



PROGRAM MATERIALS

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Representing a Client in an SEC Investigation: The Basics

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Defending SEC Investigations: The Basics

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I. Introduction

- A. The SEC has wide-ranging investigative powers.
- B. At the conclusion its investigations, the SEC can elect to bring an enforcement proceeding.
- C. Regardless of the outcome, any SEC law enforcement investigation can have a significant impact on those who become involved with it.
- D. Representing an individual or a business organization in these proceedings differs from representing witnesses or parties in civil litigation.
- E. To discuss key issues regarding SEC investigations, we will consider:
 - 1. An overview of SEC investigative powers;
 - 2. Defending an SEC investigation;
 - 3. Well submissions;
 - 4. Settlements;
 - 5. Other key considerations; and
 - 6. Conclusions.

II. Investigations: An overview

- A. The SEC is charged by Congress with policing the nation's securities markets. *See, e.g.*, Securities Law Enforcement Remedies Act of 1990, S. Rep. No. 337, 101st Cong., 2nd Sess. 2 (1990); *see also* U.S. SECURITIES AND EXCHANGE COMMISSION, SEC 2002 ANNUAL REPORT 1 (2002), <http://www.sec.gov/pdf/annrepo2/ar02full.pdf> ("The SEC enforcement program seeks to promote the public interest by protecting investors and preserving the integrity and efficiency of the securities markets.")

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- B. SEC enforcement is based on investigations and enforcement actions through which, at times, the Commission defines the law.
 - 1. Investigations, which are grand jury like in nature, are non-public, private and can be informal or formal.
 - 2. Litigation can be either in federal district court or an administrative proceeding.
- C. Traditional areas of emphasis include insider trading, financial fraud, broker dealer regulation and the Foreign Corrupt Practices Act.
- D. Investigative authority
 - 1. SEC has broad investigative powers to investigate potential violations of the federal securities laws and self regulatory organization rules. *See, e.g.* Securities Act, Section 20(a), 15 U.S.C. § 77t(a); Securities Exchange Act of 1934, Section 21(a)(1), 15 U.S.C. § 78u(a)(1); Investment Advisers Act of 1940, Section 209(e), 15 U.S.C. § 78u(a)(1); Investment Advisers Act of 1940, Section 209(e), 15 U.S.C. § 80a-42(a); Public Utility Holding Company Act of 1935, Section 18(a), 15 U.S.C. § 79r(a), Trust Indenture Act of 1939, Section 321(a), 15 U.S.C. § 77uuu(a).
 - a. Under the literal language of the statutes, the Commission is given the authority to investigate past, current or possible violations of the federal securities laws. This power is so broad that it encompasses the power to investigate to determine whether the Commission has the authority to investigate.
 - b. Under these statutes, the SEC's investigative authority which is comparable to that of a grand jury. It is in essence the power of inquisition. *See generally SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984).
 - c. In aid of this authority, the Commission is given the authority to issue subpoenas nationwide to compel the production of documents and require persons to appear before its designated officers and give testimony under oath.
 - d. Commission investigations are private and non-public. The Commission as a matter of policy, generally does not acknowledge if it is conducting an investigation.
 - e. The Commission conducts both formal and informal investigations.

- E. Informal investigations -- an overview.
1. Frequently investigations begin as informal inquiries called a “matter under inquiry.”
 2. In contrast to formal investigations, these are initiated by a staff member in the division of enforcement.
 3. The staff does not have subpoena power and thus any appearance or production of documents is voluntary.
 4. The investigation can be closed by the staff member.
 5. Interviews are conducted in the same manner as during a formal investigation.
 - a. While voluntary, the witness may be under oath.
 - b. The witness is subject to federal perjury laws.
 - c. A transcript will be made.
 - d. The witness will be furnished SEC Form 1662, titled Supplemental Information for Persons Supplying Information Voluntarily or Directed to Supply Information.
 - e. Under Rule 6, Rules Relating to Investigations, a witness may purchase a copy of his or her transcript, but not that of others; this practice is frequently followed during an informal inquiry.
 6. The staff may also request the production of documents.
 7. Any statements made to the staff are subject to 18 U.S.C. § 1001.
 8. It is typically in the interest of the company or individual to try and keep the inquiry informal.
 - a. This requires significant cooperation.
 - b. It affords more control over the investigation.
 - c. It may increase the probability of terminating the investigation without an enforcement action.
 9. Preliminary steps to take when representing a company in an informal inquiry.
 - a. The company may consider an internal investigation.

- b. Gather the relevant information.
 - i. Identify all officers and employees potentially involved.
 - ii. Consider circulating a memo directing the preservation of the relevant materials as discussed below.
 - iii. If the documents are produced, consider requesting confidential treatment under 17 C.F.R. § 200.83(a) as discussed below.
 - c. Establish a press contact.
 - d. Consider whether to disclose the inquiry.
 - e. Persons to notify:
 - i. The directors and board members;
 - ii. D & O Carrier;
 - iii. Outside auditors (but consider Reg. FD on selective disclosure); and
 - iv. Consider contacting persons staff may contact.
10. Conclusion: At the conclusion of the inquiry, the staff has the same options as at the end of a formal investigation (discussed below).

F. Formal investigations

- 1. The formal order of investigation: Formal investigations begin with the Commission issuing a formal order of investigation.
 - a. Typically the order is divided into sections
 - i. The initial section will state that the staff has reported to the Commission facts indicating that there may be violations of the federal securities laws. This section describes the possible violations in very broad terms and cites the statutes and rules involved. It is based on an Action Memorandum prepared by the staff and sent to the Commission requesting that a formal order of investigation be issued.

- ii. Another section designates specific staff members as officers of the Commission for purposes of the investigation. The designated officers are directed to conduct the inquiry and given the authority to issue subpoenas. This represents a delegation by the Commission of its investigative authority under the statutes.
 - iii. The caption of the Order gives some further definition about the nature of the inquiry and the office which originated and will conduct the inquiry.
 - b. The formal order defines the general parameters of the investigation in very broad terms. *See, e.g., SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984).
 - i. The parameters of the Formal Order do not delimit the Commission's authority to bring an enforcement action at the conclusion of the investigation. *See, e.g., SEC v. Blinder, Robinson & Co.*, 681 F. Supp. 1 (D.C. Cir. 1987); *RNR Enters., Inc. v. SEC*, 122 F.3d 93 (2nd Cir. 1997).
 - ii. Some have argued that the scope of the order delimits the scope of subpoenas issued under it. The few courts which have considered this issue have not accepted this theory.
- 2. Obtaining the formal order: Rule 7(a) of the Commission's Rules of Investigations provides for obtaining a copy of the Order: "Any person who is compelled or requested to furnish documentary evidence or testimony at a formal investigative proceeding shall, upon request, be shown the Commission's order of investigation. Copies of formal orders of investigation shall not be furnished, for their retention, to such persons requesting the same except with the express approval . . . of the Division or Divisions conducting or supervising the investigation at the level of Assistant Director or higher. Such approval shall not be given unless the person granting such approval, in his or her discretion, is satisfied that there exists reason consistent both with the protection of privacy...involved in the investigation and with the unimpeded conduct of the investigation."
 - a. Generally, the staff requires that the request be in a letter directed to the Assistant Director supervising the investigation.

- b. Some offices require that the requestor agree not to share a copy of the Order without approval from the staff or represent that it will only be used in connection with the representation of the witness and not to obstruct its investigation.
 - c. It is very unusual for the staff to refuse a request for a copy of the formal order of investigation by a person who has received a subpoena.
 - 3. Practical implications to the issuance of the formal order:
 - a. This may raise disclosure issues for a company.²
 - b. Counsel may have less influence over the inquiry in terms of when witness appear and the scope of document requests.
 - c. Unlike an informal inquiry (discussed above), a formal investigation can only be closure by senior enforcement personal. This may mean that it is more difficult to quickly obtain closure of the investigation.
 - d. Under the Commissions Rules Relating to Investigations, a letter should be issued when the investigation is closed.
 - e. In view of the impact of a formal order, if the matter begins with an informal inquiry, counsel should carefully consider cooperating with that inquiry to try and avoid converting the matter. At the same time, counsel may not be able to avoid having a Formal Order entered.

III. Defending The Investigation

- A. Overview. Defending an informal investigation and a formal investigation requires essentially the same approach.
- B. Informal investigations vs. formal investigations. Frequently, informal inquiries may appear to be nothing more than an "informal chat." They are anything but that. In fact an informal investigation is still a law enforcement investigation. Counsel should vigorously represent the client in both.
- C. SEC subpoenas -- documents

² See section VI (E) *infra*.

1. Frequently the first contact with an SEC investigation is a subpoena for testimony and documents. Typically, the subpoena will request the production of documents described in an attachment at a specified date.
2. The subpoena will be accompanied by SEC Form 1665 which is furnished to all witnesses. That form details a number of routine uses made of information gathered during investigations and the rights of witnesses including those guaranteed under the Constitution.
3. Since the subpoena is issued under a formal order of investigation, counsel should seek a copy of the formal order as discussed above.
4. The subpoena will define the term document in the broadest possible terms. The definition will require the production of the requested information regardless of the form, including paper and electronic.
 - a. Recent court decisions have imposed an obligation on counsel in addition to the producing corporation. *See, e.g., Zubulake v. UBS Warburg LLC*, 229 F.R.D. 422 (S.D.N.Y. 2004) *See also Mosaid Technologies Inc. v. Samsung Electronics Co., Ltd.*, 348 F. Supp. 2d 332 (D.N.J. 2004) (counsel to obligating investigate a client's e-discovery of digital information and review potentially discoverable evidence with the client); *Chan v. Triple 8 Palace, Inc.*, No. 03-6048, 2005 WL 1925579 (S.D.N.Y. Aug. 11, 2005).
 - b. The production of electronic documents can present particular challenges. Counsel should consider retaining an expert in this area to assist with the production.
5. SEC subpoenas are not self-executing. This means that, although the subpoena is written in the form of a directive to comply, in fact the SEC must go to court to enforce its subpoenas if the recipient chooses not to comply. *But see*, 15 U.S.C. § 78u(c)(unjustified failure or refusal to produce is a misdemeanor).
6. Retention: Immediately on receipt of the subpoena, steps should be taken to preserve the relevant materials. If the recipient is a business organization, counsel should consider circulating a written memorandum which designates which materials must be preserved.
 - a. Even before the receipt of a subpoena, the individual or organization may have an obligation to preserve the relevant documents under certain circumstances.

Generally, if the person has reason to know that the materials may be relevant to a future claim, there may be an obligation to preserve the materials. *Zubulake v. UBS Warburg LLC*, 220F.R.D. 212 (S.D.N.Y. 2003) (“[A]nyone who anticipates being a party...to a lawsuit must not destroy unique, relevant evidence that might be useful to an adversary.” The court said that the party must preserve “What it knows...is reasonably calculated to lead to the discovery of admissible evidence.”).

- b. There are stiff penalties for failing to comply with an SEC subpoena.
 - i. Section 802 of Sarbanes Oxley for example imposes stiff penalties for anyone who "knowingly alters, destroy, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States . . . or in relation to or contemplation of any such matter." 18 U.S.C. § 1519 (2002).
 - ii. 18 U.S.C. § 1512, also from the Sarbanes Oxley Act prohibits authorizes the punishment of any person who "corruptly alters, destroy, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in any official proceedings; or otherwise obstruct, influences, or impedes any official proceeding, or attempts to do so."
7. Scope of production: Frequently, document requests ask for the production of broad categories of documents for a specific time period. There may be a variety of reasons for the broad categories. Those may range from an effort to ensure that all possible materials are preserved to a lack of knowledge on the part of the staff to specifically what is available.
 - a. Limits: As noted above, the request will seek materials in all forms, including electronic documents. While the Federal Rules of Civil Procedure have recently imposed certain limits and procedures on the production of these materials in view of the costs and burdens involved, those limitations do not apply to Commission subpoenas. Fed. R.

Civ. P. 26. Indeed, the SEC has imposed sanctions on persons for failing to produce electronic documents. *See, e.g., SEC v. Lucent Technologies, Inc.*, Litig. Rel. No. 18175 (May 17, 2004) (imposing a \$25 million fine in part for an incomplete document production). *In the Matter of vFinance Investments, Inc., et al.*, Admin. Proc. File No. 3-12918 (Jan. 3, 2008)(instituting cease and desist proceedings for failure to produce all relevant documents); *SEC v. Morgan Stanley & Co., Inc.*, No. 06-882 (D.D.C. filed May 10, 2006) (SEC and Morgan Stanley settled for \$15 million regarding claims that the company failed to timely produce documents during SEC investigations.

- b. Narrowing the scope: It may be advisable to discuss the scope of the production with the staff in an effort to focus and narrow the categories. In attempting to narrow the categories, counsel should consider narrowing the time period or definition of the categories.
 - c. Time limits: Generally, the staff will consider reasonable requests for extensions. One approach that it frequently used is the so-called "rolling production." This approach is frequently used for large productions. Under this approach, the materials are produced in groups or waves over a period of time. This eases the burden on the party making the production, while permitting the staff to begin reviewing the materials. If an extension is arranged, it is typically advisable to reflect that matter in a letter.
8. Privilege: Privilege documents need not be produced.
- a. Privilege log: If privileged documents are withheld from production a log of the withheld materials should be prepared and furnished to the staff.
 - b. Exceptions: There may be certain circumstances under which a business organization chooses to produce privileged materials. It may be important for the organization to produce privileged materials to establish a defense or a critical point explaining the conduct. In some instances privileged material may be produced as part of the person's cooperation with the inquiry as discussed below.
9. Confidential treatment: Materials furnished to the SEC may be subject to production under the Freedom of Information Act, 5

U.S.C. § 552. The producing party has a right to object to such a request.

- a. Rule 83, Rules on Information and Requests governs requests for an exemption.
 - b. The request must be made at the time of the production to the staff attorney to whom the production is made. A copy must be sent to the SEC's FOIA officer who will review it.
 - c. Each document for which confidential treatment is sought must state that "Confidential Treatment Requested by [insert name of requestor]." In addition each document must bear an identifying number and code such as a bates stamped number. 17 C.F.R. § 200.83(c)(1).
 - d. Confidential treatment requests expire in ten years. 17 C.F.R. § 200.83(c)(7).
10. Index: At the time the documents are produced they should be accompanied by an index.
11. Information requests: Frequently the staff will request the production of summaries, chronologies or similar document compilations.
- a. The staff does not have any authority to compel the preparation of documents.
 - b. Counsel should carefully consider these requests. In some instances it may be advantageous to prepare specialized materials for the staff on key issues. This provides counsel an opportunity to clarify certain matters and perhaps resolve issues.
 - c. Any specialized material may however be an admission by the persons and admissible in court at a later point. *See, e.g., SEC v. First City Fin. Corp.*, 890 F.2d 1215 (D.C. Cir. 1989)(chronology submitted to SEC is admissible).
- D. SEC subpoenas -- testimony
1. Authority: The SEC has the authority as discussed above to compel persons to appear for testimony.
 - a. Location: Typically, the testimony is in the city where the staff is located. In some instances however, the location may have been selected because there is a parallel criminal

investigation.³ In some instances the staff may be amenable to moving the testimony to a location which is more convenient for the witness.

- b. Time: The subpoena will specify the time for the testimony. The staff is usually responsive to reasonable requests to reschedule the testimony. If an accommodation cannot be reached counsel should consider requesting a conference with the staff attorney's supervisor (typically a branch chief) to try and resolve the impasse.

2. Procedure:

a. Persons who can attend

- i. Rule 7(c) of the Commissions Rules of Practice, 17 C.F.R. § 203.7(c) provides that the witness has a right to be represented by counsel.
- ii. The Commission's rules relating to investigations prohibit anyone from attending the testimony other than the staff, the witness and counsel for the witness. 17 C.F.R. § 203.7(b). Typically, at the beginning of the testimony the staff will ask the witness if he or she is represented by counsel. Counsel will then be asked to identify himself or herself for the record and the capacity in which he or she is representing the witness.⁴
- iii. In some instances, it may be advisable to have an expert such as accountant available to assist the witness. This is not provided for however in the Commissions Rules of Practice. *See, SEC v. Whitman*, 613 F. Supp. 48 (D.D.C. 1985) (denying SEC request to enforce subpoena where witnesses refused to testify unless an accountant was allowed to attend and assist the them).

b. Preliminary statements:

³ See Section VI (B) *infra* regarding parallel proceedings.

⁴ In limited instances where counsel is representing multiple witnesses, the staff may try to invoke it sequestration rule to exclude counsel. Rule 7(b), Rules Relating To Investigations, 17 C.F.R. § 203.7(b). *But see, SEC v. Csapo*, 533 F.2d 7, 11 (D.C. Cir. 1976)(requiring SEC to produce "concrete evidence" that the presence of the attorney would be obstructive); *SEC v. Higashi*, 359 F.2d 550 (9th Cir. 1966)(rule not enforceable where witness would be deprived of the attorney most familiar with important issues to witness).

- i. The staff will commence the proceeding by identifying themselves and asking the witness and counsel to identify themselves. The staff will furnish the witness with a copy of the formal order of investigation for review during the testimony. A copy of Form 1662 which sets forth the routine uses made of material collected during an investigation will also be made available for the witness to review. These documents cannot be removed from the testimony room or copied.
 - ii. Some counsel make a request for confidential treatment following the introduction of Form 1662. If this practice is followed, the formal procedures outlined above should also be used. Some practitioners also take this opportunity to request the opportunity to submit a Wells submission if the staff later decides to make an enforcement recommendation.⁵ Others object to the routine uses made of information as outlined in Form 1662. In that instance, the staff will note that the Form represents the position of the Commission.
- c. The testimony:
- i. Rule 7(c) of the SEC's Rules of Investigations specify the role of counsel during testimony: Counsel may "(1) advise such person before, during and after the conclusion of such examination, (2) question such person briefly at the conclusion of the examination to clarify any of the answers such person has given, and (3) make summary notes during such examination solely for the use of such person." 17 C.F.R. § 203.7(c).
 - ii. Frequently however the staff will permit counsel to make clarifying comments regarding a question or ask a relevant question to clarify a matter. Counsel should take care not to interfere or impede the testimony, however.
 - iii. Typically, the staff will permit counsel to clarify or correct a matter at a later point in the testimony when necessary.

⁵ See Section IV *infra* discussing Wells submissions.

- iv. The Federal Rules of Evidence do not apply to SEC testimony. Thus evidentiary objections generally are unnecessary and inappropriate. Objections on the basis of privilege are however appropriate and should be made. In certain instances, other objections may be necessary if, for example, the testimony becomes overly repetitious or contentious.
- 3. Obtaining a transcript: Rule 6 of the Commission's Rules relating to Investigations provides that a witness may request the opportunity to purchase a copy of the transcript. At the same time, the Commission reserves the right to deny a request for a transcript.
 - a. Typically, requests to purchase a transcript are not denied.
 - b. In some instances, counsel may chose not to purchase a copy of the transcript. If, for example, there is parallel civil litigation if the witness has obtained a copy it may be subject to production in that action. Courts have however, ordered the production of SEC transcripts even where the witness elected not to purchase it based on the theory that it is under his or her control. *See, e.g., In re Woolworth Corp. Sec. Litig.*, 166 F.R.D. 311 (S.D.N.Y. 1996); *but see SEC v. Doody*, 186 F. Supp. 2d 379 (S.D.N.Y. 2002)(production of SEC transcripts and investigative materials denied when U.S. Attorney conducting a parallel inquiry intervened and opposed the request).
- 4. Fees and expenses: Under the Commission's Rules of Practice, witnesses are entitled to be paid the same fees and mileage that would be paid to a witness in any court of the United States. 17 C.F.R. §§ 2001.100-201.900. At the conclusion of the testimony, counsel should submit SEC Form 1712 on behalf of the witness to claim witness fees and expenses. These fees are only for the witness.
- 5. Representing the witness -- practical considerations:
 - a. Time: Although the staff typically will not agree to a time limit, prior to the testimony it is typically advantageous to try and ascertain the proposed length of the testimony and try to obtain some understanding of its contemplated length.

- b. Notice: Unlike grand jury proceedings, there are no official "targets" or "subjects" in SEC investigations. There is no right to notice as to other persons who have been or will be subpoenaed to produce documents or testify. *See SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984).
- c. Preparing the witness to appear differs significantly from preparing to give a deposition in civil litigation. In a Commission investigation, there is no complaint or other pleadings to frame the issues. The time limitations regarding depositions in the Federal Civil Rules do not apply. Nor do the Federal Rules of Evidence.
 - i. Counsel should begin by carefully studying the formal order of investigation, the subpoena and the request for documents and any other information about the investigation that can be obtained to identify the issues and potential lines of questions that may be asked.
 - ii. The witness should be informed of Commission procedures regarding the taking of testimony so that they are prepared for how it will proceed.
 - iii. Counsel should carefully gather and analyze as many documents as possible relating to the transactions which appear to be under examination. Counsel should be prepared for the fact that there may be significant limitations in obtaining materials. Many companies limit the amount of material made available to witnesses as part of their efforts to cooperate with the SEC or if there is a parallel criminal case, the Department of Justice.⁶ This can severely impede the ability of counsel to gather materials to be used in preparation of the witness. Based on all the information assembled, potential lines of inquiry should be reviewed with the witness.
 - iv. During the preparation process, the witness should not be shown materials that were not furnished to the Commission. This could result in a request for those materials.

⁶ *See* Section VI (C) *infra* regarding cooperation.

- v. Witnesses should be cautioned that in Commission testimony the appearance of the witness is often as important as what is said. The investigation is a fact-finding inquiry and the demeanor and credibility of the witness is often critical. Accordingly the witness should take care about the type of impression made on Commission investigators.
 - vi. In responding to questions, the witness should be cautioned to tell the truth; to be sure to clarify unclear questions; to avoid answering compound questions; not to guess or speculate (even when investigators encourage it) and to try and appear helpful and cooperative. In addition, the witness should feel free to consult with counsel as necessary.
 - vii. During the testimony, the witness can decline to testify based on privilege. Those include the attorney client privilege and the work product doctrine. In addition the witness may decline to testify based on the Fifth Amendment to the U.S. Constitution.⁷
- d. Background questionnaires: Prior to the testimony, the staff will frequently request that the witness fill out a questionnaire. It is typically sent to counsel.
- i. The questionnaire is designed to provide the staff with basic information such as name, address, phone numbers, bank account numbers and similar material.
 - ii. The questionnaire is designed to facilitate the testimony by eliminating the need to spend testimony time on routine matters. Counsel and the witness should take care to accurately fill out the questionnaire.
 - iii. Typically, at the beginning of the testimony, the questionnaire will be marked as an exhibit. The witness will be asked if the information in the questionnaire is accurate and complete. Generally,

⁷ See Section VI (B) *infra* regarding Commission policies.

the staff does not review all of the information in the questionnaire during the testimony.

- e. During the testimony, it is critical that the witness define in the answer what he or she is responding to.
 - i. At times the questions may not be entirely clear and may be compound. The witness should be prepared to remedy this situation by requesting that the question be clarified and simplified.
 - ii. The witness should also define in the opening sentence of his or her answer precisely what is being responded to.
 - iii. At times, counsel may want to request that the question be clarified or simplified, but care must be taken not to interfere with the testimony. Generally, counsel will want to try and ensure that the record is clear.
 - iv. At times, counsel may want to inject objections although again care should be taken not to interfere with the testimony. It may be necessary for example to either object or clarify the question to ensure that it does not call for privileged material. At other times, it may be necessary to object if there is undo repetition. Frequently, it may be more productive to try and clarify the question rather than formally object. Objections to relevance, arguing that the subject matter is outside the scope of the formal order generally are not productive and may be counter productive since they can lead to an amendment to the Order, broadening the investigation.
 - v. If the witness gives an incomplete or inaccurate answer or later recalls facts which alter a previously given answer, counsel should discuss the point with the client. When the testimony resumes, counsel should request an opportunity to clarify or correct the prior answer. Typically, the staff is amenable to such requests. It is frequently beneficial to alert the staff prior to ending the break in the testimony that a request to clarify or correct a prior answer will be made once the testimony resumes. *Cf. Fletcher v. Hook*, 446 F.2d 14 (3d Cir. 1971) (affirming

dismissal of perjury charge where the answer was corrected during the testimony session).

- vi. During the testimony, much of the questioning may be based on documents the staff has gathered. Frequently, the staff will review a number of subjects without the documents and then return to the same subjects later and mark the documents as exhibits.
 - (a) The witness should take care to request an opportunity to review a document if it appears that the questioning is based on one. If the staff declines to produce it, the witness should take care to qualify his or her answer appropriately.
 - (b) When the staff bases questions directly on a document, it is typically marked as an exhibit.
 - (c) The staff will not as a matter of policy permit the witness or counsel to take a document out of the testimony room. Counsel may however take notes about the documents used. Counsel should make sure to make a note of the bates or other identifying number on the document. This will frequently aid in assessing the scope of the inquiry.

- f. Conclusion: At the end of the testimony, the staff will offer counsel the opportunity to ask any clarifying questions. The witness will also be offered an opportunity to make any statement he or she deems appropriate.
 - i. If counsel has taken care to clarify the questions and answers during the testimony the opportunity should be declined.
 - ii. In rare instances there may be some points which counsel may want to clarify, but only if a break is taken and the witness is alerted to what questions will be asked so that the answers are clear and concise.

- iii. Generally, the witness should be encouraged to decline the opportunity. This is particularly true if there is a parallel criminal inquiry.⁸

IV. Wells Submissions

- A. Procedure: At the conclusion of an investigation the enforcement staff will prepare a recommendation to the Commission regarding a proposed enforcement action. The recommendation will be detailed in an Action Memorandum which will provide the Commission with a summary of the relevant facts, an analysis of the proposed charges and detect the liability of the proposed defendants.
- B. Wells submissions: Prior to submitting its recommendation to the Commission, the staff may give the proposed defendant an opportunity to submit a so-called, "Wells submission," named for former Commissioner John A. Wells who chaired the Advisory Committee on Enforcement Policies and Practices in 1972 which proposed the practice.
 - 1. The Commission has not enacted a rule regarding Wells submissions. Rather, they are discussed in Securities Act Release No. 5310. Under that Release, there is no right to make a Wells submission. The process is discretionary because, as the Release notes: "the adoption of formal requirements could seriously limit the scope and timeliness of its possible action and inappropriately inject into actions it brings issues, irrelevant to the merits of such proceedings, with respect to whether or not the defendant or respondent has been afforded an opportunity to be heard prior to the institution of proceedings against him and the nature and extent of such opportunity."
 - 2. Under Rule 5 relating to Informal and Other Procedures of the Commission, the issue of whether a witness is given an opportunity to make a Wells submission is a matter of discretion. If one is submitted however, the staff must transmit it to the Commission with its enforcement recommendation: "Persons who become involved in preliminary or formal investigations may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation. Upon request, the staff, in its discretion, may advise such persons of the general nature of the investigation, including the indicated violations as they pertain to

⁸ If there is a parallel criminal inquiry and the key question is whether the staff believes the witness engaged in illegal conduct, a denial by the client will not aid the situation. To the contrary, if the staff does not believe the witness and criminal charges are brought the denial by the witness will enhance the criminal case because DOJ prosecutors will use the denial as the basis for charges of making a false statement and obstructing an agency investigation.

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 Commission for the commencement of an administrative or injunctive proceeding. . . In the event a recommendation for the commencement of an enforcement proceeding is presented by the staff, any submissions by interested persons will be forwarded to the Commission in conjunction with the staff memorandum.” 17 C.F.R. § 205.5(c).

3. Accordingly, there is no right to make a submission. *See generally, Wellman v. Dickinson*, 79 F.R.D. 341 (S.D.N.Y. 1978)(no right to a Wells submission). However, once it is submitted, the staff must transmit it to the Commission.
4. The Wells submission can be a written presentation or a video tape.
5. Issuing the notice:
 - a. Typically, the staff sends a letter to counsel noting that they are considering making an enforcement recommendation in the investigation. The letter will usually designate the statutory sections alleged to have been violated and briefly outline the conduct. It will also identify the remedies being sought. It will advise counsel that a Wells submission can be submitted and provide a due date.
 - b. Frequently, the staff will telephone counsel prior to or at the time of sending the letter. The telephone call gives counsel an opportunity to try and clarify the basis for the staff recommendation.⁹
 - c. The level of detail provided about the proposed recommendation varies among the offices and staff members. It may be advisable to request a meeting to discuss the matter with the staff to try and obtain additional detail or clarify issues before making a decision on whether to make a Wells submission.

⁹ If the witness declined to testify based on his or her Fifth Amendment privilege the staff, as a matter of policy, will provide little detail regarding the proposed action. Frequently, the staff will give only the statutory sections alleged to have been violated, the remedies sought and a very general statement about the nature of the action. While the staff may meet with counsel to discuss the matter, typically they will not provide any additional detail in those meetings. *See* Section VI (B) *infra* regarding parallel proceedings.

- C. The decision to make a submission:
1. Collateral consequences: In deciding whether to make a submission, counsel should carefully consider the consequences.
 2. The Commission takes the position in Release 5310 that any Wells submission is an admission by the person making the submission and may be offered in any subsequent enforcement proceeding. If the submission is labeled as "privileged" it may be returned. Some practitioners note in the submission that it is only being made for settlement purposes.
 3. If there is a parallel criminal case, counsel should consider the fact that the submission may be transmitted along with the Commission's files to the U.S. Attorney's office conducting the parallel criminal inquiry.
 4. Any submission may be discoverable in civil litigation. *See e.g., Salomon Bros. Treasury Litig. v. Steinhardt Partners, L.P.* 9 F.3d 230, 236 (2nd Cir. 1993)(requiring production in subsequent litigation); *Champion Parts Rebuilders, Inc. v. Cormier Corp.*, No. 86-8906, 1987 WL 19149 (N.D. Ill. Oct. 26, 1987)(same).
 5. The submission may also be discoverable under an FOIA request. *See, e.g., In re Occidental Petroleum Corp.*, SEC FOIA Release No. 70, 1986 SEC LEXIS 107 (Dec. 19, 1986).
- D. Preparing a submission: Release 5310 states that any submission should focus on legal and policy issues and not the facts.
1. Factual issues: Many enforcement actions are keyed to the facts. If there are important factual arguments to be made, counsel should not hesitate to present them. This is particularly true where there are facts that the staff may not have fully considered or perhaps misinterpreted.
 - a. In making factual arguments, counsel should take care to ensure that factual statements are closely tied to the documents, testimony or another reliable source. Speculation, conjecture and overstatement will undercut the credibility of the submission. This is particularly true since the staff typically has access to a substantial body of factual material to which counsel will not have access. This point should be carefully considered in making any factual arguments. Counsel should also carefully consider the impact of denying facts which are well established by the investigative record. *See, e.g., In re Sloate*, Admin. Proc. File No. 3-8232, 1994 WL 263413 (June 6, 1994)(denials

of facts established during the proceeding considered in determining the severity of the sanction).

- b. Factual arguments may focus on the good faith of the client, a lack of scienter, a reliance on the advice of an expert advisor or a similar matter.
 - c. The arguments may also focus on remedial actions taken by the client which might mitigate liability.
 - d. Where the client is a secondary actor, counsel should carefully assess the situation. Secondary liability issues can be very thorny and are typically carefully considered by the staff and Commission. Counsel should carefully assess the role of the client in this regard.
 - e. Professionals: Where the client is a professional, such as an auditor or attorney, counsel should carefully assess the role of the client in the matter. If the client was acting in the role of a professional, this should be emphasized. The Commission traditionally takes great care in assessing the role of a professional in a proposed enforcement action.
2. Legal and policy issues: According to Release 5310, Wells submissions which are most effective focus on legal and policy issues.
- a. Key legal issues regarding the proposed charges should be carefully assessed. If an important legal issue regarding the charges can be identified, it should be highlighted in the submission. Where there is an open or undefined legal issue, counsel may be able to argue that the current case in an inappropriate vehicle under which to resolve the issue. Alternatively, counsel may be able to suggest that it is inappropriate to bring an enforcement action because the law is unsettled and it would be unfair to bring an enforcement action under the circumstances.¹⁰
 - b. Consideration should also be given to whether the staff's recommendation is consistent with other positions on the issue taken by the Commission.

¹⁰ In criminal cases there is a constitutional right to fair notice. *Cole v. Arkansas*, 333 U.S. 196(1948) (The Constitution requires that an accused criminal defendant be informed of the nature of the charges against him.). While the Commission has traditionally used enforcement actions to define the contours of the law where an important legal issue is open an effective argument may be made based on fundamental fairness. See generally *Checkosky v. SEC*, 23 F. 3d 452 (D.C. Cir. 1994); *Checkosky v. SEC*, 139 F. 3d 221 (D.C. Cir. 1998)(discussing fair notice in the context of a Rule 102(e) proceeding).

- c. If the proposed action would have significant collateral consequences and unintended business impact, these points should be carefully developed in the submission. This discussion should highlight these points.
- 3. Remedies: The staff will typically request that counsel comment on the proposed remedies.
 - a. Frequently, the remedies sought by the staff will be consistent with those sought in other actions. Accordingly, counsel should review similar cases and determine whether the proposed remedies are consistent with those invoked in other cases.
 - b. The legal predicate for the remedies and the necessity for the proposed sanctions should also be carefully assessed in view of the legal standards, the facts in the case and the necessity for the proposed sanctions in the context of the case.
 - c. If the sanctions would have a disproportionate impact in the context of the case, that should be highlighted.

V. Settlement

- A. Overview: The overwhelming majority of SEC enforcement actions are resolved by settlement. Once it is clear that the investigation will not be resolved with a closing letter, counsel should consider the advantages and disadvantages of settlement. Frequently, settlement discussions will begin during the Wells process or perhaps earlier. It is usually advantageous to negotiate a settlement before the institution of an enforcement action.
- B. Pros and cons to settlement:
 - 1. Commission settlements are made without admitting or denying the allegations in either the complaint or the Order for Proceedings. The defendant will only have to admit to jurisdiction.
 - a. Generally, a settlement is not admissible in evidence. *See generally* Rule 408, Federal Rules of Evidence. There are limitations however. Settlements can be used to establish the bias of a witness under Rule 404(b).
 - b. Unlike litigated judgments, there are no collateral estoppel consequences to a settlement. *See, e.g., Parklane Hosiery Co., Inc. v. Shore*, 449 U.S. 322 (1979)(discussing offensive collateral estoppel). This is particularly important if there is parallel civil litigation.

- c. In Commission disciplinary administrative proceedings which follow a settlement in a civil injunctive action however, the settlement is admissible and has preclusive effect as to the violation. *See, e.g., In re Melton & Asset Mgt. & Research, Inc.*, Investment Advisers Act Release No. 2151, 80 SEC Docket 2258 (CCH)(July 25, 2003).
 2. There are also certain practical consequences. For an issuer, litigating an enforcement action can be a significant distraction, taking substantial amounts of time and effort on the part of many executives. In addition, an SEC enforcement action causes continuing adverse publicity which can have a negative impact on the relationships of the company with other divisions of the SEC staff as well as corporate creditors and shareholders.
 3. On the other hand, settlement means the Commission's detailed accusations of wrongdoing in its papers will remain unchallenged on the public record. Whether the settlement involves a civil injunctive action or an administrative proceeding, the settlement will be based on the unanswered allegations of wrongful conduct made by the Commission. Under Commission policy, the defendant must agree not to contradict those allegations in any public statement.¹¹
- C. Commencing settlement discussions. If the client is going to enter into a settlement, it is generally advantageous to start the settlement discussions prior to the filing of an action. Once the action is filed, the staff will have little flexibility in resolving the action. In contrast, before the action is filed and before the staff forwards its enforcement recommendations to the Commission, there is far greater flexibility.
- D. Key considerations. Commission settlements tend to be consistent over time for similar conduct. Counsel should thus carefully consider recent settlements in other cases where there is similar conduct. Viewed in that context, counsel can then establish certain priorities and objectives for the settlement discussions.
 1. The defendants. A key question is always whether the defendant will only be the company or with the action also include individuals. Companies are more likely to settle as a pure business decision. Individuals on the other hand, may have their career at stake and may be more inclined to litigate.

¹¹ There are certain collateral consequences to settling a Commission enforcement action. The impact of these consequences should be carefully considered before entering into any settlement. *See* Section VI (C) *infra*, discussing these consequences.

- a. The inclusion of individual executives can have an extremely detrimental impact on the company. If, for example, the Commission demands an officer and director bar the company may lose key executives. At the same time, even if there is no officer and director bar there may be a continuing disclosure obligation that can effectively preclude the individual from serving.
 - b. In instances like Foreign Corrupt Practices Act cases, both the SEC and DOJ have indicated that they are focusing on individuals.
2. The violations: A key focus of settlement discussions is the violations which will be alleged in the action.
- a. Typically, a key focus of settlement discussions is avoiding a fraud charge which has certain collateral consequences. Those consequences can include a loss of the use of the safe harbor provisions for forward looking statements and additional disclosure obligations. *See, e.g.*, Section 21E, Securities Exchange Act of 1934, Section 78u-5(b)(I)(A)(ii)(II)(disqualification from safe harbor for forward looking statements); 17 C.F.R. § 229.401(f)(S-K five disclosure obligation for material events regarding the integrity of any director).
 - b. Alternatives may be violations of Section 17(a)(2) & (3) which is a negligence based fraud rather than Section 10(b) which is scienter based fraud; aiding and abetting rather than being a primary violator or causing books and records violations.
3. Forum. The Commission has the option to bring an action either as a civil injunctive action in federal district court or as an administrative proceeding.
- a. The former will be resolved with the entry of a permanent injunction which is an order from a federal court and ancillary relief. The latter on the other hand is resolved with the entry of a cease and desist order from an administrative law judge. Generally, the civil injunctive action is viewed as a much harsher than an administrative proceeding.
 - b. The staff typically prefers a civil injunctive action.
 - c. If counsel prefers an administrative settlement, arguments should be developed to demonstrate that the type of

conduct involved is not of the egregious type which warrants a civil injunctive action. Precedent from other settlements demonstrating that similar types of cases have been brought as administrative proceedings can be persuasive. In addition, credit from cooperating with the staff's investigation may also aid in obtaining this type of solution.

- d. If, however, the staff is seeking a civil penalty, the case will have to be resolved in district court. The SEC cannot seek civil penalties against individuals or nonregulated companies in an administrative proceeding. 15 U.S.C. Section 78u-(d)(3)(A) (providing that, in order to seek and impose civil money penalties, the Commission must bring an action in United States District Court.
 - i. If, however, the settlement goal is to avoid an injunction the matter can be settled by filing two actions.
 - ii. The first is an administrative proceeding which is resolved with a cease and desist order.
 - iii. The second is a civil injunctive action which is resolved by consenting to the entry of an order which directs the payment of the civil penalty but does not contain an injunction.
- 4. The papers. The settlement papers in a civil injunctive case are the complaint, the final judgment and the consent to entering the final judgment. In addition, the SEC will issue a press release. For an administrative proceeding, the Order for Proceedings will include the offer of and consent to settlement.
 - a. As part of the settlement process, counsel should discuss the language of the papers which will be filed in court or before the administrative tribunal with the staff.
 - b. A key point to consider is the accuracy of the factual statements that will be made in the complaint and Order for Proceedings. Another important point in this process is the characterizations included in the papers. The descriptions and characterizations in these documents of the conduct can have a significant impact on how the papers read and the manner in which the defendant is viewed by the press and the public once the case is filed.

- c. Typically, the staff will not negotiate the language of the press release. However, the press release usually reflects the language of the underlying documents, frequently the summary or introductory sections which summarize the case. Also, the staff frequently will discuss the day on which the papers are filed. This permits counsel to try and have the papers filed on a day when there will be a minimal amount of publicity.
5. Disgorgement and prejudgment interest. If disgorgement is being sought along with prejudgment interest, this is typically payable at settlement. Counsel should be prepared to present any mitigating factors.
 - a. If appropriate, an accountant or economist might be retained to assist with the calculations to ensure that all offsetting charges are included.
 - b. If there are parallel proceedings, it may be appropriate to try and obtain an offset for payments made in those proceedings.
 - c. The staff will also consider mitigating the obligation if it can be demonstrated that the defendant does not have the financial resources. In this instance a payment plan may also be negotiated.
6. Penalties. In many cases, the staff may also seek a civil penalty. In negotiating penalties counsel should carefully assess penalties in similar cases.
 - a. For corporate defendants, the Commission has issued a policy statement which governs the imposition of corporate penalties. The factors in that statement should be carefully considered in preparing to discuss this issue. Counsel may also consider retaining an economist to discuss this issue.¹²
 - b. The Commission has not issued a policy statement for individuals. However, the considerations discussed in its policy statements regarding corporations should be considered in assessing penalties as to individuals.
7. Undertakings. In certain instances, the Commission will want corporate defendants to implement certain undertakings typically keyed to the underlying conduct. This may include for example enhanced internal controls or other procedures.

¹² See Section VI (D) *infra*, discussing the Commissioner's policy on corporate penalties.

- a. In some instances, the Commission will seek to built on those already implemented by the company. If the company self reported and cooperated with the Commission it may have fully remediated the situation. In that instance, counsel may argue that no additional procedures are needed.
 - b. In some instances the staff may want the company to implement specific procedures. These should be keyed to the specific conduct. Here again counsel should carefully consider settlements in other similar cases for guidance.
 - c. In some cases the staff may request that a monitor be installed to supervise time implementation of the new procedures for a specified period of time. The company should carefully consider the implications of having a monitor who reports directly to the staff at the company.
8. Other considerations -- collateral consequences. Settling with the Commission can have certain collateral consequences.
- a. Disclosure: Regulation S-K requires issuers to disclosure matters which impact the integrity of a director or executive officer over the past five years. While settlement may not fall in this category, the company should seriously consider whether disclosure should be made. 17 C.F.R. § 229.401(f).
 - b. Disqualification from certain offerings. This may include a Regulation A offering as well as placements under Regulation D under Rules 504, 505 and 506.
 - c. Forward looking statements. As noted earlier, the safe harbor for forward looking statements may also be lost.
 - d. Schedules 13D and 13G also require disclosure of decrees and orders prohibiting future violations of the federal securities laws.
 - e. Professionals settling with the Commission may also be subject to additional sanctions under the Commission's Rule 102(e), as well as by the appropriate state licensing association.¹³

¹³

There are additional specific disqualifications for investment companies and broker dealers.

VI. Other considerations

- A. There are a number of other policy issues and key considerations which counsel should consider, depending on the circumstances of the particular case.
- B. Parallel proceedings. Frequently, other regulators may conduct investigations which are parallel to that of the Commission's inquiry. Of paramount concern is whether there is a parallel criminal proceeding being conducted by the Department of Justice or the local U.S. Attorney's Office. Parallel inquiries may also be conducted by the SRO's or the state attorney general. The existence of these other proceedings must be carefully considered in defending any SEC investigation.
 - 1. The SEC may make a criminal reference or cooperate with DOJ or the U.S. Attorney's Office. *See, e.g.*, Section 21(d)(1), Securities Exchange Act of 1934, 15 U.S.C. § 78u(d)(1). The Commission is authorized to make such a reference by statute. Courts have upheld the use of parallel proceedings as producing certain efficiencies for government. *See, e.g.*, *U.S. v. Kordel*, 397 U.S. 1 (1970); *SEC v. Dresser Industries, Inc.*, 628 F.2d 1368 (D.C. Cir. 1980). There are certain efficiencies for potential defendants also.
 - 2. There is no requirement that the SEC disclose this matter to witnesses who appear for testimony. To the contrary the court in *U.S. v. Stringer*, 521 F.3d 1189 (9th Cir. 2008) held that the disclosure is not required.
 - 3. The SEC informs witnesses in standard Form 1662 that there may in fact be a parallel criminal proceeding. Traditionally, the staff does not comment on whether there has been a criminal reference or if there is a parallel criminal inquiry.
 - 4. Nevertheless, counsel should ask the staff conducting the inquiry whether there is in fact a parallel criminal proceeding.
 - 5. If there is a parallel criminal inquiry, the witness may want to consider declining to testify based on an assertion of his or her Fifth Amendment privileges.
 - a. Counsel should try and determine if the witness is going to testify before appearing for testimony so that the staff can be alerted.
 - b. In some instances, the staff may agree to permit the witness to submit an affidavit asserting the Fifth Amendment rather than appearing.

- c. In other instances, the staff may insist that the witness appear and testify. In that instance the staff will insist that the witness is invoking the right against "self-incrimination." That phrase however, does not appear in the text of the Fifth Amendment. Accordingly, counsel should consider objecting to the use of that phrase.
 - d. The staff will also inform counsel that the Commission may draw an adverse inference from the invocation of the right, citing *Baxter v. Palmigiano*, 425 U.S. 308 (1976). That decision, which does permit drawing an adverse inference in civil actions is based on an adversary proceeding. Commission investigations are fact finding inquiries, not adversary proceedings. *SEC v. Jerry T. O'Brien, Inc.* 467 U.S. 735(1984). Accordingly, counsel may want that *Baxter* should not be applied. Counsel may also want to point out the Fifth Amendment is properly invoked by the innocent to avoid entanglement in a web of circumstances which may make it appear that the witness is implicated. *Ohio v. Reiner*, 532 U.S. 17, 21 (2001).
 - e. The staff will insist that the witness respond to a series of questions to ensure that the assertion will be made to each point. Counsel should work out a standard response with the staff to facilitate the testimony such as "I rely on my privilege" or a similar, neutral phrase.
6. Wells submission. During the Wells process, the staff will give little information regarding their proposed recommendation to a person who has invoked the Fifth Amendment. Under these circumstances, it may be extremely difficult to make a Wells submission. At the same time, the existence of a parallel criminal case may counsel against making a Wells submission.
- C. Cooperation. An issuer may wish to cooperate with the SEC in order to obtain cooperation credit and mitigate any potential charging decision.
- 1. In its *Seaboard* release, the SEC noted that cooperation can in certain instances mitigate any potential liability. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (Oct, 23, 2001).
 - 2. Typically, cooperation begins with the production of all the facts. This includes those identifying who is responsible for the underlying conduct.

3. To maximize cooperation credit, a waiver of the organization's attorney client and work product privileges related to the internal investigation conducted by the organization is typically required. Linda Thomsen, Director, Division of Enforcement, U.S. Securities and Exchange commission, Remarks before the Mutual Fund Directors Forum Annual Policy Conference (Apr. 12, 2007), *available at* <http://www.sec.gov/news/speech/2007/spch041207ct.htm>. Without waiving privilege, the organization may still obtain cooperation credit which can lead to a lesser sanction.
 4. There may be other implications to cooperation. Those can include limiting indemnification rights, curtailing cooperation agreements with employees and the termination of employees who may have been involved in the underlying conduct.
- D. Statement on corporate penalties. In 2006, the SEC announced a policy on corporate penalties. Statement of the Securities and Exchange Comm'n. concerning financial penalties, (Jan. 4, 2006) *available at* www.sec.gov/news/press/2006-4.htm. This release set forth a number of factors to be considered when assessing a penalty against a corporation.
1. There are two key factors under the statement: (a) the presence or absence of a benefit to the corporation and (b) the degree to which it will recompense or harm the shareholders.
 2. Counsel should carefully consider this statement in resolving any investigation where a corporate penalty may be involved.
 3. Staff members have noted that in assessing civil penalties against individuals, the factors in the statement are also considered.
- E. Disclosure. Issuers involved in an investigation should carefully consider the question of disclosure.
1. There is no statute or SEC rule which specifically requires disclosure of a Commission investigation.
 2. Regulation S-K in Item 103 discusses the disclosure of legal proceedings. While it discusses court proceeding, it does not require the disclosure of a Commission investigation.
 3. The case law on the question also does not give any clear guidance.
 4. Voluntary disclosure. The company should carefully consider whether voluntary disclosure may be appropriate. Factors to consider include:

- a. Whether the investigation is formal or informal.
- b. The significance of the underlying conduct and potential implications for the company.
- c. The likelihood that an enforcement action will be brought.
- d. An additional factor to be considered is whether once an investigation is disclosed, has an issuer assumed a continuing duty to make disclosures about it.

VII. Conclusion

- A. Becoming involved in a Commission law enforcement investigation is a significant event for any person.
- B. Representing a person before the SEC is not the same as representing a witness or a party in civil litigation.
- C. Whether the investigation is formal or informal, representing a client before the Commission requires careful preparation and a good working knowledge of SEC procedures, policies and current enforcement trends.