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Implications of the New SEC Penalty Policy

In a speech on April 13, SEC Chairman Christopher Cox announced a new policy governing monetary penalties in enforcement actions against public companies. Under the new approach, in some cases, the SEC's enforcement staff will be required to obtain authorization from the Commission before commencing settlement negotiations involving a monetary penalty. This is a fundamental change from current practice, in which the staff has first negotiated with the prospective defendant and only after reaching agreement on proposed settlement terms has then presented a recommendation for the Commission's approval. One of the Commissioners, Roel Campos, has since taken the unusual step of publicly expressing concerns about the new policy. Chairman Cox has further stated that the policy will be tested on a pilot basis in a limited number of cases. There is a high degree of uncertainty about the manner in which this new approach will be implemented, and about the implications for corporations.

Prior to this change, the staff typically brought enforcement recommendations to the Commission in two basic scenarios: (1) a proposed settlement to which the prospective defendant had already agreed, supported by a lengthy staff memorandum describing the evidence and legal issues in the case and recommending that the Commission authorize the settlement; or (2) a recommendation that a non-settled enforcement action be authorized, supported by a staff memorandum and accompanied by a "Wells" submission from the prospective defendant setting forth the reasons why the staff's recommendation should be rejected or narrowed. In other words, enforcement recommendations have reached the Commission in a fully-developed state, either following the give-and-take of settlement negotiations in which the staff's views have been tested, or through the Wells process in which the prospective defendant has the opportunity to be heard and to provide factual information and legal analysis in response to the staff's views of the evidence and the law.

Under the existing approach, the Commission has never been bound to accept what its staff has negotiated. Negotiations have always been conducted on the basis of what the staff is willing to recommend. The Commission itself has always retained the authority to accept, modify or reject what the staff recommends to it. The Commission has on many occasions exercised that authority by directing that penalties be reduced or increased, by determining not to pursue charges against certain parties, or by modifying the charges proposed by the staff. When the Commission takes one of these steps, the impact stretches far beyond the outcome in a particular case, and it is an extremely effective means for the Commission to communicate its policy views to the staff.

Under the new policy, the staff will apparently go first to the Commissioners *seriatim* to seek authorization to negotiate a monetary penalty within a specified dollar range. It is unclear how fully-developed the Commissioners' basis for providing this direction will be. The Commission's answer to this procedural question will have significant implications for affected corporations. In order for the Commissioners to form a view as to the propriety of a

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penalty and the range to be authorized in each case, they will need to be briefed by the staff concerning the evidence and potential charges. This can occur in one of two ways.

First, the staff may brief the Commissioners solely on the basis of the staff's view of the case, with no input from the prospective defendant. The principal pitfall here is obvious – in the absence of the back-and-forth discussion that occurs between the staff and defense counsel in either a settlement negotiation or a Wells process, the staff's view of any case will be untested. The Commissioners will receive a decidedly one-sided presentation of the case – a presentation made undoubtedly in good faith, but without having withstood, or been moderated as a result of, information provided by defense counsel.

A second approach would be to inform defense counsel that the staff is going to the Commissioners, and to afford an opportunity for the types of meetings with the staff and written submissions to the Commissioners that now occur through the Wells process. This approach would have the virtue of allowing the prospective defendant an opportunity to be heard and to contest the staff's view of the case before the Commissioners provide direction as to monetary penalties. In many cases, however, this approach would result in substantial unnecessary expense for corporations, as it would entail the equivalent of a full-fledged Wells process before any settlement negotiations could occur, in circumstances in which at least some companies would prefer to move directly into settlement negotiations. It is not clear, moreover, how forthcoming the staff will be about its views of the case in this pre-negotiation context. In short, while one can envision a process that could lead to more informed and balanced decision-making, it is not at all clear whether such a process will be implemented, or whether it will be as full and fair a process as the Wells process currently is.

Before permanently implementing the new penalty policy, the Commission would be well advised to be sure that the process it is fixing is in fact in need of repair. The new policy has been described as part of an effort to streamline enforcement, and to put the staff in a stronger negotiating position when it sits across the table from defense counsel knowing that the Commission has already authorized penalties at a certain level. While streamlining is an admirable goal, it should not be pursued at the cost of an adequate opportunity to understand the basis for proposed charges and sanctions. No one's interest is served if more speedy outcomes are obtained by diminishing or eliminating the opportunity for corporations to bring to the attention of the staff and the Commissioners the reasons why the evidence is more shaky than they think, or why more lenient sanctions are warranted. This opportunity to be heard is much more meaningful if it is afforded as part of the process by which the staff and the Commissioners form their views of a case, rather than much later in the day, after the views have been formed and the Commission has already given the staff precise direction on acceptable settlement terms.

Our view is that the approach that the Commission has followed for many years has served it well. If the Commission wishes to magnify its impact on the settlement process, then the most effective way to do that is to exercise its authority when settlement recommendations come before it. Settlements are considered in non-public meetings with the staff present, and additional staff tuned in by videoconference in regional offices around the country. Comments made by Commissioners at these meetings – and votes taken to modify or

reject settlement or enforcement recommendations – have a substantial impact on the staff’s handling of subsequent cases. The staff is responsive to direction given by their client, the Commission, and that direction will be on the soundest footing when it is based on a fully developed record, with an opportunity for all parties concerned to be heard.

Until there is clarification concerning the implementation of the new penalty policy, the steps that corporations may consider to protect their interests include the following:

- Request that the staff inform you whether the matter will be handled pursuant to the new policy;
- Ask the staff whether they will notify you before they make a presentation to the Commissioners regarding monetary penalties, and request an opportunity to be heard before the staff makes such a presentation; and
- Request an opportunity to make a written submission to the Commissioners before they give the staff any direction regarding penalties.

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