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5 Common Misconceptions About SEC Investigations

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There are few things that are as unpleasant, expensive and fear-inducing as a U.S. Securities and Exchange Commission investigation. Companies and individuals often find themselves in a state of high anxiety over the possibility of an enforcement action and its implications. Jobs, reputations and, in some cases, liberty are at risk. Attorneys' fees can far exceed the amount of money at issue. The longer an investigation continues, the greater the psychic drain, disruption, and toll on emotional health and financial well-being can be. And, when the conduct at issue is genuinely problematic, the consequences can be severe and life-altering.

But, as with any major challenge, achieving a positive (or less negative) outcome in an SEC investigation depends on the quality of decision-making along the way. Critical to success is one's understanding of the agency's enforcement process. Many lawyers assume the SEC's investigative process closely parallels discovery in civil litigation. But understanding how the SEC enforcement staff operates and appreciating the ways that SEC investigations are different than what they may have encountered elsewhere is crucial. Too often, defensive approaches are taken that reflect misperceptions of how the SEC enforcement game is really played.

This is not to say that even if you play the game well, you can always avoid an enforcement action. Sometimes the facts are simply bad, and a weak hand will get you only so far. A successful outcome in such cases is frequently measured not in black or white terms, but in shades of grey — lesser charges, a lower penalty, fewer and less intrusive undertakings, exculpatory or mitigating language describing the conduct and meaningful credit for remedial efforts, and cooperation. The SEC's investigative and enforcement decision-making process is a high-stakes environment, deeply nuanced and fraught with peril at almost every turn. It is a complex process susceptible to mismanagement by even the most capable or well-intentioned defense attorney.

This article sets forth five misconceptions that clients and their counsel often have about the SEC and its investigative process.

1. "The staff" is the same as "the commission."

A key misconception that counsel and their clients often have when engaging with the commission's staff is that the SEC staff and the commission are one and the same. They misperceive the distinction between

the enforcement staff conducting the investigation and the commission as a deliberative body comprised of five individual commissioners, who will later decide whether to bring an enforcement action based on the staff's recommendation.[1] In fact, while they both operate under the banner of "the SEC," it is a mistake to ascribe the views, attributes or character of the staff conducting or supervising the investigation to the commission itself.

The distinction is important because what the staff thinks about a case versus how the commission will view the facts, law or policy implications can be very different. Indeed, it is not until the two weeks before the commission decides to approve or reject a case (i.e., how each commissioner will decide to vote) that the commissioners and their counsel typically have the first opportunity to learn about the case, to consider a party's arguments and defenses, and to discuss the recommendation with the enforcement staff. Until this two-week period, irrespective of what it has previously said about how it views the law or evidence in a case, the enforcement staff does not actually know what issues each commissioner will raise before the matter is considered by the commission as a whole.

Developing insight and understanding of the SEC commissioners and their views on issues under the federal securities laws is critical. Learning their backgrounds and staying abreast of what they say in their speeches, reviewing their dissents in administrative adjudications, and developing familiarity with their economic, financial, and political perspectives is central to assessing how they may view the facts, charges and the remedies in any particular case. The enforcement staff itself pays close attention to what commissioners say in closed commission meetings in order to develop a sense of how each of them will react to recommendations in the future. Parties undergoing investigation by the agency should be thinking in similar terms.

The distinction between the staff and the commission also has constitutional implications. As seen in the U.S. Supreme Court's recent Lucia decision, there is a constitutional difference between "principal" and "inferior" officers that can have profound legal consequences on the outcome of a case, and indeed, on the commission's entire administrative process.[2] Understanding that the staff is not the commission is critical to identifying where in the SEC's investigative process the staff's legal authority, decision-making and discretion ends and where the commission's begins. Recognizing which decisions the staff is authorized to make and those that are reserved for the commission is also critical to knowing what problems the staff can and cannot resolve on its own without commission involvement or approval. And, in formulating a Wells submission or settlement proposal, recognizing that you are ultimately speaking to the commission is key to making persuasive arguments that will hold up well against the staff's enforcement recommendation.

While it is true that the staff wields enormous influence over the investigative process and that the commission approves the vast majority of enforcement recommendations in routine cases by a unanimous vote, in controversial, novel or unique cases, there is ample room within the commission's process to make arguments that may be persuasive to individual commissioners as to why no enforcement action is warranted. Taking advantage of those opportunities and keeping in mind the distinction between the staff and the commission when making such arguments can be key to achieving a successful outcome.

2. The SEC is monolithic.

While "the staff" is distinct from "the commission," neither is the agency itself monolithic.[3] To be sure, all activity in which the staff engages is performed under the aegis of the commission, and the most important decisions — on enforcement actions and rulemakings — ultimately have to be approved by the

commission. While the enforcement staff as a whole generally follows the same investigative process and procedure[4] and is bound by the same legal and evidentiary standards, each enforcement group, unit and office has its own unique docket, culture and personality. And, within each office, there is a range of personalities, idiosyncrasies and capabilities. Not all attorneys or supervisors are the same and how one office views conduct in a particular case may be very different from how another office views the same conduct in a different case. This is especially true where the investigating staff is from one of the specialized units that, having investigated the same or similar conduct many times, has developed deep, highly specialized insight into the issues in the case. Understanding who is responsible for — or has input into — the investigation, their track record of bringing enforcement actions, and who is supervising them is important to assessing their willingness to compromise and how likely it is that they can be persuaded not to recommend charges in a particular case.

The Division of Enforcement is comprised of roughly 1,400 people. Understanding the background and personality of the staff attorney handling your investigation informs you regarding what to expect as to how that attorney will treat you, how flexible she will be in extending deadlines or accommodating scheduling requests, and how diligent and thoughtful she will be in pursuing particular lines of inquiry. The SEC is not a one-size-fits-all institution. It is a complex organization comprised of diverse individuals from a wide variety of backgrounds and life experiences. Recognizing its relative strengths and weaknesses and the distinctions that exist between individuals, groups, units and offices can make a difference in how to defend a particular investigation or negotiate a favorable resolution.

3. It's best to "let sleeping dogs lie."

Conventional wisdom dictates that when you haven't heard from the SEC staff investigating your case in many months, you are better off "letting sleeping dogs lie" — that is, not initiating contact with the staff and thereby risking reawakening their interest in your case. This thinking is outmoded, potentially high-risk in cases where there may be covert criminal interest, and can result in a business or individual enduring months of needless uncertainty that could be alleviated by a quick phone call or email. From the SEC staff's perspective, there is no such thing as "letting sleeping dogs lie." This is because the staff is accountable on a regular basis for reporting the status of their investigations up the chain of command, including to the director of enforcement herself. As a practical matter, this generally prevents cases from going dormant for excessively long periods of time.

There are situations in which the staff has decided not to pursue a case where it makes sense not to engage the staff or where the decision to do so requires a high degree of care. But, in most situations, the staff has not forgotten about the case and an inquiry from counsel would not prompt the staff to continue investigating where they otherwise would not do so. While the staff does not discuss their investigations, they will sometimes signal when they intend to close a matter and are usually willing to issue a termination letter in such circumstances. Alternatively, if the staff does remain interested in the case but has reduced it to a lower priority, that is important to know and can create opportunities to have the case closed or resolved on favorable terms. And, in some cases where the staff has been inactive for a period of time but remains interested in the case, it can signal the possibility of covert interest by the criminal authorities. Asking the staff for an update after not hearing from them for many months is unlikely to change the outcome of the matter and will likely yield a greater sense of the direction in which the staff is headed.

4. "Going up the chain" can only improve the chances for a favorable outcome.

A key question in many SEC investigations is whether and when to seek an audience — "go up the chain"

— with the senior officer responsible for supervising the case. The thinking is that an appeal to a more senior person may result in a more favorable outcome or, at the very least, some reduction of the charges, penalties or disgorgement amounts at issue. In many cases, depending on the issue, it may be necessary to request a meeting with the senior officer (associate director, unit chief, deputy director or director) responsible for overseeing the investigation.

But it is important to recognize that when you ask for a new level of review within a case, it can trigger a fresh look at the merits, not only by the unit chief or associate director who will now become involved, but by the investigative and trial staff who must be prepared to get the supervisor up to speed. This can cut both ways — it can cause the staff to look more critically at the investigative record they have developed and to become more aware of the strengths and weaknesses in the case, or it may spur insight or awareness of new theories, lines of inquiry, or errors in the staff's thinking that otherwise operate to a party's detriment.

The decision to request the involvement of senior SEC officials during an investigation is an important one and implicates timing and tactical considerations.[5] Being clear and transparent about the reasons for the request, adopting the right tone and being specific about the scope of what you wish to discuss are essential to getting what you want. Framing the question to be decided in a reasonable and objective way and ensuring that the person you are meeting with has the authority to decide the issue in your favor lays a foundation for a productive meeting with the staff. The staff will rarely make concessions in a face-to-face meeting but usually will take the matter under advisement and thereafter signal whether or to what extent they have been persuaded to take a more accommodating position on the issue at hand.

The ultimate decision maker in the Division of Enforcement is the director of enforcement. Because no enforcement recommendation can go to the commission without approval from the director of enforcement, a meeting with the director is high-stakes — often a one-time-only event and almost always near the end of an investigation — where the director comes to the meeting fully prepared, ready to listen and often motivated to consider settlement possibilities. But meetings with the director are unpredictable affairs — both for the party under investigation and for the staff. It is not uncommon for a party going into a meeting with the director seeking a lower penalty to emerge from the meeting having been told that a higher penalty is warranted.

5. Delay will result in a better outcome.

Most SEC investigations last anywhere between 18 and 22 months. While some cases wrap up in less than a year, others can continue for as long as four or five years. Factors beyond the control of a party, such as the size and complexity of the case, the pendency of a parallel criminal investigation, or staff turnover, can delay investigations for months or years and are often unavoidable.

Some parties may view it as advantageous to delay investigations as long as possible believing that the longer a matter takes, the less likely the commission will pursue it or other events will intervene that are deemed a higher priority. Usually, this type of approach only succeeds in antagonizing the staff and can result in enhanced penalties for lack of cooperation, additional charges if it's a regulated entity and other unfortunate results in a settled context.

In cases where it is clear that there will be an enforcement action, the opportunity for a favorable outcome tends to diminish the longer a case goes unresolved. This is because the staff becomes heavily invested in the case and develops deep familiarity with the record and because the longer an investigation is pending, the greater the likelihood that unforeseen circumstances will arise that reinforce

the staff's conviction about the need for an enforcement action.
Tactically, this means that where there is an early opportunity to settle a case, it is often advantageous, both strategically and economically, to attempt to do so. The enforcement staff generally won't entertain settlement discussions until it is comfortable it knows all the relevant facts. Nevertheless, at different stages of investigations, there may be opportunities to engage the staff in discussions about resolution. Parties who wait until the end of an investigation to initiate such discussions relinquish critical opportunities for advantageous dialogue at earlier points in time. The longer they wait, the more hardened the staff's positions are likely to become and the less flexible the staff will be in negotiating favorable settlement terms.

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SEC investigations can be costly, disruptive and emotionally draining. Making tactically smart decisions during an investigation requires in-depth knowledge of the SEC's process and how the enforcement staff operates. Basing decisions on misconceptions about the SEC's process and staff can result in negative outcomes. Adopting a practical, informed approach based on intelligent insight can mean the difference between a serious enforcement action or no enforcement action at all.

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[1] On Sept. 13, 2018, Chairman Jay Clayton issued a public statement "regarding SEC staff views." Clayton identified a variety of staff communications (written statements, compliance guides, letters, speeches, responses to frequently asked questions, etc.) and differentiated between official commission actions, on one hand, and staff statements, on the other, which he characterized as "nonbinding" and that "create no enforceable legal rights or obligations of the Commission or other parties." He reiterated that "it is the Commission and only the Commission that adopts rules and regulations that have the force and effect of law." Statement Regarding SEC Staff Views, Chairman Jay Clayton, Sept. 13, 2018 ("SEC Statement"); https://www.sec.gov/news/public-statement/statement-clayton-091318.

[2] Lucia v. SEC, 585 U.S. __, 138 S. Ct. 736, 199 L. Ed. 2d 602 (2018) (June 21, 2018) ("as all parties agree, none of those actors appointed Judge Elliot before he heard Lucia's case; instead, SEC staff members gave him an ALJ slot.").

[3] In the context of an organization, "monolithic" is defined as "constituting a massive undifferentiated and often rigid whole; exhibiting or characterized by often rigidly fixed uniformity"; https://www.merriam-webster.com/dictionary/monolithic.

[4] See generally Enforcement Manual, Office of Chief Counsel, Division of Enforcement (Rev. Nov. 28, 2017).

[5] Section 3.1 of the SEC's Enforcement Manual provides guidance concerning "External Communications Between Senior Enforcement Officials and Persons Outside the SEC Who Are Involved in Investigations"; https://www.sec.gov/divisions/enforce/enforcementmanual.pdf.