

June 8, 2007

### SEC Penalties Revisited

In a May 15, 2007 memorandum we discussed the SEC's new pilot 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. Our memorandum expressed various concerns about the manner in which this policy might be implemented, and we emphasized the importance of defense counsel having the opportunity to be heard before the Commission reaches a view on the penalties to be sought in a particular case.

Although the SEC has not spoken publicly on the topic, word is now circulating informally regarding the procedure that will be implemented. Our understanding is as follows. In a case in which the SEC enforcement staff believes a penalty is warranted, the staff will issue a Wells notice. The typical Wells process will then follow, culminating in a written Wells submission on behalf of the company that will be submitted to the Commission along with the staff's memorandum recommending enforcement action. The staff's memorandum will also seek authority to negotiate a monetary penalty. If the Commission authorizes the enforcement action and concludes that a penalty is appropriate, it will authorize the staff to negotiate within a specified range. If the staff then is able to obtain a negotiated resolution including a penalty within that range, the settlement will then be approved in a streamlined manner by the Commissioners acting seriatim. If the staff is not able to negotiate a settlement, it then has authority to file a non-settled enforcement action without needing to go back to the Commission.

We strongly suspect that the practical difficulties inherent in implementing this policy may outweigh any perceived benefit that it may be intended to achieve.

#### What If You Want To Settle?

In some instances, a company receiving a Wells notice would prefer to settle the matter. The company may recognize that there is some measure of validity to the staff's charges; the company may not wish to incur litigation risk even though it has colorable defenses; or the company may not wish to be embroiled in litigation against a regulator for years to come – and the company may be willing to pay a monetary penalty as part of the resolution. It would appear that a company in this posture would have three choices under the new policy, each of which has significant downsides.

First, the company could seek to negotiate a proposed settlement with the staff encompassing all of the necessary terms except the monetary penalty. The staff could then recommend the partial settlement to the Commission and simultaneously seek authority to negotiate the penalty. The company could make a Wells submission addressing only the penalty. It would be asking a great deal, however, if the Commission is expecting companies to negotiate settlement terms without being able to address the penalty amount as part of that same discussion. A company contemplating a possible settlement should continue to have the ability

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to consider all of the material elements of the proposed enforcement action when deciding whether or not to pursue settlement. Few companies will be willing to answer questions like the following without knowing what level of penalty the Commission is going to seek as part of a settlement:

- Are we willing to accept a fraud charge, or will we insist on lesser violations?
- Are we willing to accept an injunctive action, or will we seek an administrative proceeding?
- Will we accept the burden and expense of an “independent consultant” review, or attempt to persuade the staff that it is not needed?
- Are we willing to enter into a company settlement without a resolution as to whether the staff intends to pursue charges against one or more of the company’s personnel?

While the Commission’s stated position is that it does not “trade” penalty payments for other settlement elements, it is nonetheless true that both sides take into account the full mix of factors in deciding whether a proposed overall package of settlement terms is acceptable. The inability to negotiate the penalty element with the staff on the front end may mean that fewer cases will settle at this stage.

Second, even though the staff is no longer permitted to negotiate (or even discuss) a proposed penalty amount, a company is not precluded from submitting a settlement offer that includes a proposed penalty. The enforcement staff’s policy – in conformity with the ethical rules governing lawyers – has always been to communicate all settlement offers to their client, the Commission. Under the new policy, however, a company wishing to take this approach will presumably have to be willing to fly blind – without knowing whether the staff will recommend to the Commission that the offered penalty amount be accepted or rejected, and without knowing what level of penalty the staff will tell the Commission it believes is warranted.

Perhaps in these circumstances the staff will be permitted to give counsel some indication of what its recommendation to the Commission will be with respect to the offer that a company is contemplating submitting. That would lead to a more rational process. But where is the line between that sort of interchange and the “negotiation” that has now been declared off-limits?

Third, the company could simply make a Wells submission and defer any settlement negotiation until the staff comes back from the Commission with authority to negotiate the penalty. But this approach will be anything but simple, for a host of reasons.

*Needless expense and delay* – Writing a Wells submission is a time-consuming and expensive undertaking. It requires mastery of the evidentiary record – which can often include defense-oriented factual development that goes far beyond the record created by the enforcement staff in their effort to build their case. It may involve substantial legal research. It may involve retention of and extensive work with experts, and generation of expert reports. It

certainly involves considerable time and effort devoted by counsel to evaluating and framing the arguments so as to be as credible and persuasive as possible. Historically, avoiding this burden and expense was one of the benefits of settling.

*Collateral consequences* – In some cases, a company may prefer not to write a Wells submission for strategic reasons having nothing to do with the SEC investigation. For example, there may be concern about a Wells submission being discoverable in pending or anticipated private litigation. If counsel attend meetings with the staff and orally present the company's views, the same concerns do not arise. But under the Commission's new policy, a company will apparently have the opportunity for its views to be considered before the Commission makes a penalty determination only by putting them in writing.

*Which Wells submission are you writing?* – A company desiring to settle may face difficult questions of how to frame its Wells submission. These questions will be even more difficult if the company does not know what range of penalties the staff will be seeking authority from the Commission to negotiate. The answers to questions such as the following may differ greatly depending on the level of penalty that the staff is seeking:

- Should the Wells submission advocate that the Commission not bring any enforcement action at all? Or should it acknowledge that there will be a case, and only advocate narrowing the charges that the staff is proposing?
- Should the Wells submission sharply dispute the staff's view of the evidence? Should the submission be strongly adversarial in tone, or more moderate?
- Should the Wells submission present arguments in support of a settlement, or in favor of particular settlement terms?
- Should the Wells submission's discussion of penalties be premised on the staff's view of the facts (which the company is willing not to contest for settlement purposes), or should it be based on the company's view of the facts (which the staff will seek to refute in its memorandum to the Commission)?
- Should the Wells submission propose a specific penalty amount that the company is willing to pay?

The answers to these and other questions will have a substantial impact on how the Wells submission is written. This will in turn, have a significant impact on how the staff frames its action memo to the Commission.

#### What Problem Does The New Policy Solve?

It is useful to return to the question of what problem the Commission is seeking to solve with this new policy. The policy has been portrayed as an effort to give the staff a stronger bargaining position in settlement discussions because defense counsel will know that the Commission has already given the staff authority to negotiate within a prescribed range. While

there may be flaws in the settlement negotiation process, insufficiency of bargaining power for the staff is simply not one of them.

It has also been suggested that the new policy will streamline the Commission's review and authorization of settlements. As we have indicated above, however, it appears that the policy is likely to have the opposite effect. Indeed, the policy appears likely to make it more difficult and costly for both sides to reach settlements, for reasons unrelated to the merits.

Finally, the new policy may be an effort to address a perception by Commissioners that settlement recommendations reach them as a *fait accompli*, leaving the Commission without the level of influence that it should have upon settlement terms and trends. If the new policy is an attempt to respond to these concerns by giving the Commission a more direct role in settlement negotiations, we would question the need for such a change. The Commission is already able to exert as much influence and control as it chooses when enforcement and settlement recommendations come before it. If the Commission does not like what the staff is bringing to it, whether in a particular case or more generally, the Commission has ample means at its disposal to communicate its views by rejecting or modifying the staff's recommendations. The Commission does in fact exercise this authority, and is not a rubber stamp for the staff.

At the same time, the Commission's staff-centered case review and settlement process has functioned admirably, literally for decades. The participants in that process include not only the investigative team who are closest to the case and more senior enforcement officials above them, but also all other interested divisions and offices within the agency. The senior staff take this review process very seriously, and it is not a rare event for a presentation by defense counsel – or purely internal discussions with staff from another division or office – to lead to charges being dropped or narrowed. But this review process can work well only when the staff who know the case most intimately communicate their views transparently to defense counsel. We would urge the Commission to reconsider whether it is desirable to adopt a new penalty policy that risks altering this time-tested process in the ways we have described, particularly where it is so difficult to identify any practical problems that the penalty policy appears likely to solve.

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