Bloomberg BNA

Corporate Law & Accountability Report™

SEC ENFORCEMENT

Leveling the Field: Strategies to Respond to the SEC's Increased Reliance on Administrative Proceedings

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The Securities & Exchange Commission is increasingly turning away from federal court in favor of enforcement tools that tilt the playing field in its favor. These tools, including vigorous whistle-blower programs (12 CARE 1558, 11/21/14) and increased reliance on Administrative Proceedings (APs) to prosecute cases that previously would have been filed in federal court (13 CARE 254, 2/6/15), require defense counsel to adjust their responses to SEC inquiries. Not only are more APs being filed, under new authority granted under the Dodd-Frank Wall Street Reform and Consumer Protection Act, they are being brought against persons who are not registered with the SEC, but who touch the securities markets in some other way.[1] More than ever before, companies and individuals will find themselves pressed to collect facts and prepare a defense without the benefit of formal discovery or the benefit of time. And to do so without exposing themselves to charges that they chilled whistle-blowers from sharing the company's secrets with the SEC. The challenges and perils of the new enforcement environment are many, but with proper prior planning and preparation they can be successfully navigated.

In response to the 2008 global financial crisis, the SEC undertook many changes designed to enhance its effectiveness and convey a new ''tough cop'' attitude to the public and registrants. It reorganized the Enforcement Division into five specialized areas—Asset Management, Market Abuse, Structured and New Products, Foreign Corrupt Practices, and Municipal Securities and Public Pensions—and established a new Office of Market Intelligence. It also brought in highly respected career prosecutors Mary Jo White as Chair and Andrew Ceresney as Director of Enforcement. Since 2011, it more than doubled the size of its cadre of administrative judges, hiring ALJs with experience in federal law enforcement.

The SEC has been actively advertising its new get-tough attitude, where suspected wrongdoers can expect to face increasingly draconian sanctions. As one Commissioner explained, ''I envision a world where . . . our enforcement actions . . . have market-wide impact, and . . . sanctions . . . are significant enough to stop similar conduct in its tracks. The possibility of being sanctioned by the Commission should not be considered part of the cost of doing business.''[2] And it signaled that it will increasingly avoid federal courts—and juries who hear cases only after drawn-out proceedings where defendants were afforded the time to build a defense based on expansive discovery—by bringing an increasing number of its cases as APs:

[1] *See* Dodd-Frank Act, Pub. L. No. 111-203, § 929P, 124 Stat. 1376, 1862 (2010) (codified as amended in scattered sections of 15 U.S.C.).

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[2] Luis A. Aguilar, SEC Comm'r, Address to Practicing Law Institute's SEC Speaks in 2011 Program (Feb. 4, 2011), *available at* http://www.sec.gov/news/speech/2011/spch020411laa.htm.

 ISSN 2330-6300

> I think you are seeing us use the administrative proceeding more and it's a venue that has a sophisticated trier of fact, and one where it's a more streamlined proceeding. So it has great benefit to us and I think you have seen that in the last year or two, and I think you'll see that more and more in the future . . . I will tell you that there have been a number of cases in recent months where we have threatened administrative proceedings, it was something we told the other side we were going to do and they settled.[3]

The Commission generally enjoys absolute discretion in deciding whether to pursue a case administratively or in federal court,[4] and statistics bear out the SEC's prediction that it would increasingly turn to ALJs to preside over its cases. In 2013, the SEC filed more than twice as many APs (469) as civil cases (207).[5] Of those 469 cases, it lost only one,[6] compared with its 61 percent win rate in federal court.[7] Given these statistics, and absent unlikely congressional or judicial intervention, practitioners should anticipate that the SEC will more and more frequently avail itself of APs.[8]

Though similar to other in-house federal administrative tribunals, SEC APs differ from federal civil trials in several respects:

- extremely short time—no greater than four months—from charge to trial;
- essentially no depositions and only limited opportunities for other discovery;
- nationwide service of process for hearing subpoenas;
- no trial by jury;
- the Rules of Evidence do not apply;
- appeals of AP rulings are heard by the commission in the first instance; and
- factual findings by the SEC in APs are reversible on appeal only if the findings fail to meet the ''substantial evidence'' test, which, depending on the law of the presiding circuit court, mandates that the court examine the evidence with a ''deferential eye.''

Each of these factors affects how counsel should handle SEC investigations from their inception, long before an AP is filed.

APs are a true ''rocket docket.'' When it makes its charging decision, the commission determines whether a case will proceed on a fast track—no more than four months from charge to trial—a medium track (75 days to trial), or a hyper-speed track that allows defendants only one month to prepare for trial.[9] The timeline for each case is set in the Order Instituting Proceedings (OIP)—which serves as the complaint in an AP. The commission's practice has been to set complex contested cases on the four-month track. These timelines are mandated by regulation, and the commission's timing decision is essentially unreviewable, though in some cases, short continuances have been allowed.[10]

Compounding the challenges facing counsel in preparing for an administrative hearing is the fact that the SEC Rules of Practice allow for minimal discovery. An AP respondent's discovery consists largely—though not exclusively—of the SEC's investigatory file—the documents and testimony the SEC chose to collect during its investigation. Respondents are entitled to open file discovery of ''documents obtained by the Division [of Enforcement's] prior to the institution of proceedings, in connection with the investigation leading to the Division's recommendation to institute proceedings.''[11] This includes transcripts of SEC depositions, but may exclude documents that would identify a confidential source as well as interview material for which there is no official transcript.[12] Nor will the investigatory file include documents over which the SEC claims work-product or deliberative-process protections, which may include the most helpful material for defense counsel.

And depositions generally are out of the question, except where a witness will be unavailable for trial because of, for example, imminent death.[13] As a result, the only pretrial depositions generally will be the testimony collected by the SEC staff during investigatory depositions. This testimony may be relatively one sided, because the company's counsel may not be allowed to attend unless they also represent the witness, and the witness's counsel may ask only narrow, clarifying questions.[14] Meanwhile, witnesses may be subpoenaed na-

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[3] (12 CARE 1772, 12/19/14).

[4] Of course, the Commission's discretion is limited by the U.S. Constitution, though there has yet to be a successful attack on an SEC charging decision. One attempt that appeared promising was truncated when the SEC dropped the AP and charged the defendant in federal court, perhaps avoiding an adverse ruling. See *SEC v. Gupta*, No. 1:11-CV-07566 (S.D.N.Y., filed Oct. 26, 2011).

[5] Sarah N. Lynch, *U.S. SEC beefs up administrative court to meet rising demand*, REUTERS, June 30, 2014, http://in.reuters.com/article/2014/06/30/sec-court-hires-idINL2N0PB18H20140630.

[6] At a recent Practicing Law Institute conference, U.S. District Court for the Southern District of New York Judge Jed Rakoff observed that the SEC was undefeated in APs in the fiscal year ending Sept. 30, 2014, whereas it won only 61 percent of its trials in federal court during the same period. Jed S. Rakoff, PLI Sec. Regulation Inst. Keynote Address: Is the SEC Becoming a Law Unto Itself?, at 7 (Nov. 5, 2014), https://securitiesdiary.files.wordpress.com/2014/11/rakoff-pli-speech.pdf. In 2013, ALJs ruled against the SEC in *In re Ferrer*, Securities Act Release No. 33-9496, (Dec. 13, 2013), and *In re Flannery*, Release No. 438, 102 SEC Docket 1392, (Oct. 28, 2011), but the Commission recently reversed the ALJ's decision in *Flannery* (13 CARE 187, 1/23/15).

[7] Jean Eaglesham, *SEC Is Steering More Trials to Judges it Appoints*, WALL ST. J., Oct. 21, 2014, *available at* http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590.

[8] Until 2011, the SEC employed two ALJs who act as judge and jury in APs. Since then, it has added three additional judges and doubled the size of the judges' support staff. *See* Press Release, *SEC Announces New Hires in the Office of Administrative Law Judges* (June 30, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542202073#.VK6qPCvF9dt; Press Release, *SEC Announces Arrival of New Administrative Law Judge* (Sept. 22, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543014965#.VK6qgivF9dt.

[9] SEC Rule of Practice 360.

[10] See, e.g., *In re* Fortenberry, Release No. 1800, (ALJ Sept. 12, 2014).

[11] SEC Rule of Practice 230.

[12] The Division, however, must produce any statement of any person called or to be called as a witness by the Division that pertains, or is expected to pertain, to his direct testimony and that would be required to be produced pursuant to the Jencks Act. SEC Rule of Practice 231.

[13] SEC Rule of Practice 233.

[14] SEC Enforcement Manual ¶ 3.3.5.2.2 (2013).

   ISSN 2330-6300

tionwide to provide testimony at the hearing.[15] As a result of these two rules—no depositions in APs and nationwide service of process for hearing testimony—it is likely that AP witnesses will tell their complete stories for the first time at the hearing.

Although counsel may petition the ALJ for leave to take third-party discovery,[16] such discovery is within the ALJ's discretion and her ruling is virtually unreviewable. In addition, a respondent might be able to use a document subpoena to seek production of documents prepared by the commission staff that are not part of the investigative file.[17]

The unhappy result of all this is that while the SEC may have had years to collect documents and take depositions that support its charges, defense counsel have few of these tools at their disposal. The SEC's Director of Enforcement, however, recently defended these rules, pointing out that criminal defendants, too, have little access to pretrial discovery.[18] Of course, criminal defendants are tried under a reasonable doubt standard before juries of their peers, and while the SEC enforcement staff is ostensibly obliged to turn over exculpatory evidence pursuant to *Brady v. Maryland*, 373 U.S. 83, 87 (1963),[19] ALJs may take a more restrictive view of what is considered ''exculpatory'' than the standard applied in federal district court.[20]

At the hearing, SEC ALJs enjoy extremely broad discretion to admit evidence they believe useful and to exclude evidence they find unhelpful or cumulative: ''The Commission or the hearing officer may receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial, or unduly repetitious.''[21] The Federal Rules of Evidence do not apply. Hearsay or other questionable evidence may be admissible if the ALJ deems it relevant.[22] Other evidence that counsel may seek to admit to place conduct in context may be excluded.

If the deck were not sufficiently stacked in the commission's favor, it has another card to play in the rare event that it loses an AP: the commission itself is the appeals court of first resort. Never mind that just a few months prior, the commission had made the charging decision. As generally is the case with administrative proceedings before other federal agencies, the commission hears AP appeals *de novo* and is not required to give deference to the ALJ who observed all of the witnesses first hand. The commission's ruling on appeal may itself be appealed to the federal circuit court of appeals for the circuit in which the defendant resides or has its principal place of business, or to the U.S. Court of Appeals for the District of Columbia.[23] Appeals of APs to federal circuit courts are considered according the standards applicable under the Administrative Procedures Act: the commission's ruling typically will be overturned only if it is '' 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law,' 5 U.S.C. § 706(2)'' or not supported by substantial evidence.[24] Thus, no person outside the SEC reviews the evidence *de novo* to determine if it supports a finding against the respondent.

The landscape is indeed bleak for defendants, but a timely and well-prepared response to an SEC investigation can enable defense counsel to position the client for the best possible resolution. Of critical importance, the brief time allowed between charge and the hearing requires counsel to begin preparing for trial from the start of an SEC investigation by taking the following steps.

1) First, Do No Harm

A company that learns it is the subject of an SEC investigation can become its own worst enemy if it heeds the wrong instincts. For example, hasty, superficial investigations followed by overblown denials can make matters worse. They not only can be viewed by the SEC as indications that the company does not take its concerns seriously, they also can become the subject of a broadening investigation if they are viewed as doubling down on already suspect disclosures to investors. Either way, they can become a roadblock to avoiding charges, winning at trial or obtaining an acceptable resolution at the time when every action the company takes should be designed to resolve the investigation as favorably, quickly and narrowly as possible.

2) Treat Whistle-Blowers (and Potential Whistle-Blowers) Appropriately

Whatever temptations there may be to the contrary, a company cannot react to an SEC investigation by precipitously punishing employees it suspects of cooperating with the government. Such employees may be protected whistle-blowers, and retaliating against them—even with a business justification—can be harshly punished. Great care should be applied in dealing with all employees potentially involved in the events underlying an investigation. Of course, good corporate governance practices must be followed and the time may come when their conduct should be addressed, but that decision should be made with the benefit of a well-developed record and in a manner that is mindful of the protections afforded whistle-blowers, not as a knee-jerk reaction to the SEC's investigation.

Again, caution is essential. Flexing powers granted it under Dodd-Frank, the SEC's whistle-blower protection office has gone hunting for companies (and specifically

[15] *See* 15 U.S.C. § 78u(b) (2012).

[16] SEC Rule of Practice 232.

[17] *See* Rules of Practice, Exchange Act Release No. 34-35833, 60 Fed. Reg. 32,738, 32,741 (June 23, 1995) (''Rule 230 is not the exclusive means by which a respondent may obtain access to documents. Production of documents prepared by the staff . . . may be sought by subpoena or through other procedures.'').

[18] Andrew Ceresney, Director, SEC Division of Enforcement, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 21, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543515297.

[19] SEC Rule of Practice 230.

[20] See, e.g., *In re* Bridge, Securities Act Release No. 33-9068, at *20–21 & n.89 (Sept. 29, 2009).

[21] SEC Rule of Practice 320.

[22] See, e.g., *In re* Malouf, Release No. 1831 (ALJ Sept. 23, 2014) (admitting prior sworn testimony), *available at* https://www.sec.gov/alj/aljorders/2014/ap-1831.pdf; *In re* Abbondante, Exchange Act Release No. 34-53066, at *7 (Jan. 6, 2006) (stating that the SEC is not ''bound by rules of evidence and may rely upon hearsay evidence under appropriate circumstances''); *In re Arouh*, Exchange Act Release No. 34-62898, at *11 (Sept. 13, 2010).

[23] 15 U.S.C. § 78y(a)(1).

[24] *VanCook v. SEC*, 653 F.3d 130, 137 (2d Cir. 2011); *Canady v. SEC*, 230 F.3d 362, 364 (D.C. Cir. 2000).

company counsel) whom it thinks are interfering with whistle-blowers. According to Sean McKessy, the Chief of the SEC's Office of the Whistleblower, his office is:

> actively looking for examples of confidentiality agreements, separates agreements, employee agreements that . . . in substance say as a prerequisite to get this benefit you agree you're not going to come to the commission or you're not going to report anything to a regulator. . . . And if we find that kind of language, not only are we going to go to the companies, we are going to go after the lawyers who drafted it . . . [W]e are actively looking for examples of that.[25]

Indeed, at least one public company reportedly is under investigation for routine confidentiality agreements with employees who were involved in an internal investigation.[26] Under Dodd-Frank, whistle-blowers stand to make millions—awards can be up to 30 percent for cases that yield monetary sanctions greater than $1 million[27]—so companies should expect more and more employees and contractors to seek whistle-blower status. Even before an investigation begins, companies should be planning how *not* to be the example the Whistleblower Protection Office is looking for.

3) Make Separate Counsel Available to Key Current and Former Employees

Under the indemnification practices of many companies, officers and employees are entitled to indemnification, which includes reasonable provisions for legal fees for personal counsel. The company should consider seriously any legitimate request for counsel. Making independent counsel available to key individuals serves several important purposes. Critically, it communicates to individuals that their interests are being protected. It also gives them a confidant with whom they can candidly share concerns—and have questions answered in a privileged manner. In conjunction with an appropriate common interest or joint defense agreement, providing potential witnesses with counsel also opens up an avenue for company counsel to gain a better understanding of the nature, scope, and direction of the SEC's investigation. Separate representations of employees also avoids the potential substantive and ethical traps that arise when a company's and a jointly-represented individual's interests diverge.[28]

Care must be taken not to appear to be providing counsel simply for the purpose of preventing an adversary from interviewing employees,[29] and the SEC is keenly concerned about companies actively dissuading employees from becoming whistle-blowers. However, that risk is mitigated by the SEC's ability to subpoena employees for investigative depositions, irrespective of whether they are represented by counsel.

4) Become the Authority on the Facts

Command of the relevant facts is the best defense, and getting ahead of the SEC's learning curve is the best way to obtain an acceptable resolution. By the time a company learns of an investigation, the SEC probably will have a head start, and it has the ability to take discovery of third parties. Nonetheless, a company that commits itself to the task can get ahead of the SEC's investigation, if for no other reason than it has better access to its people and documents and may have more resources to bring to bear.

A company's first steps should be to identify key personnel and to identify and preserve relevant documents. This usually will be done in conjunction with responding to the SEC's subpoena, but it should go beyond the strict confines of the subpoena. Companies and their counsel love to say that the SEC ''gets it wrong''—yet time and again companies' responses to SEC investigations simply follow the SEC down the wrong path. This prevents a company from building out the proper context that can exonerate itself and its employees. Moreover, passively following the SEC's lead can result, paradoxically and frustratingly, to charges of not sufficiently cooperating with the SEC. Instead, a company should look at the SEC's subpoenas and questions as starting points. Where are they really headed? Do they have erroneous assumptions that we should address? A company that can answer those questions early on can end up addressing the concerns animating the SEC's investigation rather finding itself—at the end of the investigation—trying to convince the SEC that its staff's recommendations are incorrect.

Specific steps a company should take upon learning it is a subject of an SEC investigation include:

a) Identify the key current and former employees likely to have relevant documents or information.
   i. Consider also whether there are outside consultants, attorneys or accountants who might have relevant information. Reach out to them as appropriate to assist your investigation.
   ii. In light of the potentially compressed schedule, begin to collect and organize documents as soon as practical. The SEC's subpoena(s) will offer some guidance, but remember to think outside the subpoena for documents that will be helpful to the company.

b) Institute an appropriate litigation hold. Do not let the SEC add spoliation to its list of concerns.

c) Assess which third parties are potentially relevant to the investigation: Auditors? Consultants? Counsel? Investors? Analysts? Customers?
   i. Who is talking to the SEC already?
   ii. Are there third parties to whom the SEC *should* be talking to get relevant (and exculpatory) facts?
   iii. Does the company have a relationship with a third party that is conducive to cooperation in shaping the company's defense? Can a common interest agreement be entered?

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[25] (12 CARE 322, 3/21/14).

[26] *See* 17 C.F.R. § 240.21F-17 (making it a violation to ''take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement'').

[27] Dodd-Frank Act, § 922 (amending Securities Exchange Act of 1934 to add new section 21F).

[28] See, e.g., *United States v. Stringer*, 521 F.3d 1189 (9th Cir. 2008), *opinion amended and superseded*, 535 F.3d 929 (9th Cir. 2008).

[29] See *Rivera v. Lutheran Med. Ctr.*, 866 N.Y.S.2d 520, 526 (Sup. Ct. Kings Cty. 2008), *aff'd*, 899 N.Y.S.2d 859 (App. Div. 2010).

   ISSN 2330-6300

iv. Be mindful of disclosure and other considerations, including insider trading and confidentiality obligations.

d) To the extent possible, debrief individuals' counsel and collect transcripts of witnesses questioned as part of the SEC's investigation. Although, as discussed above, the SEC will typically be obliged to turn over its investigatory file prior to the AP, including transcripts of SEC depositions, it is often a major advantage to have those transcripts and other information about the SEC's lines of inquiry as soon as possible while the investigation is progressing.

e) Identify and retain consultants and experts.
   i. Because of the expense involved, companies often are tempted to delay getting experts engaged until the last possible moment. This can be pennywise and pound foolish for at least three fundamental reasons:
      i. With the prospect of facing an AP that allows for a maximum of four months between charging and trial, ''the last possible moment'' to hire an expert on a complicated topic is well in advance of being charged. Otherwise, there simply will not be sufficient time to get him or her ready for trial.
      ii. On a more basic level, where an expert will carry a central part of a company's defense, the company's defense needs to be structured around the expert's opinions, including how the company prepares its witnesses and how it responds to each inquiry by the SEC. Waiting until the case already has gelled before engaging experts can severely limit their effectiveness.
      iii. A company, in some cases, should consider disclosing to the SEC that it has retained experts, which conveys both the seriousness with which the company takes the SEC's concerns and the company's commitment to trying the case if necessary.

f) Begin immediately to track the proof you will offer at trial—and what the SEC will need to prove. The company's proof chart is a living document that will be updated continuously up to and through trial, but it is essential to create it at the outset to guide the company's response.
   i. What are the elements of the potential charges?
   ii. What are the elements of any affirmative defenses?
   iii. Which witnesses will testify regarding which facts?
   iv. Which documents will come in through which witnesses?
   v. What are the elements/concepts for which expert testimony is appropriate?
   vi. What third parties will the company need to seek documents from once the AP commences? Because of the short time allowed from charge to trial, third party discovery needs to be fully prepared so it can be served *as soon as possible* once the AP starts.

5) Encourage the SEC to View Your Team as a Resource

For all of the outward bravado, the more experienced SEC Enforcement Division staff often are haunted by its awareness that there are ''known unknowns'' in its investigations—and the nagging concern that there are substantial ''unknown unknowns'' that could undermine the thrust of an investigation. These concerns can provide real opportunities to defense counsel. By working aggressively to gain command of the facts, counsel can spot the holes in the SEC's investigation and, where advantageous, help fill them. This builds trust between the SEC and counsel (and the client), which is essential in shaping and resolving an investigation.

6) Use Resource Asymmetry to Turn Time Pressure to the Client's Advantage

These steps will put a defendant in the best position to win its case if it cannot be settled before trial. But for any defendant facing the prospect of an AP hearing, the ultimate goal is of course to encourage the SEC to settle on favorable terms. To that end, company counsel who have gained command of the facts and earned the trust of the SEC can use time pressure to the company's advantage.

Settlements with the SEC generally are driven by two competing concerns: the commission does not want to end an investigation only to have a hidden fraud reveal itself soon after the settlement, and it does not want to take a weak case to trial, only to suffer an embarrassing loss. Earning the trust of the staff by, among others, evincing comprehensive command of the relevant facts, is key to convincing the SEC there is no soon-to-break scandal lurking in the shadows of the case. And approaching the case in a way that signals unambiguously that the company is ready, willing, and able to take the case to trial and through all appeals plants the seed of fear in the commission's mind: if it tries the case, is it certain to obtain a better result than through settlement? Or does trying the case risk not only losing all or part of the case but also the leverage that the commission's virtually perfect AP record allows it to exert against other defendants?

Defendants can also use the rocket-docket nature of APs to their advantage. As one former SEC attorney explained, once the SEC files its Order Institution Proceedings (the charging document in an AP), the commission is '' 'pretty much locked in,' '' whereas in federal court, ''the agency might have two to three years before it has to head to trial, giving it much more flexibility to adjust its complaint when facts on the ground or in the law changes.'' Therefore, defendants should use their resources and command of the facts to identify and exploit gaps in the SEC's legal or factual theories.

Conclusion

APs will be a central feature of the SEC's arsenal for the foreseeable future. They unquestionably entail substantial challenges for respondents and their counsel, but they also can provide opportunities to resolve SEC matters quickly and at a more reasonable cost.