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Regulatory Developments at the SEC

By William J. Kelleher III

The market-shaking events of the past two years have prompted significant regulatory change. Beginning in December 2008, when it became clear that the SEC had missed opportunities to detect wrongdoing in the Madoff scheme, criticism of deficiencies at the SEC and the ensuing public and political discontent have led to several new investigative and enforcement initiatives and reconsideration of old practices. Now, in a series of public announcements, the SEC has issued new policies for handling securities investigations.

They include encouraging high-level officials and other individuals to cooperate in SEC investigations; streamlining procedures for issuing subpoenas and quickly pursuing investigations; creating five new units in the Division of Enforcement to focus on priority areas; and establishing new enforcement priorities. The latter include "pay to play" practices of investment advisers, regulation of companies doing business with foreign countries, insider trading and hedge funds.

In conjunction with these changes, the SEC issued a revised Enforcement Manual elaborating on the policies.

The cooperation initiative

Previously, the SEC had no specific policy for individuals who cooperated in its investigations, although it sometimes entered into cooperation-like promises in agreements when it settled cases. In a 2001 investigative report, which became known as the Seaboard Report, the SEC adopted a cooperation and self-disclosure policy for corporations. Although every investigation and enforcement
matter is different, under the ground rules of the Seaboard Report, there was unevenness in terms of the weight or credit given to cooperation and how various forms of cooperation were received by the SEC in its regional offices.

For example, in one recent case that pre-dates the new policy, in which this author was involved as defense counsel, the SEC required some of the defendants to pay a civil penalty and “cooperate fully” with later investigations and cases arising from the same matters, including testifying at trial.

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**In January 2010, the SEC formally extended a policy to encourage individuals to cooperate in its investigations.**

In January 2010, the SEC formally extended a new policy to encourage individuals to cooperate in its investigations. The initiative takes several pages from the Department of Justice playbook. It includes a framework to determine whether, and how much, credit is due, and it specifically encourages the SEC to “carefully consider the use of cooperation by individuals and companies to advance its investigations and related enforcement actions.”

**FOUR CONSIDERATIONS**

In general, the SEC identified four considerations in weighing cooperation: (1) the help provided, (2) the importance of the matter, (3) the interest in ensuring that the individual is held accountable for the misconduct, and (4) the appropriateness of cooperation credit in the individual's case.

The new policy includes formal “cooperation agreements” under which the SEC recommends certain credit for assisting in an investigation, “deferred prosecution agreements,” by which it agrees not to bring an enforcement action provided the individual cooperates during an agreed period; and “non-prosecution agreements,” for limited cases where the SEC agrees to forego any enforcement action if the individual cooperates.

The SEC hopes that the policy will encourage insiders – for example persons who through position (usually a high position), or knowledge, have the most sensitive information and the detailed knowledge about any wrongdoing -- to come forward sooner.

The bottom line is that subjects of an investigation who decide to cooperate might be able to convince the SEC that less severe punishment is in order. Rather than a court ordered injunction and monetary sanction, counsel might be able to negotiate a better cease-desist settlement, or no action at all.

The potential benefits for senior corporate officers and other individuals include the possibility of obtaining settlement recommendations by the SEC, even without a cooperation agreement. Upon request from the cooperating individual, "cooperation letters" from the SEC to courts or other regulators detailing the cooperation can be rendered.

On a business and legal level, however, the cooperation policy may face challenges in execution and workability. The SEC has said that, where appropriate, it will have parallel cooperation agreements with the Department of Justice. It is not known how a coordinated effort with the DOJ will work out, however, because authorities in these two agencies often jockey for top billing in bringing major cases.

Therefore, senior executives and officers (and the companies that employ them) should consult legal counsel about the extent of cooperation early in an investigation. Typically, the first person to cooperate gets the best deal, as the SEC moves up the corporate hierarchy.

Another area of opportunity is the wording of settlements. The SEC's Director of Enforcement confirmed recent reports that it is reconsidering its position about the level of detail included in settlements. Generally, the SEC yields sparingly to a defendant’s requests regarding how the settlement is worded. Presently, although companies and individuals are not required to admit to any liability or wrongdoing, the SEC usually includes some statement of the misconduct.

If the reform is implemented, corporate counsel might have leeway to negotiate inclusion of some favorable facts (significant cooperation or lack of direct involvement, for example) that it considered in reaching the settlement.

While more transparency would enable the SEC to provide more guidance in its settlements, such a change has potential downsides. In-depth "findings" of the SEC may make it more difficult to encourage cooperation from individuals who are interested in having as few harmful facts revealed as possible. This is especially true when what the SEC believes are facts were never subject to scrutiny in court or in a deposition.

More detailed statements could also have negative implications for companies and individuals that are the subject of related criminal or civil litigation, especially if the findings can be used against them. Only time will tell how this new cooperation policy will fare in garnering cooperation from individuals in the civil context.

**STREAMLINEd ENFORCEMENT PROCEDURES**

Previously, it was widely known that SEC investigations were slow to start, and once underway, dragged on. As a result, the SEC made frequent informal requests for voluntary production of information and documents.

The intent of several of the new measures is to expedite the process for starting investigations, hasten the pace and efficiency of the SEC’s reaction to developing cases and focus its expertise in key areas.

In 2009, without inviting the usual public comment, the SEC amended its rules to make it easier for the Division
of Enforcement to issue Formal Orders and subpoenas that compel – as opposed to merely request – testimony and documents.

The Director of Enforcement wasted no time stating in a speech that if defense counsel resisted voluntary compliance with requests for production of documents and witnesses, they probably would find a subpoena on their desk the next morning. Without the cushion of time to prepare, the receipt of an SEC subpoena may raise the need for prompt regulatory disclosure and public acknowledgment.

Experienced counsel can help investigation targets determine how to respond to the SEC’s informal requests for information. While counsel might not be able to avert service of a subpoena, they can often help lessen its impact on the company’s business.

The SEC also announced in January that within the Division of Enforcement it had created five specialized investigative units dedicated to priority areas: Asset Management (including hedge funds and investment advisers); Market Abuse (large-scale insider trading and market manipulation); Structured and New Products (including derivative products); FCPA violations; and Municipal Securities and Public Pensions.

The SEC also established an Office of Market Intelligence.

Previously the Division of Enforcement was comprised of generalists. The restructuring augments the investigative staff with expertise in financial services, markets and products, and it presumably will result in more efficient investigations and swifter reaction to market events. Along with a new Office of Market Intelligence, the Division of Enforcement will now be the central office for processing the information contained in the thousands of complaints, tips, and referrals that are sent to the SEC.

TOP PRIORITIES
The SEC has staked out some near term enforcement priorities. For companies these will necessitate a clear understanding of the regulatory framework, and attentive compliance and risk management.

In addition to insider trading and hedge funds, two major priorities are the Foreign Corrupt Practice Act, and pension funds and municipal markets.

In general, the FCPA prohibits U.S. companies and their officials and agents from providing anything of value to foreign officials to obtain or keep government contracts and other business. The SEC is responsible for civil enforcement of the FCPA. In the past year, we have seen several large-scale FCPA cases involving prominent companies and individuals that demonstrate how serious the SEC and Department of Justice are about broadening the scope of enforcement.

Where violations are found pervasive or FCPA compliance policies are deemed inadequate, the SEC can impose a corporate monitor or outside consultant in addition to stiff monetary sanctions. Large multi-nationals, such as pharmaceutical companies, medical device, industrial and manufacturing concerns, oil and mining firms, and conglomerates that do business overseas, especially in developing regions, are most likely to be affected by this initiative.

Misconduct in the municipal securities markets and public pension funds, including "pay-to-play" arrangements and related public corruption, have recently become a priority area for the SEC. Several cases have been brought recently against investment advisers, consultants and politicians in New York, Connecticut and elsewhere. Some of these were filed in combination with related criminal cases.

The confluence of politics with large investment funds makes this fertile ground for enforcement. In various pay-to-play arrangements, for example, the SEC focused its enforcement through the use of existing general anti-fraud and investment adviser rules, and through the more specialized Municipal Securities Rulemaking Board's rules. In 2009, the SEC proposed a new rule to, among other things, ban political contributions by investment advisers and ban payments from investment advisers to third parties for soliciting business from government funds.

This proposal evoked comments from all quarters. Late last year, the SEC backed away from part of the proposal, and it has asked the independent Financial Industry Regulatory Authority to issue regulations concerning registered broker-dealers who act as placement agents. Corporate practitioners will continue to monitor the evolving regulatory framework.

While the SEC will surely face obstacles in implementing so many new rules and policies, it likely will have the financial and political support to move forward. In 2010 and beyond, we are likely to see stepped-up enforcement in key areas, faster issuance of subpoenas and more aggressive investigations, especially in areas that the SEC has designated as a priority.

New policies will present opportunities for negotiating less severe sanctions from the SEC, or forestalling regulatory action altogether, and they will impact disclosure considerations for individuals and companies who are responding to investigations. Experienced corporate counsel can help companies and individuals navigate the new rules to effectuate the best possible outcome.

WILLIAM J. KELLEHER III is a litigation partner at Robinson & Cole LLP, a commercial law firm with offices in Connecticut, Boston, and New York City. He represents companies and individuals in enforcement actions and government investigations by agencies such as the SEC, the Department of Justice and state authorities in New York, Connecticut and elsewhere. wkelleher@rc.com