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Minimizing Missteps When Interfacing With SEC Staff

Law360, New York (July 06, 2012, 11:54 AM ET) -- There is no doubt that all defense counsel strive to provide zealous and competent representation for their clients particularly when faced with a U.S. Securities and Exchange Commission enforcement proceeding. They know the consequences of such matters can be detrimental. What counsel might not fully appreciate, however, is that how they defend and how they interact with the staff of the Enforcement Division (the "staff") during such proceedings is fundamental to the conduct, and potentially, the outcome of the investigation.

While courtesy and professionalism will not avoid actions where they are warranted, mismanaging interactions with staff can make matters worse and even seemingly small and simple mistakes can be costly to the reputations (and wallets) of clients.

The impact that questionable tactics can have on the outcome of an SEC investigation cannot be overstated. After providing numerous examples of bad lawyering, SEC Enforcement Director Robert Khuzami concluded a June 2011 speech as follows:

> Our enforcement recommendations to the Commission are based not only on testimony and documents gathered in the investigation, but also on staff's view of the credibility of counsel.
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> Counsel serves as a kind of prism through which the staff invariably assesses certain evidence developed in the investigation, including that based on representations of counsel. ...
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> The staff shares with each other their experiences with certain lawyers or firms. Senior managers also listen closely to staff who bear the brunt of the tactics I've described. Lawyers contemplating sharp practices should ask themselves what kind of reputation, and what level of credibility, they want to have with the staff, and whether that matters to them — and to their clients.

Similarly, in a recent speech, the U.S. Attorney for the Southern District of New York, Preet Bharara, remarked about the incredible role of counsel as "gatekeeper" in encouraging corporate integrity and fostering compliance. He commented that counsel had to ask the "hard questions" even in the face of opposition and noncooperation.

Some noteworthy settled enforcement proceedings illustrate that cooperation is key. For example, during one 2004 SEC investigation, the staff, in response to what it perceived as frustrating and nonresponsive document production tactics, filed a separate enforcement action for violations of the SEC's recordkeeping and access requirements, pointing to a number of factors allegedly showing that the investigation's subject had failed to cooperate including by failing to produce email and compliance reports in a timely manner and by providing the staff with misinformation concerning the availability and production status of such documents. The $10 million settlement was, at the time, one of the largest fines ever levied by the SEC against a company for "willfully" failing to produce documents in an SEC probe.

In another example, as part of the settlement of an enforcement action against another firm for improperly recognizing revenue, the investigation's subject agreed to pay a $25 million fine for "lack of cooperation." According to the SEC, the penalty resulted from several instances of misconduct, including failing to provide complete document productions and producing key documents after the testimony of relevant witnesses. In addition, the SEC took issue with the company's former chairman and CEO, when, in an interview with Fortune magazine, he effectively denied that an accounting fraud had occurred by characterizing the situation as a "failure of communication" after the company had reached a settlement in principle with the commission.

For defense counsel and clients, situations like these are avoidable. By strictly adhering to certain best practices, counsel can provide targeted advice to companies and individuals which maximizes cooperation and minimizes staff frustration. These steps are fundamental to the successful representation of a client through all aspects of an SEC investigation.

Counseling the Client Prior to and in the Early Stages of an Investigation

SEC guidance to companies and individuals for the past decade has focused increasingly on compliance, cooperation and self-policing as a means to reduce charges, lighten sanctions, and resolve enforcement actions. The SEC's Enforcement Manual, which is available online and with which all defense counsel should become familiar, details the commission's framework for evaluating cooperation by companies and individuals and articulates the tools available to the staff for rewarding cooperation with its investigations and enforcement actions.

The Seaboard Report

In the 2001 report of investigation issued pursuant to Section 21(a) of the Exchange Act, commonly referred to as the Seaboard Report (the "report"), the commission first announced what factors it would consider, when settling future enforcement actions, in determining whether, and to what extent, to credit cooperation and assistance with investigations. The SEC's report was announced simultaneously with the settlement of a proceeding against the controller of a division of Seaboard Corp. along with the commission's decision not to prosecute the parent company.

This decision, according to the report, resulted from Seaboard's quick report of the controller's wrongdoing, thorough responses during the investigation and overall cooperation with the SEC. The commission used the report to identify four broad measures the staff would consider in deciding whether and how to exercise its discretion: self-policing, self-reporting, remediation and cooperation, and provided a roadmap detailing the specific criteria it would consider once misconduct was discovered. Given the fact that the report is one of the SEC's most important policy statements, counsel should study and fully absorb its guidance.

The policies outlined in the report are similar to the U.S. Department of Justice's practices. According to DOJ guidelines, U.S. Attorneys may decide not to bring criminal charges against a corporation after taking into consideration the corporation's cooperation with the government and its investigation, voluntary disclosure of violations, implementation of effective compliance programs, and disciplining of wrongdoers. In the same vein, the Federal Sentencing Guidelines allow for a reduction in a corporation's punishable offense level to reward a corporation's voluntary disclosure of violations and cooperation with law enforcement.

Compliance Programs / Whistleblower Provisions / Individual Cooperation Tools

Counsel must work with their clients to ensure a robust compliance system. Strongly emphasize the importance of self-reporting as soon as improprieties are discovered and advise the client promptly to launch an internal investigation that examines the nature, extent, origins and consequences of the misconduct. When using discretion during an investigation, SEC attorneys should look upon these efforts favorably. A recent Foreign Corrupt Practices Act case provides a good example of this. After a thorough investigation, the commission chose to charge the company's managing director — but not the company — based on its extensive FCPA compliance training program, in which the managing director participated.

In working with clients to develop, expand and integrate compliance programs, counsel must not overlook the new SEC whistleblower provisions implemented under the Dodd-Frank Act. By offering monetary rewards of up to 30 percent of the penalties collected in an action to those who provide the SEC with information about violations of the federal securities laws, the new whistleblower provisions incent individuals to risk reputation and career to report their observations of improper conduct to the SEC.

Although the whistleblower provisions may, at first blush, appear to encourage whistleblowers to report to the SEC first, if a company amends its internal whistleblower infrastructure and protocols in a manner consistent with certain of the rules, the opposite is true.

The rules allow internal whistleblowers to (1) delay their report to the SEC by 120 days while keeping their internal report date as their SEC report date; (2) tack onto their SEC whistleblower report any work performed by the company in responding to the whistleblower's internal complaint; and (3) receive a small percentage increase in the discretionary 10 to 30 percent SEC award determination. Taking advantage of these provisions will require amending old, or implementing new compliance protocols that seek to educate employees and assure them that the compliance function is trustworthy and effective. Thus, it is essential to counsel clients regarding their internal compliance and reporting systems to ensure that they are responsive and reliable.

Like the whistleblower provisions, the SEC's individual cooperation tools (described in more detail below) provide incentives for corporate insiders who are complicit in illicit corporate conduct to report to the SEC. Assisting clients with integrating new provisions into existing compliance infrastructure will encourage employees to report internally first.

Attorney-Client Privilege

Regarding the attorney-client privilege and work product doctrine, the Seaboard Report, recognized that although some choose to waive these protections when providing information to staff, the commission understands that they serve important interests in encouraging clients to be completely truthful with their attorneys and enabling effective representation.

In fact, in the 2004 amicus curiae brief filed by the commission in McKesson HBOC Inc. v. Superior Court of San Francisco, 115 Cal. App. 4th 1229 (2004) (No. A103055), the commission argued that the provision of privileged information to the SEC pursuant to a confidentiality agreement did not necessarily waive the privilege as to third parties.

The Enforcement Manual also emphasizes that a privilege waiver is not necessary for a party to obtain cooperation credit with the staff. Counsel should work with their client to determine the appropriate disclosure of information and documents so as to cooperate with staff, but not to waive the privilege to the detriment of the company.

Cooperation Initiative

In 2010, the commission announced its cooperation initiative as part of its efforts to "improve the quality, quantity and timeliness of information and assistance it reviews." While the SEC had used various cooperation tools in the past, the initiative introduced cooperation agreements, deferred prosecution agreements and nonprosecution agreements, to encourage individuals and companies to report violations and provide assistance to the agency.

With a cooperation agreement, the Enforcement Division agrees to recommend to the commission that the individual or company receive credit for cooperating in the investigation or other enforcement action. By entering into a deferred prosecution or nonprosecution agreement, cooperative parties admit fault and pay reduced penalties, but avoid more damaging consequences such as administrative and court actions. With these new tools, counsel can better advise their clients on the potential settlement options available.

Most recently, the commission elaborated on its individual cooperation initiative when it brought two enforcement actions against AXA Rosenberg Group LLC and its CEO based in large part on the substantial cooperation of one of the company's executives. The commission expressed that although the evaluation of cooperation requires a case-by-case analysis of the specific circumstances presented, it will evaluate the following four considerations in determining whether, how much and in what manner to credit cooperation by individuals: the assistance provided by the cooperating individual in the investigation; the importance of the underlying matter; the societal interest in ensuring that the cooperating individual is held accountable for his or her misconduct; and the appropriateness of cooperation credit based upon the risk profile of the cooperating individual.

This case marked the first time the SEC outlined the circumstances under which individuals may receive credit as part of the Initiative. With this elaboration, the SEC sets a high bar for those who seek to receive credit under the Initiative, but counsel can advise clients that acting quickly and voluntarily will almost always be advantageous.

Best Strategic Practices to Follow During Investigations and Settlement Discussions

Instilling confidence in the staff is essential to success throughout the investigation and settlement discussions. When the staff is confident that counsel is advising the company or individual to cooperate fully, the client can receive any number of benefits from extensions for document productions and keeping requests voluntary, rather than compelled, to receiving lighter sanctions.

One thing to avoid is a scenario in which the same firm represents multiple individuals with potentially divergent interests from the outset. Potential conflicts of interest weigh heavily on the staff and multiple representations may generate skepticism. For example, the staff may become concerned that firms' presentations in important areas such as comprehensive document and information production are untrustworthy.

Scope of Investigation and Requests for Documents

- At the outset of an investigation, ask for a meeting with the staff to understand fully the general concerns and what the staff is hoping to uncover. When asked to supply documents or information, request the formal order of Investigation to get a better sense of the staff's concerns.

- With respect to requests for documents, counsel must assure the staff that the client is cooperating fully and timely, that documents are subject to a standard litigation hold, and that appropriate efforts have been undertaken to uncover, review, and produce, or appropriately identify in a privilege log, all relevant and responsive information.

- Always memorialize communications with the staff to avoid misunderstandings especially when document requests, testimony subpoenas or any other agreements are modified.

Staff Interactions and Public Disclosures

- Never permit a client to interact with the staff without either going through outside counsel or having outside counsel present. Outside counsel presents a buffer and will minimize the potential for admissions and ad hoc agreements. There should be no exceptions to this rule.

- Carefully construct any public disclosures of the SEC's investigation. Choosing the appropriate method and means of disclosure is important as statements that are understated or inaccurate could frustrate the staff and influence commissioners' attitude when presented with a potential settlement offer.

Presenting Internal Investigation Results to Staff

- Once an internal investigation is complete, counsel should offer to make an in-person oral presentation to the staff.

- Presentations should communicate facts and findings in a straightforward manner, minimizing legal advocacy. If counsel chooses to present in an advocacy posture, do so carefully and either advocate at the end of the presentation or use transitions strategically to make it clear to the staff that you are switching into an advocacy role.

- In certain circumstances, counsel should consider producing "hot" documents or excerpts from internal investigation interview notes referenced in the presentation under a cover letter indicating the client's intent to preserve privilege.

Wells Notices and White Papers

The SEC Enforcement Manual states that the objective of the Wells notice is "not only to be informed of the findings made by its staff but also, where practicable and appropriate, to have before it the position of persons under investigation at the time it is asked to consider enforcement action." The new Dodd-Frank-imposed 180-day limitation has put added pressure on staff to quicken the settlement process. Therefore, when the commission ultimately issues a Wells notice, it should be taken very seriously and taken to mean that the staff is ready to proceed with the next enforcement steps. Counsel needs to act delicately and strategically at this time.

- If the staff extends a white paper invitation or an invitation to discuss settlement, treat it as if it were a Wells notice when presenting your case.

- When negotiating language in settlement documents with the staff, date and retain all versions and clarify requested changes from one version to the next. If the staff indicates that no action is planned, request a closing letter to confirm resolution in writing.

Determining Penalties and Other Settlement Discussions

- If the staff communicates that it is likely to recommend an action to the commission, counsel should perform a comprehensive analysis of the monetary and nonmonetary relief sought in prior similar cases. Much of the staff's determination is made on a case-by-case basis. Therefore, counsel must be creative in counting penalties as the staff has wide latitude in applying penalty provisions. If possible, seek to minimize penalties by offering to undertake independent reviews and audits.

- Where the SEC views penalties as appropriate, counsel should review the SEC's 2006 statement of financial penalties for guidance as to the criteria considered when making a penalty determination, including whether the corporation improperly benefited as a result of the violation and the impact a penalty may have on shareholders. Keep these factors in mind when negotiating settlement terms with SEC staff.

- If you believe there is no way to persuade SEC staff to back away from recommending to the commission the filing of an enforcement action, attempts should be made to persuade staff to consider censures and 21(a) reports to avoid the greater stigma that comes with administrative and court actions. Arguments should be advanced that reference the importance of self-policing and timely remediation throughout the process in an effort to avoid or lessen the SEC's censure.

- Lastly, attempt to determine from the staff the exact date of the filing of an action and whether a press release will be issued so as to prepare the client for the appropriate public relations response. If done with great care, companies usually can weather the negative publicity that comes with an SEC action in one or two days.

Conclusion

Counsel's conduct and interactions with SEC staff prior to, during and following any type of informal or formal investigation can have a huge impact on the staff's treatment and management of your clients' matters. Following these best practices will minimize missteps and lead to effective representation throughout all aspects of SEC investigations.

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