Representing Clients in SEC Investigations

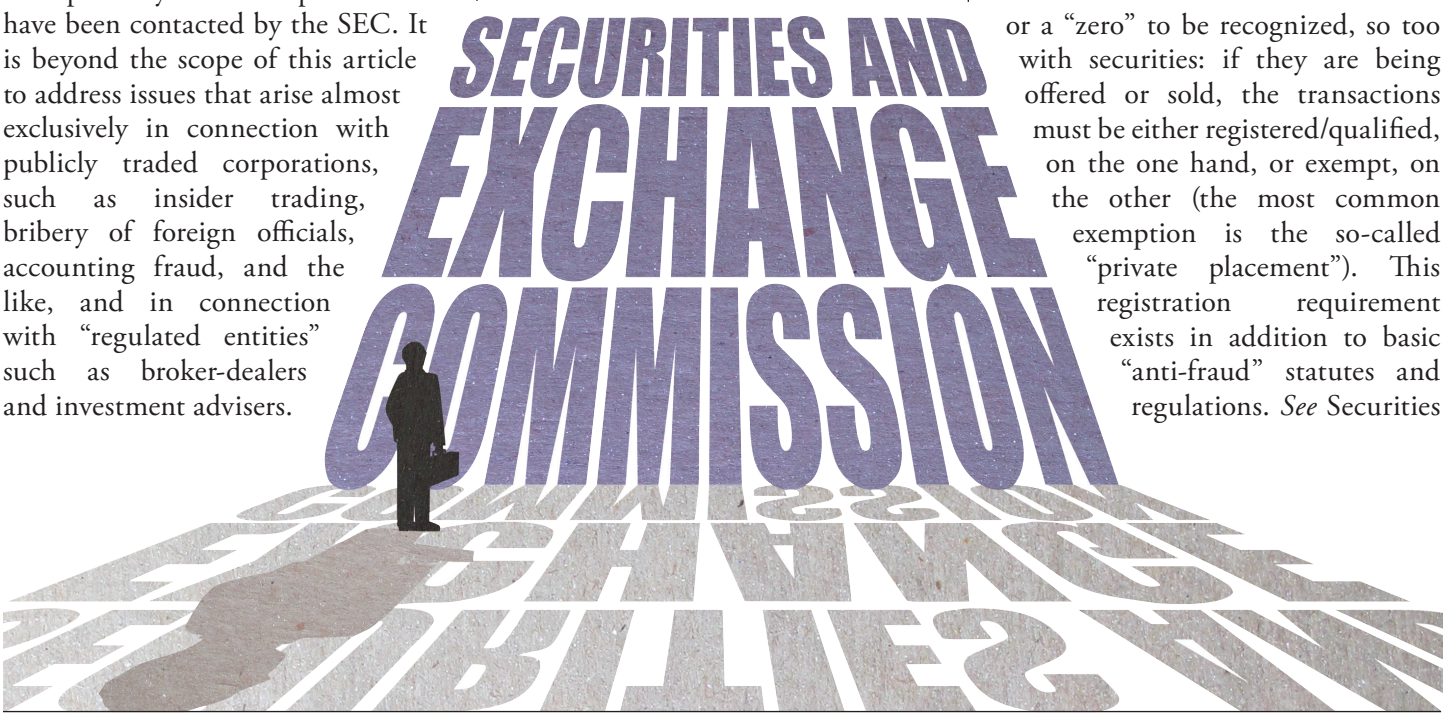
by DENNIS A. STUBBLEFIELD

Introduction to Securities Regulation

The United States Securities and Exchange Commission ("SEC" or "Commission") is the independent federal agency charged with investigating potential violations of, and enforcing, the nation's securities laws. Although the SEC is most visible when it brings high-profile Ponzi scheme, insider trading, and public company accounting fraud cases, in fact the agency has jurisdiction over virtually any and all matters involving a "security," extending to the smallest deals encompassing just a few individuals and privately-held companies. This article is intended for non-securities lawyers who are asked to advise and represent individuals and privately-held companies who have been contacted by the SEC. It is beyond the scope of this article to address issues that arise almost exclusively in connection with publicly traded corporations, such as insider trading, bribery of foreign officials, accounting fraud, and the like, and in connection with "regulated entities" such as broker-dealers and investment advisers.

Under federal law, a "security" includes not only stocks and bonds but virtually every passive investment through the catch-all category of "investment contract," which is defined as an investment of money in a common enterprise, in which the anticipated profits are to be derived from the significant, managerial efforts of others. *SEC v. Murphy*, 626 F.2d 633, 640–41 (9th Cir. 1980) (citing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–301 (1946)). Securities include many promissory notes (unless they bear a "strong family resemblance" to non-investment-oriented instruments such as commercial paper, *Reves v. Ernst & Young*, 494 U.S. 56, 58–68 (1990)), and the interests involved in very small "friends and family" deals. The breadth of the federal securities laws often catches entrepreneurs (like small real estate developers) by surprise: if they are raising money from passive investors, they are almost always selling "securities." A fundamental purpose of federal securities laws is to protect investors through full and fair disclosure. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687 (1985) (citing *Howey*, 328 U.S. at 299).

If a "security" is involved, it must be either (1) registered with the SEC (and/or qualified with various states where it will be sold) or, alternatively, (2) exempt from such registration/qualification. Securities Act of 1933 § 5, 15 U.S.C. § 77e (2011) [hereinafter Securities Act]; *Murphy*, 626 F.2d at 640–41. Just as all computer software code must be written as either a "one" or a "zero" to be recognized, so too with securities: if they are being offered or sold, the transactions must be either registered/qualified, on the one hand, or exempt, on the other (the most common exemption is the so-called "private placement"). This registration requirement exists in addition to basic "anti-fraud" statutes and regulations. *See* Securities



Act § 17(a), 15 U.S.C. § 77q(a) (2011); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2011) [hereinafter Exchange Act]; SEC Rule 10b-5 (promulgated thereunder), 17 C.F.R. § 240.10b-5 (2011). California has substantially the same statutory framework of securities regulation. Resources for practitioners include: Louis Loss et al., *Securities Regulation* (3d ed. 1989) (as well as the abridged "Fundamentals" volume (6th ed. 2011)); Thomas L. Hazen, *The Law of Securities Regulation* (6th ed. 2009); C. Hugh Friedman, James F. Fotenos et al., *California Practice Guide*. Corporations ch. 5 (The Rutter Group et al. eds., 2012) (focus on California law).

The Core of the SEC Enforcement Process

The two most significant aspects of the SEC's enforcement process are: (1) its non-public investigations, and (2) its statutory authority to bring civil injunctive actions. The agency's enforcement mandate is much broader (*e.g.*, increasingly used court and/or administrative tools seeking, *inter alia*, fines, penalties, and cease-and-desist orders). However, the most common interface with the SEC, when representing privately held concerns and related individuals, will involve these two core components of the agency's program. Practitioner resources include Marc I. Steinberg & Ralph C. Ferrara's *Securities Practice: Federal and State Enforcement* (2012) [hereinafter S&F], particularly chapters 1–5. Two sources for current developments are "Securities Regulation and Law Report," (Bureau of National Affairs, Inc. weekly report), and "This Week in Securities Litigation," a blog by Thomas O. Gorman (of Dorsey and Whitney LLP). *SEC Actions*, *available at* http://www.secactions.com; *see also* William R. McLucas et al., *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 Temp. L. Rev. 53 (1997) [hereinafter McLucas].

The SEC enjoys very broad investigative powers. Its investigations, virtually all conducted by staff of its Division of Enforcement ("Division"), are non-public fact-finding vehicles, in which there are no parties, no issues, and no adjudication of rights. S&F § 3:5 (citing, *inter alia*, *SEC v. Jerry T. O'Brien*, 467 U.S. 735, 742 (1984)). They fall into one of two categories. First in "Informal Inquiries," (also known as "Informal Investigations" and/or "Matters Under Inquiry") the Staff is permitted to request information and documents on a voluntary basis. Second, in "Formal Investigations" the staff secures from the Commission or the Division Director a "Formal Order [of Investigation]." In a Formal Investigation, the SEC has nationwide subpoena power to command the production of documents and giving of testimony. *See generally* S&F at ch. 3.

It is this "likelihood" element which becomes a strategically important factor in the decision of whether, and how much, to cooperate during the SEC's investigative stage.

In all SEC investigations, and in many Informal Inquiries, witnesses' testimony is transcribed, under oath, and thus subject to both perjury laws and the "false statements" statute. 18 U.S.C. § 1001 (2011). In both cases, witnesses are furnished with SEC Form 1662, which describes important information about the Commission's investigative and enforcement process, including the "Routine Uses" of information received by the agency. *See generally* S&F at ch. 3.

If the Staff determines that there appear to be violations of the federal securities laws, it will typically seek authorization from the Commission to file a civil injunctive action in the appropriate United States District Court. By statute, the SEC may seek such injunctive relief "whenever it appears that a person 'is engaged or [is] about to engage in any acts or practices' constituting a violation of the [applicable provisions of the federal securities laws]." *Aaron v. SEC,* 446 U.S. 680, 700 (1980). The Staff's practice, however, is to first provide the intended defendants of such action the opportunity to furnish what is known as a "Wells Submission," essentially a legal brief in which such companies/individuals attempt to persuade the Staff to either abandon any intended enforcement action and/or to lay the foundation for the pre-filing settlement of the matter. The majority of proposed SEC actions are settled, which is understandable given the risks of an adverse outcome at trial, including the danger of collateral estoppel. *See Parklane Hosiery v. Shore*, 439 U.S. 322 (1979); *see generally* S&F § 3:54–73. Most settlements, however, still require the entry of an injunction by "consent," ("without admitting or denying" the SEC's allegations), and thus carry the risk of various "collateral consequences," such as damage to reputation, the threat of civil and/or criminal contempt if the injunction is violated, and the inability to rely on certain federal provisions/exemptions for securities offerings (additional consequences face regulated entities). *See* S&F § 5:10–12.

If the Commission files its action, it often applies for extraordinary relief, such as TROs, freeze orders, and the like, to prevent ongoing fraud. Unlike most common law injunctions which issue in equity under familiar principles, an SEC statutory

injunction is qualitatively different. For example, the Commission need not prove "irreparable injury or the absence of an adequate remedy at law." S&F § 5:3, pp. 5–6 (citing *Aaron*, 446 U.S. at 700–02*)*. However, it is required to plead and prove the threat of recurrence: the "likelihood of future violations." *Murphy,* 626 F.2d at 655–56 (discussing factors considered by the court). Even if the past conduct is clearly violative, if there is no possibility of recurrence, a statutory injunction is improper. *See, e.g.*, *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F. 2d 90, 99–100 (2d. Cir. 1978). It is this "likelihood" element that becomes a strategically important factor in the decision of whether, and how much, to cooperate during the SEC's investigative stage.

Key Considerations in Dealing with the SEC

Any contact by the SEC must be treated seriously. Several steps should be undertaken promptly. These include a brief interview with the key client contact to determine the likely focus of the SEC division staff, written instructions regarding document preservation, a review of key documents that may be at issue, a courtesy call to the staff person who initiated the inquiry (which will include, if applicable, a request for a copy of the formal order), and a recommendation, if appropriate, to immediately cease any violative activity (often this recommendation must wait further investigation).

After counsel has developed a basic understanding of the matter, the staff should be contacted again. Counsel should seek to gather further information (the staff is usually very circumspect in light of the non-public nature of its investigations), if applicable, in order to narrow and clarify the scope of documents requested under subpoena, and to offer any initial information which could be helpful to the client (such discussions at the early stage need to be very circumspect, and the importance of accurate factual representations from the outset cannot be over-emphasized). Additional steps may include notifying insurance carriers, contacting auditors, issuing instructions to line staff regarding the impact the matter may have on normal business activities, reviewing major contracts in order to anticipate collateral consequences (*e.g.*, clause in credit line agreement which provides that an injunction constitutes an event of default), and if applicable, extending a rescission offer to investors.

Ideally, in any matter, counsel should review, analyze, and organize all potentially relevant documents, including emails. In addition, all potentially relevant witnesses should be interviewed in depth after the documents have been analyzed. Counsel must be vigilant about resisting attempts by the client to take shortcuts in this process. Do not be surprised to hear suspicion and even contempt for what headstrong entrepreneurs may likely see as an unnecessary, intrusive process (they are the experts in their businesses, and why should the SEC second-guess them just because the market didn't cooperate), as unfair (they need to hire expensive lawyers when they didn't do anything wrong), and/or as illegitimate (initiated by the agency which, in their view, got caught napping with Madoff, Stanford, etc.). Any shortcuts are fraught with danger both to the client and to counsel. The SEC has specific authority to regulate the integrity of the representation of professionals who practice before it. *See, e.g.*, *Touche Ross & Co. v. SEC*, 609 F. 2d 570, 578 (2d. Cir. 1979); *see also* S&F § 4:15, 18, 29–34.

In most cases, the initial assessment will result in the determination to fully cooperate with the SEC in the production of relevant documents and making clients and witnesses available for interviews/investigative testimony. In preliminary inquiries, a pro-active, cooperative approach with the staff is typically in the client's best interests, in the anticipation that this may obviate the necessity of a formal investigation. The detailed strategies, tactics, and mechanics of dealing with the SEC in such investigations are beyond the scope of this article. Major aspects of this process include document production, significant issues relating to electronically stored data, the narrow circumstances under which a direct challenge to SEC subpoena power may be warranted, the specific rules that apply to SEC investigative testimony (which are materially different than those that apply to depositions in state or federal court), the importance of witness preparation and demeanor, and various delicate issues regarding ethics/professional responsibility (*e.g.*, multiple representation of witnesses or the preservation of documents). Practitioners should consult S&F (particularly chapters 3 and 10), and the numerous sources cited therein for detailed guidance in this area. In addition, the SEC's website includes its "Enforcement Manual," which sets out its investigative/enforcement process in detail. *See also* McLucas; Arthur F. Matthews, *Effective Defense of SEC Investigations: Laying the Foundation for the Successful Disposition of Subsequent Civil, Administrative and Criminal Proceedings*, 24 Emory L.J. 567 (1975).

In certain cases, however, cooperation might be imprudent or even dangerous. Securities law violations may be charged criminally by virtue of section 24 of the Securities Act, 15 U.S.C. § 77x (2011), and section 32(a) of the Exchange Act, 15 U.S.C. § 78ff(a) (2011). Securities enforcement has become increasingly criminalized in the last decade. S&F § 7:2 (2011 Supp.). The SEC does not have criminal authority itself, but routinely and vigorously cooperates with prosecutorial agencies, particularly the U.S. Department of Justice and its various U.S. Attorneys' Offices. Information regarding the

SEC's practices in this regard is included in its Form 1662, and in its Enforcement Manual. Moreover, parallel civil and criminal proceedings are generally unobjectionable. Absent extraordinary circumstances amounting to government bad faith, such investigations and actions may be pursued either simultaneously or successively. *United States v. Stringer*, 535 F.3d 929 (9th Cir. 2008); *SEC v. First Financial Group*, 659 F.2d 660, 666–67 (5th Cir. 1981) (citing *United States v. Kordel,* 397 U.S. 1, 11–12 (1970)).

Thus, counsel must promptly evaluate the likely risk of criminal prosecution. Major factors in this regard include the presence of blatant fraud and/or defalcation of substantial investor funds; a scheme, such as a "pump and dump," or a Ponzi scheme; and recidivism by key persons involved. Counsel should promptly seek to ascertain if the staff has made, or is contemplating, a criminal reference of the matter, and, further, whether the particular client is a target of the investigation. *See* S&F § 7:14–18.

If it appears that the individual may need to invoke his or her Fifth Amendment right (corporations do not enjoy Fifth Amendment protection, *see, e.g.*, *George Campbell Painting Corp. v. Reid*, 392 U.S. 286, 288–89 (1968)), what are the likely costs of doing so? Typically, there are three basic consequences: First, the division staff could very likely construe the invocation as an admission of guilt. S&F § 3:21 (citing Seymour Glanzer, Howard Schiffman & Mark Packman, *The Use of the Fifth Amendment in SEC Investigations*, 41 Wash. & Lee L. Rev. 895, 914 (1984)). Second, if the Fifth Amendment is invoked in the subsequent SEC civil injunctive action, the Commission may seek to have an "adverse inference" drawn as to matters for which the privilege was invoked. *See Baxter v. Palmigiano*, 425 U.S. 308, 318–20 (1976). Third, a preclusion order may be entered to prevent the introduction of evidence at trial on matters relating to the invocation during discovery. *See SEC v. Graystone Nash, Inc.*, 25 F.3d 187 (3d. Cir. 1994).

While the Fifth Amendment is a fundamental protection in the face of likely criminal prosecution, its cost and effect on the civil side can be catastrophic. In any situations in which the choice on the Fifth Amendment is not clear-cut, it is prudent to associate in specialized criminal defense counsel to advise on available options, including issues relating to immunity. *See* S&F § 3:27.

Absent criminal concerns, it is generally in the client's own self-interest to fully cooperate with the SEC. "Cooperation" here is not used in the same sense as it is in cases in which the Commission is investigating public company fraud. *See* S&F § 2:1 (Supp. 2011) (discussing the development of such cooperation, and the SEC's policies and procedures re same (*e.g.*, entailing an extensive internal investigation, and the furnishing of such investigation, with waiver of the attorney-client privilege, to the Commission)); *see also* Enforcement Manual § 6; Seaboard Release on Cooperation, Exchange Act Release No. 44969, 56 SEC Docket 1 (Oct. 23, 2001), *also available at* http://www.sec.gov/litigation/investreport/34-44969.htm.

Although such level of "cooperation" is rarely warranted in cases involving small privately held companies and individuals, certain analogous approaches may be prudent to insure the best possible outcome of the SEC investigation. For example, a company could conduct a limited internal investigation, taking requisite remedial steps such as the revision of policies and procedures, and/or necessary personnel changes. This process need not necessarily be prohibitively expensive, completely reduced to writing, or entail the waiver of the attorney-client privilege. The company could then argue that, given the corrective measures taken, there is no likelihood of recurrence, and therefore no need for injunctive relief. Such an approach might be effective to convince the Staff to close the matter with no action, or to negotiate a relatively favorable outcome with any necessary injunction limited to registration violations under Securities Act Section 5 or merely negligence-based charges. *See Aaron,* 446 U.S. at 695–700. In the event of litigation, such efforts can demonstrate that there is no need for an injunction.

Conclusion

The SEC has formidable investigative powers and sweeping enforcement authority. If the agency has contacted your client, there is likely a very good reason. In most cases, the optimum approach is to be proactive. The notion of "cooperation" is counter-intuitive, and even offensive to many clients, but, absent criminal exposure, is generally the most effective way to achieve the best possible outcome in a Commission investigation.

Dennis A. Stubblefield *was an attorney with the SEC's Enforcement Division from 1977 through 1984. His legal practice focuses on securities regulatory/enforcement defense and securities litigation. He also serves as an expert witness and mediator on investment disputes. He is 2012 Chair of OCBA's Solo Practitioner/Small Firm section, and can be reached at dennis@stubblefieldsolutions.com.*

This article first appeared in Orange County Lawyer*, December 2012 (Vol. 54 No. 12), p. 14. The views expressed herein are those of the Author. They do not necessarily represent the views of* Orange County Lawyer *magazine, the Orange County Bar Association, the Orange County Bar Association Charitable Fund, or their staffs, contributors, or advertisers. All legal and other issues must be independently researched.*