

Winter 2015, Vol. 5 No. 2

Investigations by the U.S. Securities and Exchange Commission

By John S. Durrant, Adam M. Reich, and Neil J. Schumacher – March 12, 2015

The U.S. Securities and Exchange Commission (SEC) [strives to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation](#). To accomplish its mandate, the SEC investigates publicly traded companies and associated individuals suspected of violating federal securities laws. These investigations often lead to enforcement proceedings, with the SEC bringing “[hundreds of civil enforcement actions against individuals and companies](#)” annually.

The Decision Makers

The SEC is led by five commissioners—Luis A. Aguilar, Daniel M. Gallagher, Michael S. Piwowar, Kara M. Stein, and Chair Mary Jo White—appointed by the president of the United States with the advice and consent of the U.S. Senate. SEC staff [must seek](#) consent from the commission, which acts through a majority vote, for certain key actions, including whether to bring a case or to assess a penalty. Although recent reforms have delegated more responsibility to the staff for case management, the commission continues to provide oversight and serves as a de facto appeals court for decisions made by the SEC’s administrative-law judges.

Agency Organization

The SEC’s functional responsibilities are organized into 5 divisions, across 23 offices:

Enforcement. Recommends the commencement of investigations of securities-law violations; recommends whether to bring civil actions, administrative proceedings, and criminal actions; obtains evidence of possible securities violations; and conducts private investigations.

Corporation Finance. Focuses on disclosure issues with public companies, reviewing publicly filed documents and offering guidance to registrants, prospective registrants, and the public, including through no-action letters (i.e., advisory letters indicating whether Corporation Finance would recommend that the SEC take action against a company if it acted in a certain manner).

Trading and Markets. Oversees major securities-market participants and the Securities Investor Protection Corporation (SIPC), and also assists the SEC in establishing rules and interpreting matters impacting operations of the securities markets.

Investment Management. Oversees and regulates the investment-management industry (e.g., mutual funds, fund managers, analysts, and investment advisors), responds to non-action requests, and assists the SEC with enforcement matters relating to investment companies and advisors, including interpreting laws and regulations.

Economic and Risk Analysis. Interacts with nearly every division and office, and provides economic and risk analyses to help inform agency policymaking, rulemaking, enforcement, examinations, and litigation.

SEC personnel working in these divisions may be located in any of the agency's 23 offices throughout the country. The cross-office nature of these divisions is significant because it may prevent you or your client from identifying where the investigation is based, sponsored, or supported. In addition, any of the divisions may play a prominent role in an enforcement investigation, [not just the Division of Enforcement](#).

Origin of an SEC Investigation

An SEC investigation may be prompted by several occurrences. SEC staff may, and often do, recommend an investigation without prompting by external sources. However, numerous external sources may provide information directly to the SEC, which prompts an investigation. As substantial awards are sometimes available to whistleblowers who provide original information to assist an SEC investigation, this has created something of a cottage industry for opportunistic plaintiff-side attorneys assisting whistleblowers' efforts to recover an award. Apart from whistleblowers, other external sources of information for SEC investigations include:

- securities violators or those under investigation who self-report or implicate others in the course of an investigation;
- U.S. Department of Justice and other law-enforcement agencies;
- self-regulatory organizations involved in the public markets, including the New York Stock Exchange and the Financial Industry Regulatory Authority;
- Public Company Accounting Oversight Board;
- Congress;
- state securities regulators; and
- private attorneys.

Five Stages to an SEC Investigation

An SEC investigation can be divided into five stages: (1) Matter Under Inquiry (MUI); (2) formal order of investigation; (3) investigation; (4) Wells stage; and (5) enforcement actions.

MUI. At the first stage, the SEC staff evaluates whether a formal investigation is warranted. Essentially, at this point, the SEC conducts an investigation through informal requests for information without any formal order or subpoena power. Though the lack of these powers technically leaves compliance voluntary at this stage of an investigation, it is generally not advisable to ignore informal requests. For internal SEC administrative purposes, [the MUI stage automatically converts to an investigation after 60 days](#).

Formal order of investigation. Rule 5(a) of the SEC's Informal and Other Procedures gives the SEC discretionary authority to "make such formal investigations and authorize the use of processes as it deems necessary to determine whether any person has violated, or is violating, or is about to violate any provision of the federal securities laws or the rules of a self-regulatory organization of which the person is a member or participant." 17 C.F.R. § 202.5(a). Generally, investigations at this stage are nonpublic, but the formal order may provide for public disclosure. A formal order of investigation, based on a delegation of authority by the five-member commission, may be issued by senior officers of the Enforcement Division, including the director, deputy director, chief counsel, chief litigation counsel, and all supervisors responsible for enforcement matters at or above the level of associate director or associate regional director. SEC Enforcement Manual § 4.1.3. The showing required for this order to issue is minimal. Upon issuance, certain SEC staff members are delegated to act as officers of the commission for investigative purposes, and they may administer oaths and compel testimony. A formal order of investigation also permits delegated SEC staff to issue administrative subpoenas.

Lawyers retained by companies or individuals who have received a formal order of investigation may affirmatively request that the SEC provide a copy of the formal order. However, these orders are generally vague and often provide little information of value to defense counsel.

Investigation. During the investigation stage, SEC staff will issue subpoenas for testimony and documents. While these subpoenas are not self-enforcing, the SEC may apply to federal court for an order compelling subpoena compliance. To prevail upon a federal court to enforce a subpoena, the SEC must demonstrate four things: (1) a legitimate purpose for the investigation; (2) that the particular inquiry at issue may be relevant to that purpose; (3) that the SEC does not already possess the information sought; and (4) that all required administrative steps have been followed.

If your client is being investigated by the SEC, there are several things to consider:

- **With respect to subpoena itself:** You may have the opportunity to negotiate the scope of the subpoena, so as to avoid an undue burden. In addition, witnesses may have the right to invoke the Fifth Amendment privilege against self-incrimination. However, invoking this right may have adverse consequences, including the filing of charges by the SEC and adverse inferences in civil proceedings. Lawyers must advise their clients of these risks.
- **With respect to steps to take upon receiving a subpoena:** First, if you have not already done so, you should issue a document-preservation notice (generally, it is best to issue such a notice as soon as you learn about your client being a potential subject of investigation, including at the MUI stage). Second, you should evaluate your client's insurance coverage and, if applicable, issue a notice to the relevant carrier(s). Third, you should identify dependable, cost-effective vendors who can assist with collection of electronically stored information (ESI) and also host a database (e.g., Ringtail) that you and your fellow attorneys may use to evaluate the responsiveness of any collected ESI to the subpoena. Fourth, you should identify custodians and develop search parameters for identifying responsive ESI. Finally, you need to strategize with your client about whether to disclose the investigation to the public and, if so, how to do it. The SEC has never given clear-cut guidance as to when an SEC investigation must be publicly disclosed, e.g., upon receipt of a subpoena or commencement of a civil action, etc.
- **With respect to responding to the subpoena:** First, you must determine with your client whether you are going to provide any response to the subpoena or force the SEC to file a miscellaneous action in federal court. On the one hand, forcing the SEC to file a federal enforcement action will allow you the benefit of a neutral, knowledgeable judge who has the authority to narrow the subpoena. On the other hand, a federal enforcement action could become a public-relations problem for your client, as the SEC's filing may contain damaging or unsupported allegations. Second, if your client decides to respond to the subpoena, your client should consider requesting confidentiality under the Freedom of Information Act (FOIA) to preclude subsequent requests by the media, competitors, or plaintiffs' attorneys. Finally, before responding to any subpoena, it is important that you carefully review the subpoena's requirements for the document production. Failing to comply with the SEC's specific requirements regarding organization of documents and ESI can strain your relationship with the SEC investigators.
- **With respect to cooperating with the investigation:** In many instances, cooperation with an SEC investigation is advisable. There is precedent for persons or entities who have committed securities violations to receive more lenient treatment if they cooperate substantively and meaningfully. While some evidence suggests that the benefits of cooperation are difficult to quantify, the SEC has stepped up its [Cooperation Initiative](#) in recent years. Your client's cooperation ensures eligibility for alternative, less severe dispositions, including a non-prosecution agreement, a deferred prosecution agreement, a cooperation agreement, or a request for immunity.

In the event that you and/or your client get the sense that an investigation is moving toward the Wells notice stage, there are two primary things to consider. First, your client may want to make a pre-Wells submission to the SEC with the hope that it allays SEC concerns and preempts a Wells notice. Second, to the extent your client has not done so already, your client should evaluate whether to publicly disclose the investigation in advance of the issuance of a Wells notice. Such disclosure may inure to your client's benefit as [studies have found such disclosures to cause on average negative, statistically significant stock price movements](#).

Wells notice stage. Once the investigation has been completed, the SEC may issue a Wells notice to individuals or companies identifying what the SEC believes to be improprieties or infractions. The Wells notice offers investigated parties the opportunity to present evidence countering or explaining away investigations' conclusions, in the hope of avoiding any future enforcement action. See 17 C.F.R. § 202.5(c) ("Upon request, the staff, in its discretion, may advise such persons [involved in preliminary or formal investigations] of the general nature of the investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a staff recommendation to the five-member commission for the commencement of an administrative or injunction proceeding."). Once a Wells notice issues, the SEC has at most 360 days to bring an enforcement action (the Dodd-Frank Act calls for 180 days, but the SEC has discretionary authority to continue this for another 180 days).

If your client receives a Wells notice, you should consider requesting access to the testimony of any important witnesses, as well as to documents produced by third parties. In addition, upon receipt of a Wells notice, it is generally advisable to request an in-person meeting with the SEC staff to gather more detail. In the event that the SEC staff is uncooperative with your requests for a meeting or documents, you can emphasize this point in any response provided to a Wells notice.

Enforcement actions. Should the SEC commissioners approve an enforcement action, it may be brought in federal court or as an administrative proceeding before an SEC-employed administrative-law judge. Administrative proceedings generally have the advantage to the SEC of occurring on an expedited basis and before an SEC employee. However, administrative remedies are not self-enforcing and administrative actions provide for only limited discovery. Enforcement actions may result in injunctions and significant financial penalties. In addition, criminal liability may follow for violators of the securities laws.

Conclusion

Securities investigations are complex and may last for years. Companies and individuals operating in public markets under the SEC's purview should be mindful of the formal progression from initiation to conclusion of SEC investigations as this may inform and improve day-to-day practices, investor relations, public relations, and corporate culture.

Keywords: litigation, young lawyer, SEC, securities, investigation, commission, agency, MUI, Wells, enforcement

[John S. Durrant](#) and [Adam M. Reich](#) are with Paul Hastings LLP in Los Angeles, California, and [Neil J. Schumacher](#) is with the firm's Washington, D.C., office.