SEC Investigations and Enforcement Actions:

A Practical Handbook for Municipal Securities Issuers

ORRICK

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DISCLAIMER: Nothing in this booklet should be construed or relied upon as legal advice. Instead, this booklet is intended to serve as a general introduction to the subject of SEC investigations and enforcement actions.

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I. Introduction

The Securities and Exchange Commission ("SEC") is focusing on municipal bonds and their municipal issuers as never before. Issuers must be mindful of the SEC's new focus on increasing enforcement activity in the municipal bond market, and be prepared to respond if approached in an SEC enforcement action.

In recent months, the SEC has enhanced staffing and organization in its Enforcement Division, obtained new enforcement techniques, adopted new regulations, and made requests of Congress for additional authority over this sector. The SEC clearly has municipal issuers on its enforcement agenda, and the new tools at its disposal substantially heighten the risks for municipal issuers and the officials and employees of those issuers. The vigor with which the SEC intends to pursue investigations is evident from the formation of a specialty unit within its Enforcement Division that focuses on municipal securities and public pension funds, the steady drumbeat of public statements by SEC officials directed at the municipal securities market, and recent enforcement actions.

Of particular note, the SEC not only has a renewed interest in and greater resources devoted to enforcement actions related to municipal securities, but it also has a powerful new tool. A provision of the federal Dodd-Frank Act, passed in the summer of 2010, permits the SEC to impose civil penalties of up to $150,000 on "any person" as part of an administrative cease-and-desist ("C&D") proceeding if the Commission finds that the person violated any provision of the Securities and Exchange Act of 1934 (the "1934 Act") or any rule or regulation issued thereunder. The SEC prefers to use C&D actions, rather than suits in federal court, because a C&D action is handled administratively within the SEC—on its "home court." In the past, it could only get an injunction if it succeeded in a C&D action, and would have to go to court to obtain monetary penalties. Plainly, the risk of monetary penalties imposed through an administrative proceeding substantially increases the risks associated with an SEC enforcement action.

The SEC's current focus on municipal securities is attributable to the sheer size of the market (nearly $3 trillion in outstanding securities) and its importance to millions of retail investors. Elaine Greenberg, the chief of the SEC's municipal securities and public pension enforcement unit, crisply stated her mission at a public finance conference in San Francisco in October 2010: "If we find that you hid or misrepresented material information to these investors, we will be holding you accountable . . . ."

Furthermore, the Dodd-Frank Act created new whistleblower provisions that will inevitably spur additional investigations and enforcement actions directed at municipal issuers and their officials and employees. Mark Zehner, deputy director of SEC's municipal and public pension fund enforcement unit, has publicly stated that "numerous" municipal market participants have queried the SEC about bringing municipal bond abuses to its attention under the whistleblower program. Under the Dodd-Frank mandated whistleblower program, individuals who report wrongdoing can receive 10-30% of SEC recoveries of more than $1 million.

This handbook is designed to provide municipal securities issuers and their staffs with an overview of:

- the issues the SEC is emphasizing as it seeks to regulate the municipal securities market through enforcement actions;
- steps to take both in advance of and at the outset of an SEC investigation to help minimize the risk of an unfavorable outcome; and
- the mechanics of an SEC investigation/enforcement action.

II. The Enforcement Landscape

A. Source of Enforcement Authority

Municipal securities are generally exempt from the registration requirements of the Securities Act of 1933 (the "1933 Act"). In addition, the "Tower Amendment" to the 1934 Act prohibits both the SEC and the Municipal Securities Rulemaking Board ("MSRB") from requiring municipal issuers to file disclosures in advance of offering debt securities for sale. Municipal issuers are, however, subject to the anti-fraud provisions of the securities laws. These laws, contained in both the 1933 and 1934 Acts, prohibit offering or sale of municipal securities by use of offering materials (normally called Official Statements) which contain materially false information or omit material information which investors would want to know to make an investment decision. Consequently, public disclosures made by municipal issuers in the course of new offerings of municipal bonds, in making post-issuance reports to investors, and in some other circumstances when they are "speaking to the market," permit the SEC's Enforcement Division to police the municipal securities market, including issuers, through these anti-fraud provisions[1].

Although the SEC is prohibited from directly regulating municipal issuers, it has found an indirect way to accomplish some of its goals. The 1934 Act gives the SEC the authority to regulate dealers in municipal securities. In 1989, the SEC adopted Rule 15c2-12, which prohibited a dealer from underwriting most issues of municipal bonds unless the issuers took certain actions. This Rule was greatly expanded in 1994 so that it indirectly mandated municipal issuers to agree to provide certain continuing disclosures after bonds were issued, something which is required in the corporate markets but which had never before been mandated for municipal securities. In its current form, Rule 15c2-12 makes it unlawful for any dealer to act as a "participating underwriter" in a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more (subject to certain exemptions) unless, among other things, the participating underwriter (a) obtains an official statement from the issuer, (b) before offering any bonds, obtains a representation from the issuer that the preliminary

[1] The most well-known anti-fraud provision is Rule 10b-5 promulgated under the 1934 Act.

official statement is "near final," and (c) obtains a written agreement from the issuer to (i) submit annual reports that include financial statements and other financial and operating information about the issuer and the bonds to a central website maintained by the MSRB and (ii) provide notice to the same website in a timely manner not to exceed 10 business days of the occurrence of any of 14 enumerated events.

Thus, of necessity, municipal issuers make extensive public disclosures in connection with the issuance and sale of their securities, and now, because of Rule 15c2-12, on an ongoing basis after bonds are issued. Misrepresentations and omissions in those disclosures create a risk of liability under Rule 10b-5 and other laws. As noted, civil penalties imposed through administrative cease-and-desist proceedings have recently been added to the traditional liability risks. Section 21C(a) of the 1934 Act has long empowered the SEC to issue cease-and-desist orders. Specifically, it provides:

> If the Commission finds, after notice and opportunity for hearing, that *any person* is violating, has violated or is about to violate any provision of this ACT, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person . . . to cease and desist from committing or causing such violation and any future violation of the same provision rule or regulation. (emphasis added)

The Dodd-Frank Act added a provision to Section 21B, titled Civil Remedies in Administrative Proceedings, that permits the imposition of civil penalties in cease-and-desist proceedings. Specifically, new Section 21B(a)(2) provides:

> CEASE-AND-DESIST PROCEEDINGS – In any proceeding instituted under section 21C against *any person*, the Commission may impose a civil penalty if the Commission finds, on the record after notice and opportunity for hearing, that such person –
>
> (a) is violating or has violated any provision of this title, or any rule or regulation issued under this title; or
>
> (b) is or was a cause of the violation of any provision of this title, or any rule or regulation issued under this title.

There should be no doubt that the SEC will seek to impose civil penalties on municipal issuers and their officials and employees in administrative proceedings when it believes there have been misrepresentations or omissions. Ms. Greenberg publicly announced that intention at a National Association of Bond Lawyers conference in October 2010.

B. Specialized Enforcement Unit

In 2010, the SEC formed five specialized enforcement units to focus on high-priority issues. In announcing the specialized units, the SEC stated that the combination of dedicated resources and enhanced specialization will yield more effective, efficient, and rigorous enforcement in the high priority areas. One of the specialized units focuses on municipal securities and public pensions. That unit is headed by Elaine Greenberg and Mark Zehner, both of whom have prior experience with enforcement actions related to municipal securities.

The most significant fact may be that the new unit targeting the municipal securities market has a staff of approximately 30 lawyers spread over 10 of the SEC's 12 regional offices. Such a large investment of enforcement resources will almost certainly lead to an increase in the number of investigations and enforcement actions directed at participants in the municipal securities market.

C. Points of Emphasis

Ms. Greenberg has announced that, while the scope of the new unit's mandate is broad, it will seek to expand the relatively limited decisional law concerning municipal securities by focusing on five specific areas:

- Offering and disclosure fraud: Potential misrepresentations and omissions in offering documents.
- Tax or arbitrage-driven fraud: Profiting by borrowing at lower rates and investing at higher/market rates is generally impermissible under the tax code and can affect the tax-exempt status of bonds for investors. On March 2, 2010, the SEC and IRS announced the signing of a Memorandum of Understanding designed to improve compliance. The two agencies will work cooperatively through a standing Tax Exempt Bond/Municipal Securities Committee to identify issues and trends related to tax-exempt bonds. They will also share information as appropriate.
- Pay-to-play practices and public corruption: The pay-to-play rule (MSRB Rule G-37) generally prohibits firms from underwriting municipal bonds for an issuer for two years after a "municipal finance professional" involved with the firm makes a campaign contribution of more than $250 to an elected official of the issuer.
- Fraud involving valuation and pricing: Focus on thinly traded securities typically issued by small municipalities and utilities.
- Public pension accounting and disclosure violations: At a June 22, 2011

conference sponsored by the Pew Center for the States, Mr. Zehner stated: "I think it is in everyone's interests here to come up with a voluntary method of adequately disclosing public pension-fund liabilities being faced by state and local governments." The SEC's recent enforcement action against the State of New Jersey highlights the SEC's willingness to spur that process along through enforcement actions.

D. Recent Enforcement Actions

It has been approximately 18 months since the enforcement unit focusing on the municipal securities market was formed. Although its investigations are generally confidential, the enforcement actions settled in that period and anecdotal reports of investigations suggest that the SEC is indeed focusing on the areas identified by Ms. Greenberg.

- In March 2010, the SEC took action on two occasions to enforce compliance with the play-to-play rule:
  - The SEC issued a report of investigation warning firms that play-to-play rules apply to affiliated professionals, not just to a firm's employees. The firm in question underwrote bonds issued by the State of California within two years of a campaign contribution to the Treasurer of California made by the vice-chairman of the firm's parent (bank holding) company. The contributor was not a director, officer, or employee of the securities firm unit, but the SEC determined that he functionally supervised the securities firm.
  - The SEC filed a settled enforcement action against a securities firm based on contributions made by a senior vice-president of the firm to the Treasurer of Massachusetts within two years of the firm co-managing 19 Massachusetts bond offerings. The securities firm was required to disgorge all earnings plus interest and pay a civil penalty.
- In August 2010, the State of New Jersey settled claims that it misled investors in $26 billion of municipal bonds by masking underfunding of its two biggest pension funds. It was the first SEC enforcement action against a state. Announcing the settlement, Ms. Greenberg said, "We need to be out there sending a message to the market participants, especially the issuers of municipal bonds really, that they need to be out there taking seriously their obligations under the federal securities laws." Following an extensive investigation, the SEC found that New Jersey's bond offering documents failed to disclose the pension plans' asset and funded ratio information on a market-value basis.

Because that information was not provided on the basis of market value, the offering documents effectively concealed an unfunded liability (i.e., using current market values, the funded ratio was less than 100%).

- In October 2010, the SEC announced that four former San Diego city officials agreed to pay financial penalties for roles in misleading investors in municipal bonds about the city's fiscal problems related to its pension and retiree health care obligations. The San Diego enforcement action is the first time the SEC has secured financial penalties against city officials in a municipal bond fraud case. Three former officials were fined $25,000 each and one was fined $5,000. In announcing the result of the enforcement action, the head of SEC's Los Angeles regional office said, "Municipal officials have a personal obligation to ensure that investors are provided with complete and accurate information about the issuer's financial condition."
- In November 2010, it was reported that the SEC had issued subpoenas seeking information related to bonds issued by the City of Bell, California (the small city neighboring Los Angeles caught up in a public pay and pension scandal). Press reports indicated that Bell may have issued $50 million in general obligation bonds to build a sports complex without a documented plan and time frame for how to use proceeds or an apparent need for the money.
- Recent reports suggest the SEC has been investigating $600 million of Build America Bonds sold by the Metropolitan Water Reclamation District of Greater Chicago in 2009. Such an investigation would be consistent with reports that the SEC is focusing on Build America Bonds because they are a significant new product. The SEC is reported to have met several times with the IRS to discuss these bonds. If the IRS finds that Build America Bonds do not comply with tax rules on issue price, it could withhold subsidy payments (35% of interest costs).

III. Preparing for the New Era of SEC Enforcement

Issuers and individuals who become targets of SEC investigations need to be prepared to act quickly. Officials of public issuers should conduct an assessment of the entity's preparedness under the guidance of experienced counsel. Once the issuer learns of an investigation, whether formal or informal, there are certain steps it should take as promptly as possible to help guard against an unfavorable outcome.

A. Preparedness Assessment

An assessment of an issuer's preparedness for the possibility of an SEC investigation should include the following steps:

1. Document retention policies

Ensure that document retention polices are in place *and* being followed. When the issuer is notified that an investigation has been commenced, it likely will be required to retain documents that relate to the investigation. While the scope of documents that must be retained is subject to negotiation, enforcement officials routinely take an expansive view of what must be preserved. Issuers that have been lax in enforcing retention policies cannot suddenly become vigilant without risking the appearance of having something to hide. To avoid creating the appearance of hiding or destroying evidence, issuers should be consistent in reminding employees of the importance of following retention policies.

2. IT systems

Understand the information systems that automatically purge documents and other electronic records, and establish procedures for stopping that process at the inception of an investigation. Some software systems automatically overwrite or purge data. Issuer decision makers should work closely with the IT staff to understand those systems and design work-arounds that can be immediately implemented if the issuer learns of an investigation.

3. Compliance training

Issuers should take care to educate the responsible employees about the increasing risks of SEC investigations and the heightened disclosure obligations imposed by the recent amendments to Rule 15c2-12. Those amendments require underwriters to obtain commitments from issuers to provide notice of an expanded list of specified events in a timely manner not to exceed 10 business days. The enumerated specified events range from ratings changes to adverse tax opinions to substitution of property securing repayment. Even if the issuers have retained an outside consultant to assist with continuing disclosure matters, if the responsible employees are not well informed of these notice obligations and/or there are not systems in place to ensure that they are promptly informed of the occurrence of triggering events, an issuer could easily fail to provide the required notice within 10 business days.

B. First Steps Upon Learning of the Investigation

1. Take the investigation seriously

SEC enforcement personnel may conduct informal investigations, but they do not conduct casual investigations. Any inquiry from SEC enforcement personnel is a serious matter with potentially significant consequences. There is no reason for the recipient of the initial inquiry to provide any substantive responses on first contact. Issuers should politely inform the SEC's enforcement personnel that they will respond promptly after conferring with counsel. The SEC staff will not draw any negative inferences from that initial response because it is standard operating procedure.

2. Retain experienced counsel

The issuer should then seek guidance from counsel with experience in SEC enforcement matters. SEC investigations invariably spawn new risks beyond any preexisting disclosure issue (e.g., the risk of an incomplete document production or a misstatement caused by the target's inadequate investigation of the facts). They also present opportunities to shape the Staff's views through the substance of the response, reference to what the SEC has done in other matters, and cooperation. Counsel with experience in SEC investigations can help navigate these risks and opportunities so as to obtain the best possible outcome. Bond counsel, disclosures counsel, or underwriters counsel may have ample experience with disclosures but insufficient experience with SEC investigations and enforcement.

3. Investigate quickly and thoroughly

The issuer, with assistance from counsel, should promptly gather and analyze relevant facts. Providing less than accurate and thorough information to the SEC, no matter how well intentioned, will not end well. Such errors can create heightened suspicions and leave the impression that the issuer or its officials and employees are not respectful of the laws and/or the regulators. Among other things, the issuer should interview employees with knowledge of the underlying events or information to ensure that, if they are later examined by the SEC, their statements will be consistent with the information supplied to the SEC by the issuer.

4. Preserve documents

Act immediately to preserve all documents, both hard copy and electronic. The universe of documents that must be preserved can often be narrowed through negotiation with the SEC's staff. Until those parameters are agreed to and memorialized, the best course is to preserve everything in order to avoid any risk that the SEC will interpret the loss of documents as the destruction of evidence.

5. Preserve the attorney-client privilege

From the moment an inquiry from the SEC is received, the issuer should take care to preserve the privileged nature of its communications with counsel, including the privileged nature of the internal investigation. Retaining outside counsel at the outset can help achieve that protection. Employees, especially senior officials, should be cautioned that communications not involving counsel may be discoverable. The issuer may decide to waive the attorney-client privilege as part of an effort to cooperate with the SEC, with the hope that such cooperation will persuade the SEC not to initiate an enforcement action or to be more lenient. But, sharing privileged information with the SEC should be a choice after careful deliberation, not the unfortunate product of failing to take adequate steps to protect the privilege.

6. Consider taxpayer confidentiality

The SEC sometimes asks the issuer to waive restrictions on the IRS disclosing taxpayer information so that the IRS can communicate with the SEC. Such waiver may not always be wise, and issuers should consult with counsel before doing so.

7. Seek to narrow the scope of the document request

The initial document request from the SEC is often quite broad and burdensome. The cost of producing documents can be staggering. Recipients of document requests should seek to limit the burden and cost by negotiating with the SEC to narrow the scope of the document request. Experienced counsel will know what features of the document request will be most costly, the points on which the Staff might be flexible, and how to negotiate narrowing the document requests.

8. Evaluate whether there is a duty to disclose the investigation

In many instances, there will not be duty to disclose the fact or nature of an SEC investigation. But, issuers should not simply assume that there is no such duty. For example, the investigation may surface information that casts prior disclosures in doubt or the cost of responding to the investigation may cause financial peril for the issuer. Consequently, issuers should consult with counsel to determine whether an SEC investigation is a material event warranting disclosure.

IV. How SEC Investigations and Enforcement Actions Work

A. The Power of the SEC

Congress has vested the SEC with broad authority to conduct investigations into possible violations of the federal securities laws and to demand production of evidence relevant to such investigations. The SEC's authority includes the power to subpoena witnesses, administer oaths, and compel the production of books and records.

In October 2008, the SEC made its Enforcement Manual available on its website. The manual is a useful resource for entities and individuals targeted by the SEC.

B. The Initiation and Escalation of an SEC Investigation

1. Sources of an SEC investigation

SEC investigations may spring from any of a large number of different sources. Often, investigations grow out of examinations by the Staff of periodic public disclosures. Complaints from members of the public are yet another common source of SEC investigations. In the past decade, the financial press has become a potent source of leads for the SEC, as business journalists now conduct aggressive investigations even before the Staff is aware of certain conduct. Likewise, tips by internal whistleblowers have prompted many investigations. Whistleblower complaints are likely to escalate in light of the "bounties" made available by Dodd-Frank. Finally, referrals from other government agencies are also a common source of SEC investigations.

2. Informal inquiries

SEC proceedings usually begin as "informal investigations" or "informal inquiries." At the informal inquiry stage, the SEC's Staff has not yet sought the authority to issue subpoenas for compelling documents and testimony. Instead, it usually asks witnesses to give testimony and provide documents voluntarily.

a. Informal inquiries typically are not publicly disclosed

The SEC is authorized to conduct an informal inquiry in private. Only very rarely will the SEC disclose the pendency of an informal inquiry, which means that private plaintiffs may be kept in the dark as long as an inquiry remains informal.

b. Document and testimonial discovery in informal inquiries

In connection with an informal inquiry, the Staff nearly always requests a voluntary production of documents. Indeed, an informal inquiry very often commences with a letter attaching a request for documents. Given that informal inquiries are often exploratory fact-finding exercises focused on several areas of reported or suspected misconduct, the Staff's document requests are often broader and less specific than those in private litigation.

It is also common for the Staff to request creation of various documents or compendiums of information and data. For example, the Staff may request the submission of a chronology of events, complete with the identities of participants at any meetings. The preparation of such documents must be handled with care.

After document production has commenced, the Staff will commonly request witness interviews and/or testimony. If the prospective witness can persuade the SEC that a transcript would disadvantage him or the Staff, the Staff may agree to conduct its interviews without a transcript.

c. Conclusion of an informal inquiry

Where documents and testimony provided to the Staff do not indicate a securities violation, the subject of an informal inquiry may simply never hear from the Staff again regarding the inquiry. That is also the case if, under the circumstances, it is questionable whether any violation occurred and the subject of the inquiry acted in a cooperative and credible manner. Generally, if the Staff decides that it will not pursue the inquiry beyond the informal stage, the subject of the inquiry will not receive any formal notification.

In contrast, an informal inquiry may conclude because the Staff is convinced, without the need for additional evidence, that a securities violation occurred. In such a case, the Staff may decide to "skip" the formal investigation stage altogether and recommend to the Commission that it commence an administrative proceeding against alleged violators

or file a complaint in federal court seeking injunctive relief. The Staff may also refer the suspected violation to the Department of Justice for initiation of criminal proceedings against alleged violators. In recent years, it is becoming somewhat more common for the Staff to skip directly from an informal inquiry to an administrative, injunctive, or criminal proceeding.

3. Formal investigations

The Staff may escalate an informal inquiry into a formal investigation if it believes that a subpoena is necessary to obtain documents or testimony from the subject of the investigation or from third parties that will not or cannot voluntarily comply with an informal request for information.

a. Formal order of investigation

The Staff cannot initiate a formal investigation—and enjoy the concomitant powers to issue subpoenas and require oaths—until the Commission issues a formal order of investigation. A formal order of investigation will be issued if the Commission believes that a violation of the federal securities laws is occurring or has occurred. Most importantly, a formal order will often describe—albeit vaguely—the general subject matter of the formal investigation. This may provide the target of an investigation with the first written indication of the nature of a suspected violation.

b. Contents of a formal order

A formal order is a brief document outlining suspected statutory and regulatory violations. A formal order will not provide much (if any) detail regarding the Staff's evidence or the bases for the Staff's legal theories. The order will generally contain four sections: (1) the Public Official Files section, which refers to information contained in the Commission's public files; (2) the Staff Report section, which presents, in a highly conclusory form, the facts then known to the Staff, as well as the securities laws that the Staff suspects have been or are being violated; (3) the Purpose and Order section lists the violations that may have occurred or are occurring; and (4) the Authorized Staff section lists the members of the Staff who are authorized to administer oaths and to issue subpoenas.

c. Guidelines governing formal inquiries

Formal investigations will remain nonpublic in almost all cases. The Staff may, however, share information with other governmental agencies.

If asked for information regarding a suspected investigation, the Staff will neither confirm nor deny the existence of an investigation. Nevertheless, occasionally the existence of a formal investigation is leaked by persons within the subject entity, so it may be appropriate to develop a response plan in anticipation of such a leak.

Pursuant to the SEC's Rules Relating to Investigations, witnesses in formal investigations receive a number of procedural protections. Among the more important protections are a witness's right to review the formal order, to review a transcript of his or her own testimony, and to be accompanied by counsel while giving testimony.

The subject of an SEC investigation is entitled to the same testimonial privileges as during a judicial proceeding, including Fourth and Fifth Amendment protections against unreasonable searches and self-incrimination. The attorney-client privilege likewise exists in connection with an SEC investigation.

d. Conclusion of a formal inquiry

The Staff may conclude a formal investigation by either determining that no action is appropriate or by recommending to the Commission that enforcement proceedings commence. If the Staff recommends no action, the Staff generally will inform the subject of that determination.

If the Staff believes that the investigation should result in enforcement action, it will draft an action memorandum to the Commission recommending that the Commission take action. The recommendation will set forth the grounds for the recommendation and will recommend a course of action and a remedy. Finally, the Staff will also forward to the Commission any Wells submission (discussed below) provided by the proposed respondents or defendants.

4. Internal investigations

It can be in an issuer's interest to respond to notice of an SEC investigation by instituting an internal investigation. At an issuer's request, the Staff may defer its investigation pending the completion of the internal investigation, provided the issuer agrees to forward the results of its investigation to the Staff. An issuer can greatly expedite resolution of the Staff investigation, and thereby avoid the cost and disruption of a Staff investigation, by utilizing this process.

An issuer that launches an internal investigation may also curry favor with the Staff by showing its willingness to cooperate. The Commission and

the Staff often consider such cooperation in determining what remedy, if any, to impose.

5. Wells notice and submission

Where the Staff believes that it will recommend to the Commission that charges be brought against the subject of an investigation, the Staff will usually issue a "Wells notice." A Wells notice invites persons involved in an investigation to present a statement to the Commission setting forth their interests and positions.

a. No right to receive a Wells notice

The Wells submission practice is exactly that—a practice or custom that is not required under law. No court has held that the subjects of SEC investigations have a due process right to receive a Wells notice (or the subsequent opportunity to make a Wells submission).

b. Whether to make a Wells submission

Most potential respondents and defendants choose to make a Wells submission, perhaps because the Staff and the Commissioners appear to evaluate these submissions with care. After evaluating a Wells submission, the Staff may very well alter its recommendations to the Commission, including dropping certain individuals from or reducing the severity of the proposed action. Moreover, because a Wells submission accompanies the Staff's recommendation to the Commission, the submission may have a positive and direct impact on the Commission itself. In some circumstances, strategic considerations may argue against making a Wells submission.

c. Content of a Wells submission

A Wells submission is essentially a legal brief that highlights the hurdles that an action by the Commission would face. The Commission has stated that the most helpful Wells submissions address questions of law and policy, rather than arguing factual matters.

6. Action by the Commission

Where an action has been investigated by the Staff and recommended to the Commission, the Staff's opinion and recommendations are consolidated in an "action memo" to the Commission. This memo sets forth a recommended course of action—enforcement, litigation, no action, or settlement—that the

Commission will usually adopt. The action memo marks the beginning of the Commission process: a two- to three-month period of consideration that determines the fate of the investigation. The Commission conducts a closed meeting to consider the Staff's suggestions and to decide either to do nothing, to commence civil litigation, or to commence an administrative proceeding. While the Commission does not have the power to bring a criminal suit, it may refer the matter to the Department of Justice or state and local authorities for prosecution.

C. Disclosing an SEC Investigation

The SEC's formal investigative proceedings are normally conducted privately to avoid unwarranted injury to the reputations of the persons being investigated. Section 21 of the 1934 Act does authorize the Commission to publish information concerning violations it uncovers during the course of its investigations. Courts have sustained the Commission's right to investigate subjects privately and publicly.

While it usually runs in the favor of a party under SEC investigation to refrain from disclosing the existence or nature of an investigation—if for no reason other than to keep the plaintiff's bar at bay until the investigation is concluded—where the investigation (or matter being investigated) is material, the party may need to disclose it or potentially face additional penalties and litigation. Additionally, whether determined to be material or not, the existence of an investigation must not be falsely denied by an issuer's officials.

D. Civil Enforcement Actions

The Commission is empowered to bring a wide variety of civil enforcement actions.

1. Injunctive actions

Section 20(b) of the Securities Act gives the Commission authority to bring an action to enjoin any person engaged in or about to engage in any act or practice that violates any provision of the Act. In some instances, defendants (without admitting the alleged violations) may consent to the entry of the injunction. Defendants may contest a preliminary or final injunction, however, by arguing that they have not violated the Act and/or that any further violation is improbable.

2. Civil penalties

The Commission may seek a monetary penalty against any person in violation of the federal securities laws or a Commission cease-and-desist order. That includes not just the issuer, but individuals such as officials and staff of

the issuer. As evidenced by the penalties imposed on the San Diego officials in the matter described above, the risk of monetary penalties is not just a theoretical risk for individuals. Moreover, under current Commission policy, a defendant must agree to seek no tax benefit or insurance benefit for a penalty payment.

There are six factors that the Commission considers to determine whether a fine is in the public interest: (1) whether the act in question involves "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement"; (2) resulting harm to other persons; (3) extent of unjust enrichment; (4) degree of recidivism; (5) the need to "deter such persons and other persons from committing such acts or omissions"; and (6) other considerations as justice may require.

3. Prospective relief

As part of a settlement, the Commission will often require that a company agree to an "undertaking"—a particularized prospective action—designed to ensure that the issuer cannot and will not commit the same violation again.

E. Administrative Proceedings

The Commission has the authority to itself adjudicate certain alleged violations of the securities laws after an administrative hearing on the record.

1. Process

a. Conduct of hearings

Once initiated, a formal proceeding is usually tried before an Administrative Law Judge ("ALJ"), an independent Commission employee. The proceeding is conducted in a manner similar to a non-jury trial, with each of the respondents able to present evidence and testimony and to cross-examine witnesses. Unlike a trial, however, a proceeding before the Commission affords the respondents no right to discovery and proceeds at a much faster pace under looser evidentiary standards. At the proceeding's conclusion, the ALJ files an "initial decision."

b. Appeal to the Commission

After issuance of the ALJ's initial decision, respondents may file a petition for a Commission review or the Commission may order a review on its own initiative. The Commission then renders judgment on the basis of submitted materials. It may modify the initial decision in any way, even increasing the initial sanctions.

c. Appeal to United States Court of Appeals

Once a final order has been entered, parties may appeal the Commission's decision to either the United States Court of Appeals for the District of Columbia or the circuit in which the appealing party resides or has its principal place of business.

2. Sanctions

a. Cease-and-desist orders

The Commission has broad authority to administratively enter cease-and-desist orders that restrain violation or threatened violation of the securities laws by any person. If the Commission finds "that any person is violating, has violated, or is about to violate any provision" of the Securities Act, the Exchange Act, or any rule or regulation adopted thereunder, it may enter an order directing the respondent "to cease and desist from committing or causing such violation and any future violation." The order may also direct the respondent to take specific steps "to effect compliance . . . within such time" as the Commission may order. If a cease-and-desist order is violated, the Commission can initiate a proceeding in an appropriate federal district court to impose a civil penalty.

b. Monetary penalties

As noted above, the Dodd-Frank Act conferred on the Commission the authority to impose a monetary penalty on municipal issuers and their officials and employees in connection with administrative cease-and-desist proceedings. The Dodd-Frank Act added a provision to Section 21B, titled Civil Remedies in Administrative Proceedings, that permits the imposition of civil penalties in cease-and-desist proceedings. Specifically, the new Section 21B(a)(2) provides that the Commission may impose a civil penalty against any person who " is violating or has violated any provision of [the Exchange Act], or any rule or regulation issued under [the Exchange Act]" or who is or was "a cause of the violation."

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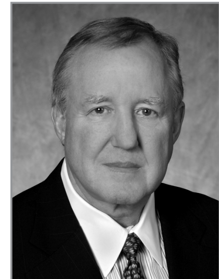

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