that the client is confident of its position and is not looking to hide anything, and allows for the cooperation argument down the road.

Moreover, the timely and responsive provision of documents or information is a good opportunity for counsel to present to the Staff, whether orally or in writing, what counsel views as salient factual points that favor the client. The most persuasive defenses are often those that are made in the context of cooperation and that are based on the fullest record, where counsel can argue that the Staff has had full access to relevant documents, information and witnesses.

4. Present key defenses and arguments early on. Counsel should focus its defensive efforts on respectfully yet forcefully advocating to the Staff the client's key factual and legal positions. Generally speaking, counsel should begin this advocacy, in a measured way, as early as possible and should continue it, with increasing force, at appropriate junctures throughout the investigation. This effort is critical because well-armed and well-prepared counsel may be able to persuade the Staff that its theories or hypotheses are incorrect before it becomes too settled in its thinking or too invested in the process.

After counsel obtains a reasonably complete understanding of the factual and legal issues, it is important for counsel to present clearly what it believes is the right conclusion for the Staff to reach (e.g., no violation whatsoever, no fraud, limited damages, etc.), with the ultimate goal of persuading the Staff, prior to its consideration of whether to issue Wells notices,⁸ that counsel's proffered conclusion is the correct one.

In advocating with the Staff, whether in a Wells submission or before, counsel should take care to make only the client's strongest arguments. Arguing every point, or a long

list of disparate defenses, will usually dilute the strength and effectiveness of the core arguments. It also can undermine counsel's credibility and effectiveness in negotiating a settlement—assuming that is something the client wants to do.

In addition, counsel should try to focus on issues that carry the greatest likelihood of persuading the Staff. Although many cases will require counsel to address the details of the Staff's proof on highly disputed factual issues, such as fraudulent intent or materiality, on which it is notoriously difficult to persuade the Staff, counsel is sometimes best served by focusing more on clearer structural issues—such as the role of the entity or individual in the alleged violation, the legal duties and responsibilities of particular parties, or the job responsibilities of particular individuals within an organization. When counsel does need to address thorny factual issues like scienter, it is usually best to focus on a few critical facts that undermine the Staff's theory rather than making a wholesale attack on the Staff's evidence.

5. Focus on compliance and remediation.

In addition to cooperation in the Staff's factual investigation, company counsel in many cases will want to emphasize the client's compliance and remediation efforts. The SEC's public statements, including the Seaboard Report, make clear that the agency will give credit for, among other things, (a) the existence of generally effective compliance procedures prior to the occurrence of the alleged misconduct, and (b) the company's remediation efforts, including changes to internal controls and procedures designed to prevent recurrence of misconduct.⁹

Although they may not be "merits" arguments, counsel should take care to delineate the client's compliance and remediation efforts in as thorough and detailed a way as possible, as it is critical to persuade the Staff that these are real and concrete measures that have real and concrete effects, not just window dressing designed to win additional credit.

6. Keep the Wells submission as focused as possible. If the Staff issues a Wells notice and the client decides to try to persuade the Staff through a Wells submission, counsel should strive to keep the submission as focused as possible. As discussed above, while there are certainly cases that merit detailed explications of a variety of factual and legal issues, in many cases counsel will be best served by focusing on the most important and clearest arguments, particularly those based on facts the Staff will have difficulty disputing.

As the Staff has already reached a preliminary conclusion that the client violated the law, it is usually best not to provide an encyclopedic recitation of the case and how the Staff is wrong on every point, but rather to present a few simple arguments that are most likely to persuade the Staff that it is analyzing the case the wrong way.

7. Focus on the practical impact of the Staff's proposed relief. In some cases the Staff (or more rarely the commission itself) can be persuaded that no charges are warranted against the client. In some cases the client decides that no proposed settlement is acceptable and thus decides to litigate with the SEC. But in these and in all other cases, it is important for counsel and the client to consider, as early as possible, the practical relief sought by the Staff, the practical impact of such relief on the client, and the client's business and legal objectives.

There is often a range of possible charges, allegations and relief that the Staff would accept. Notably, Mr. Khuzami has stated that in appropriate cases the Enforcement Division would be prepared to recommend to the commission a form of "Deferred Prosecution Agreement" in which the SEC would forgo enforcement action against a company or individual in exchange for certain terms and undertakings.¹⁰

It is counsel's job to get a sense of the range of outcomes that would be acceptable to the Staff and the commission and, through

continued and focused advocacy—which may include, but should not begin with, a Wells submission—to try to persuade the Staff to agree to a settlement or other resolution that is acceptable to the client.

All told, the current financial and legal environment suggests that the SEC will be aggressive in investigating potential securities law violations by financial firms and public companies, and counsel should remain thoughtful about their response to such an investigation and strategies for achieving the best outcome for the client.

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1. Remarks of Robert Khuzami before the New York City Bar, Aug. 5, 2009 ("Khuzami Remarks") (available at www.sec.gov/news/speech/2009/spch080509rk.htm), at 2-3.

2. Khuzami Remarks, at 5-6.

3. Khuzami Remarks, at 3-4.

4. *SEC v. Bank of America Corp.*, No. 09 Civ. 6829 (JSR), 2009 WL 2916822 (S.D.N.Y. Sept. 14, 2009).

5. See Report of Investigation Pursuant to §21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exch. Act. Rel. No. 44969 (Oct. 23, 2001) ("Seaboard Report"); SEC Press Rel. 2001-117 (Oct. 23, 2001).

6. See Seaboard Report; SEC Press Rel. 2001-117.

7. Khuzami Remarks, at 6.

8. A Wells notice is a formal letter from the SEC Staff to an organization or individual communicating the Staff's preliminary conclusion that such organization or individual violated the federal securities laws. Typically the Staff will articulate its proposed charges in the Wells notice and will outline the alleged bases for such charges orally. A Wells submission is a written memorandum provided to the Staff by a recipient of a Wells notice that addresses the Staff's proposed charges and allegations and usually attempts to persuade the Staff that some or all of the proposed charges lack merit or otherwise should not be brought.

9. See Seaboard Report; SEC Press Rel. 2001-117.

10. Khuzami Remarks, at 6.