April 2015

In This Issue

Message from the Chair

Upcoming Meeting

Upcoming Program

Featured Articles

- What directors need to know: SEC broadening D&O liability for securities fraud
- The policies, procedural rules and other considerations governing administrative investigations by and proceedings before the United States Securities and Exchange Commission
- Crowdfunding and the JOBS ACT - It Seemed So Simple!
- The Top Ten D&O Stories of 2014

Important Dates

Business Law Section Spring Meeting
April 16-18, 2015
San Francisco, CA

Editorial Board

- Corinne Elise Amato
- Frances Floriano Goins
- Michaela Sozio

Message from the Chair

I hope you will join us at the ABA Business Law Section Spring Meeting in San Francisco. On Thursday morning April 16 from 8:00 a.m. to 10:00 a.m., our committee will sponsor a CLE panel entitled Director Oversight Liability In The Cybersecurity Age: The Interplay of Caremark/Stone and Effective Risk Management. The Panel includes our own Frances Floriano Goins and Brett Amron. They have also asked that I participate along with a cybersecurity technical expert from Stroz Friedberg and an insurance broker from AXIS Insurance. The Panel will take place at the Marriott Marquis, Salon 14 & 15, Yerba Buena Ballroom, Lower B2 Level.

In addition, on Friday April 17 at 10:00 a.m. our committee will meet to discuss timely topics under state and federal law affecting officers and directors. That meeting will be held at the Marriott Marquis, Sierra C, Fifth Level. Please use the following dial in information if you are unable to attend in person:

Toll-free dial-in number (U.S. and Canada): (866) 646-6488
International dial-in number: (707) 287-9583
Conference code: 7227876294

Our CLE, this newsletter and our Committee meeting exemplify the Committee’s goal to be a reliable provider of information concerning cases, statutes and other developments affecting director and officer liability. Our numbers are growing and you are welcome to join. Opportunities abound to publish or speak on topics of interest to officers and directors or those who counsel them.

I look forward to seeing you. Feel free to contact me directly at llazarus@morrisjames.com with your suggestions or ideas.

Lewis H. Lazarus
Morris James LLP
Chair, Directors and Officers Liability Committee
ABA Business Law Section

Upcoming Meeting

Director and Officer Liability Committee Meeting
Friday, April 17, 2015
10:00 AM - 11:30 AM
Marriott Marquis
Sierra C, Fifth Level

Upcoming Program

Please be sure to attend the program entitled “Director Oversight in the Cybersecurity Age: The Interplay of Caremark/Stone and Effective Risk Management” which will be presented by the Director and Officer Liability Committee and co-sponsored by the Corporate Governance Committee, the Business & Corporate Litigation Committee, the Private Equity and Venture
Capital Committee and the Corporate Counseling & Litigation Subcommittee.

The program will take place on Thursday, April 16, 2015 from 8:00 a.m. to 10:00 a.m. at Salon 14 & 15, Yerba Buena Ballroom, Lower B2 Level, Marriott Marquis, during the ABA Business Law Section Spring Meeting in San Francisco, California.

The program will be chaired by Frances Floriano Goins, Esq. of Ulmer & Berne LLP and panelists will include: Lewis H. Lazarus, Esq., Morris James LLP; Emy Donavan, Vice President - Technology, Media, Specialty E&O, and Cyber Underwriting of Axis Capital; David E. Garrett, Managing Director of Stroz Friedberg, LLC; and Brett M. Amron, Esq., Co-Managing Partner of Bast Amron LLP.

This panel is will focus primarily on how cybersecurity and data breaches can impact liability for corporate directors and officers. The panel will discuss (i) development of "oversight" liability theories under Caremark/Stone; (ii) impact of snowballing data breachers and resulting litigation; (iii) increased government and regulatory attention; (iv) best practices to avoid liability; and (v) insurance coverage for data breaches.

### Featured Articles

**What directors need to know: SEC broadening D&O liability for securities fraud**

*By Bradley J. Bondi*

Senior leadership at the Securities and Exchange Commission (SEC) has vowed to use section 20(b), an obscure section of the Securities Exchange Act of 1934, to charge individuals who may have had some role in a corporate disclosure but were not the requisite "makers" of the statement.

The ramifications are significant for directors, including members of the audit committee, and officers who may have reviewed or assisted in the preparation of corporate disclosures. SEC Chair White and Enforcement Director Ceresney both indicated that the SEC will pursue gatekeepers, including directors, and the SEC recently charged the chair of an audit committee for allegedly failing to act promptly enough to investigate red flags.

[Read more...](#)

**The policies, procedural rules and other considerations governing administrative investigations by and proceedings before the United States Securities and Exchange Commission**

*By Daniel P. Dwyer*

The Dodd-Frank Wall Street Reform and Consumer Protection Law of 2010 included amendments to the securities laws that allow the Securities and Exchange Commission ("SEC") to pursue significant monetary penalties from both regulated and unregulated persons through its administrative proceedings. These administrative proceedings offer shorter times within which proceedings are to be resolved, quasi-judicial determinations made by an employee of the SEC, limited discovery and very limited and deferential appellate review. Therefore, attorneys who defend officers and directors should be informed about the rules and standards applied in the SEC's administrative proceedings. They should also be aware of the reporting, compliance, document and equipment retention and destruction and insurance considerations that the increased use of administrative proceedings imply. This article describes the rules and policies governing SEC investigations and administrative proceedings. It also identifies some of the considerations that counsel should raise with their clients when or prior to being presented with an SEC investigation.

[Read more...](#)

**Crowdfunding and the JOBS ACT - It Seemed So Simple!**
By Daniel R. Formeller

The JOBS Act was signed into law in April 2012 with significant fanfare and was thought by most observers to be a vehicle which would stimulate growth through the accelerated process of raising capital to allow start-up companies to grow. Whether this prognostication comes true is yet to be seen but the predictions that the Act would simplify the process of getting from start-up to an initial public offering certainly have not become a reality.

To entrepreneurs, the JOBS Act seemed like the answer to their needs in raising capital from a larger pool of investors and in providing a streamlined ramp in the process of preparing and filing for the initial issuance of publicly traded stock. The reality appears to be something else altogether. We need look no further than the mechanics of Title III of the Act to understand the alchemy of turning simple into complex.

Read more...

The Top Ten D&O Stories of 2014
By Kevin LaCroix

This article originally appeared in The D&O Diary, http://www.dandodiary.com, and is reproduced with the permission of the author.

The year just ended was an eventful one in the world of directors' and officers' liability. Many of the year's key events represented significant changes in the D&O liability environment. Many of the changes during 2014 have important implications for 2015 – and possibly for years to come. The list of the Top Ten D&O Stories of 2014 is set out below with an eye toward these future possibilities.

Read more...
INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Law of 2010 included amendments to the securities laws that allow the Securities and Exchange Commission (“SEC”) to pursue significant monetary penalties from both regulated and unregulated persons through its administrative proceedings. These administrative proceedings offer shorter times within which proceedings are to be resolved, quasi-judicial determinations made by an employee of the SEC, limited discovery and very limited and deferential appellate review. Therefore, attorneys who defend officers and directors should be informed about the rules and standards applied in the SEC’s administrative proceedings. They should also be aware of the reporting, compliance, document and equipment retention and destruction and insurance considerations that the increased use of administrative proceedings imply. This article describes the rules and policies governing SEC investigations and administrative proceedings. It also identifies some of the considerations that counsel should raise with their clients when or prior to being presented with an SEC investigation.1

---

1 This article was written for the purpose of providing general information to legal practitioners. It is not, and should under no circumstances be considered, legal advice upon which any individual litigant can rely. Any person posed with any circumstances described in this article should promptly retain appropriate counsel in writing and obtain any needed advice from that counsel.
# Table of Contents

Introduction ........................................................................................................................................... 1  
Table of Contents ................................................................................................................................. 2  
I. The SEC’s Increased Use of Administrative Proceedings ................................................................. 3  
II. A Description of the SEC’s Administrative Proceedings ................................................................. 5  
   A. The Statutes, Regulations and Internal Documents Governing SEC Investigations and Administrative Actions, Generally ................................................................. 5  
   B. Informal SEC Investigations/MUIs .................................................................................................. 6  
      1. Events Leading to Initiation of Informal SEC Investigations .................................................. 6  
      2. Target Cooperation in MUIs ...................................................................................................... 8  
      3. Privilege Waiver in SEC Investigations ................................................................................... 11  
   C. Formal SEC Proceedings .............................................................................................................. 13  
      1. The Order Instituting Proceedings and the Answer .................................................................. 14  
      2. Prehearing Conferences, Submissions and Disclosures .......................................................... 16  
      3. Discovery Limitations on Subpoenas and Depositions ............................................................ 17  
      4. The Hearing ............................................................................................................................. 19  
   D. Appeals of SEC Proceedings ......................................................................................................... 20  
      1. Appeals of an Administrative Law Judge’s Initial Decision to the Commission .................... 20  
         a. Timing ................................................................................................................................... 20  
         b. The Contents of a Petition for Review ............................................................................... 21  
         c. The Commission’s Review of the Petition ......................................................................... 21
2. Appeals of the Commission’s Decision to the United States Circuit Court of Appeals.................................22

III. Conclusion and Suggestions ...........................................................................................................24

I. THE SEC’S INCREASED USE OF ADMINISTRATIVE PROCEEDINGS

There was a marked increase in the number of administrative actions brought by the Enforcement Division of the SEC during 2014. Between April 1 and September 30, 2014, the Enforcement Division filed 43 more administrative proceedings than it had during the previous six month period, an increase of 45 percent. In June 2014, in response to a question inquiring whether the SEC would use administrative proceedings against insider trading defendants, Andrew Cersney, the SEC’s Co-director of Enforcement responded:

I think you are seeing us use the administrative proceeding more and more and it’s a venue that has a sophisticated trier of fact, and one where it’s a more streamlined proceeding. So it has a great benefit to us and I think you have seen that in the last year or two, and I think you will see that more and more in the future.

Shortly after this statement was made, the SEC announced that it had doubled its administrative law office staff.

The SEC’s increased use of administrative proceedings has been attributed, at least in part, to changes to the various securities statutes that were included in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Statute. Sections 929 M, N and O allow the SEC to

---

pursue aiding and abetting claims for violators of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940. 6 Sections 929 P(a)(1), (a)(2), 929 P(a)(3) and 929 P(a)(4) permit the SEC to recover monetary penalties through its administrative proceedings, for violations of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisors Act of 1940. 7 Officers and directors of many businesses, including professional services providers such as auditors, ratings agencies, law firms and banks, which provide services to those who are regulated by the SEC could be subject to potential liability. 8 Moreover, these claims may be asserted in a forum that applies few evidentiary rules, has limited discovery, is subjected to limited and deferential judicial review and is administered by an employee of the SEC. Given the advantages enjoyed by the SEC in these proceedings, counsel should be well-informed about the procedures used.

question-of-home-court-edge.html (Dodd-Frank amendments to securities statutes which allow SEC staff to obtain monetary penalties against person not regulated by SEC in venue with limited discovery, possible lack of neutrality, limited appellate review and high success rate for SEC gives rise to an expectation that SEC will make increased use of administrative forum); Hon. Jed. S. Rakoff, IS THE SEC BECOMING A LAW UNTO ITSELF?, Address Before the Practicing Law Institute Securities Regulation Institute (Nov. 5, 2014) at 5 (discussing, inter alia, whether the provisions of Section 929P of Dodd-Frank Act, permitting recovery of monetary penalties against non-regulated persons in administrative proceedings remove all incentives for SEC to avail itself of United States District Courts).


7 Dodd-Frank Act §929 P (codified at 15 U.S.C. §§77h-1, 78u-2(a), 80a-9(d) and 80b-3(i)(i))

8 See, July 21, 2011 letter from Susan D. Sawtelle, Managing Associate Director of the United States Governments Accountability Office to the Honorable Tim Johnson, the Honorable Richard C. Shelby, the Honorable Spencer Bachus and the Honorable Barney Frank (discussing secondary liability of banks, brokers, accountants and lawyers for violations of securities law)(GAO-11-664, Securities Fraud Liability of Secondary Actors).
II. A DESCRIPTION OF THE SEC’S ADMINISTRATIVE PROCEEDINGS

A. The Statutes, Regulations and Internal Documents Governing SEC Investigations and Administrative Actions, Generally.

The documents, regulations and statutes that govern the SEC’s administrative remedies include the Securities and Exchange Commission Division of Enforcement, Enforcement Manual (Oct. 9, 2013) (“Enforcement Manual”)\(^9\), the SEC’s Rules of Practice and Rules on Fair Fund and Disgorgement Plans (March 2006) (“ROPs”)\(^10\), the sections of the Administrative Procedures Act governing procedures before federal agencies and administrative law judges\(^11\) and the provisions of the United States Code providing for the scope and standard of review of an appeal of the SEC’s adjudication in an administrative proceeding.\(^12\)

The Enforcement Manual provides guidance on background and policy issues but does not create any enforceable procedures or substantive rights for the target of an investigation.\(^13\) As the discussion turns to the specific procedures of an administrative proceeding, one relies more on the ROPs because they govern “… proceedings before the [SEC] under the statutes it

\(^9\) http://www.sec.gov/enforce#.VKHa4l7tIiJN
\(^10\) 17 C.F.R. §201.100, \textit{et seq.}; http://www.sec.gov/about/rulesofpractice.shtml
\(^11\) 5 U.S.C. § 554, \textit{et seq.}
\(^12\) 15 U.S.C. §§77i; 78y.
\(^13\) Specifically, the Enforcement Manual states that:

[The Enforcement Manual] contain various general policies and procedures and is intended only to provide guidance to the staff of the [Enforcement Division of the SEC]. It is not intended to, does not, and may not be relied upon to create any rights, substantive of procedural, enforceable at law by any party in any matter civil or criminal.

Enforcement Manual at 1, §1.1.
administers” but do not apply to investigations. These authorities and the procedures they describe are also subject to constitutional limitations on the exercise of governmental power.

B. **Informal SEC Investigations/MUIs**

1. **Events Leading to the Initiation of an Informal SEC Investigation.**

The first step in an SEC administrative proceeding is an informal investigation. Anything that piques the SEC’s interest can give rise to an informal investigation. Possible causes of an investigation include: direct contact between a member of the general public and SEC personnel, the receipt of information from a whistle blower, information generated about a broker-dealer through the Bank Secrecy Act, referrals from the Public Company Accounting Oversight Board, or state securities regulators, Congress or other self-regulatory organizations. If the SEC staff determines that either the source of a claim is credible or that a “set of facts suggests that further inquiry could lead to an enforcement action” the inquiry becomes a Matter Under Investigation (“MUI”). The SEC staff endeavors to either close an MUI or convert it to a formal investigation within 60 days.

To determine whether to convert an MUI to a formal investigation, the SEC staff considers whether the investigation has the potential to substantively and effectively address violative conduct. This evaluation includes consideration of:

1) whether the possible violations include fraud or other serious misconduct and, if so;

---

14 ROP 100.
15 Enforcement Manual at §§ 2.2.1 – 2.2.2.5.
16 Enforcement Manual at § 2.3.1
17 See Enforcement Manual at §2.3.1 (“As a general matter, MUIs should be closed or converted to an investigation within 60 days.”)
18 Enforcement Manual at §2.3.2.
2) the magnitude of the violations;
3) the size of the victim group;
4) the amount of losses, profits or losses avoided as a result of the misconduct;
5) the materiality of any misreporting;
6) the potential for the misconduct to undermine the fairness or liquidity of U. S. securities markets;
7) recidivism, and;
8) SEC or Congressional priorities.¹⁹

This analysis may require much more information and documentation than the SEC has in its possession when the MUI is opened.

2. Target Cooperation in MUIs

The SEC cannot compel document production or other discovery from the target while pursuing an MUI.²⁰ Therefore, SEC staff must often rely on a target’s cooperation. Two documents describe the benefits of target cooperation in an MUI. The first, known as the Enforcement Manual at §2.3.2. Some commentators suggest that the ability of an investigation to result in the recovery of fines and penalties may play a disproportionate part when the SEC determines whether to convert and MUI to a formal investigation. See, Kenneth B. Winder, Laura S. Kwarterski, *Assessing SEC Power in Administrative Proceedings*, LAW360 (March 24, 2011)(discussing SEC’s increased ability to recover greater monetary penalties in administrative proceedings with limited due process protections); Sonia A. Steinway, *SEC Monetary Penalties Speak Very Loudly, ” But What Do They Say? A Critical Analysis of the SEC’s New Enforcement Approach*, 124 YALE L.J. 209, 221 (Oct. 2014)(discussing how Fair Funds and disgorgement statutes led to the SEC’s ability to recover increased penalties and fines from a widening range of respondents and why such funds are placed in federal general fund and not paid to wronged parties).

²⁰See, 17 C.F.R. § 202.5(a)(“In such preliminary investigation no process is issued or testimony compelled.”)
Seaboard Report,\textsuperscript{21} describes the factors that guide the SEC’s willingness to credit a target corporation’s cooperation with an SEC investigation. The second document has the self-explanatory title of SEC Release No. 34-61340, re: Policy Statement Concerning Cooperation By Individuals in Investigations and Related Enforcement Action (Jan. 19, 2010).\textsuperscript{22} Although these documents address the SEC’s policies for artificial entities and individuals in slightly different order and terms, when read together they identify many of the same issues.\textsuperscript{23}

Both documents are clear about the potential benefits of cooperation. Benefits include a decision not to pursue enforcement action, reduced charges, or the inclusion of mitigating language in documents used to announce and resolve enforcement actions.\textsuperscript{24} Cooperation may also affect the Enforcement Division’s recommendations to the Commission, influence its agreement to enter into deferred prosecution agreements, expedite its immunity requests to the Department of Justice and/or to stipulate to limitations on the subsequent use of proffer statements.\textsuperscript{25}

The degree to which the SEC credits cooperation depends on many factors. These include:

1. **The Nature of the Misconduct**: The SEC considers whether the misconduct was the product of mere inadvertence or simple negligence or


\textsuperscript{22} 17 C.F.R. § 202.


\textsuperscript{24} Seaboard Report at 2/5; 17 C.F.R. § 202.12.

was it the product of a venal environment or intentional wrongdoing; how high in the corporate chain of command did it occur; what harm resulted and to who; how large is the class of harmed parties; what is the subject matter of the wrongdoing and is it related to any SEC priorities.\textsuperscript{26} Is essence, how bad was the conduct and the resulting harm?

2. \textbf{The Discovery of and Response to the Misconduct}: Who discovered the misconduct; was it the SEC or another agency or was it self-reported; how long did the wrongdoing continue before it was discovered; how long did it take to respond; what was the response; were wrongdoers removed; what steps were taken to prevent future misconduct.\textsuperscript{27} How and when was the conduct discovered and what did the actor do when she learned about it?

3. \textbf{Value of the Assistance}: Was the cooperation and assistance timely, truthful, reliable, voluntary and forthcoming; was the target forthcoming with its own investigative materials and did it agree to any waivers of privilege.\textsuperscript{28} What did the SEC get as a result of the cooperation?

4. \textbf{The Interest in Holding the Corporation or Individual Accountable}: Does the corporation still exist or has it merged or otherwise changed; in the case of an individual, what is his background; was there scienter; should anyone have known better; what is the individual’s or corporation’s history of lawful-or lawlessness.\textsuperscript{29} What difference will penalties make and who will pay for them?

In summary, the SEC may weigh the severity of the misconduct against the timeliness, value to the SEC and remediating effect of the response and cooperation (particularly in terms of whether there was self-reporting and other signs of initiative), while also considering other factors like policy considerations and the corporate culture in which the misconduct occurred. Both documents identify these lists as non-exclusive descriptions of factors that may be considered subject to the facts of each given case.\textsuperscript{30} Both documents also emphasize self-
reporting, prompt action and broad disclosure and cooperation that include willingness to waive attorney-client and work product privileges.

3. Privilege Waiver in SEC Investigations

Although both the Seaboard Report and 17 C.F.R. § 202 mention privilege waiver while evaluating target cooperation, recent revisions to the SEC Enforcement Manual address waiver as follows:

A key objective in the staff’s investigations is to obtain relevant information, and parties are, in fact, required to provide all relevant, non-privileged information and documents in response to SEC subpoenas. The staff should not ask a party to waive the attorney-client privilege or work product protection without prior approval of the Director or Deputy Director …

Both entities and individuals may provide significant cooperation in investigations by voluntarily disclosing relevant information. Voluntary disclosure of information need not include a waiver of privilege to be an effective form of cooperation and a party’s decision to assert a legitimate claim of privilege will not negatively affect their claim to credit for cooperation. However, as discussed below, if a party seeks cooperation credit for timely disclosure of relevant facts, the party must disclose all facts with the party’s knowledge.31

This Section of Enforcement Manual makes it clear that while the Enforcement Division is limited in its attempts to request privilege waiver, cooperation credit requires that a target voluntarily disclose any and all relevant facts regardless of whether the facts were gathered in a privileged or non-privileged fashion.32 Therefore, a party may nevertheless feel compelled or pressured to waive privilege in the interest of obtaining cooperation credit.

31 Enforcement Manual § 4.3 (emphasis in original)
32 This is consistent with changes to Department of Justice policies regarding privilege waiver which, while purporting to make privilege waiver non-mandatory, render it necessary for any cooperation credit. See, Memorandum from Paul J. McNulty, Deputy Attorney General, U.S. Department of Justice, to Heads of Department Components and United States Attorneys (Dec. 12, 2006) (the “McNulty Memorandum”), available at http://www.justice.gov/dag/speeches/2006/mcnulty_memo.pdf.
A target must also consider whether the waiver of privilege while dealing with the SEC will also be a waiver as to any subsequent private litigants. Although some Circuit Courts of Appeal once recognized a limited waiver that would not apply to private litigants, more Circuit courts reject limited waiver and require that documents provided to the SEC and other government agencies in administrative and enforcement actions also be produced to private litigants in subsequent litigation. Other courts have “left the door open” to recognizing limited waivers in cases where stringent non-disclosure agreements and other protective measures are taken. Therefore, when making decisions regarding cooperation and privilege waiver, targets

33 See Diversified Industries, Inc. v. Meredith, 572 F.2d 596, 611 (8th Cir. 1977)(memorandum produced by target’s counsel regarding SEC investigation was subject to limited waiver and so not required to be produced to private litigants, although factual information contained in it could be obtained from non-privileged sources and documents).

34 See e.g., United States v. Massachusetts Institute of Technology, 129 F.3d 681, 685 (1st Cir. 1997)(rejecting selective waiver after target disclosed privileged documents to Defense Audit Agency); Ratliff v. Davis, Polk & Wardwell, 354 F.3d 165, 170 (2d Cir. 2003)(documents sent with intention to be provided to SEC as part of investigation not subject to privilege); Columbia/HCA Healthcare Billing Practices Lit., 293 F.3d 289, 302-03 (6th Cir. 2002)(rejecting limited waiver “in any of its forms” in case where defendants tried to withhold document in civil litigation that had been produced to government agencies in enforcement action); In re Pacific Pictures Corp., 679 F.3d 1121, 1127-28 (9th Cir. 2012)(holding that documents produced to grand jury pursuant to subpoena must also be made available to private litigants); In re Qwest Communications Int’l., Inc., 450 F.3d 1179, 1193-95(10th Cir. 2012)(documents produced to SEC and DOJ in administrative and enforcement actions were subject to production to private litigants despite execution of non-disclosure agreement).

35 See, Qwest Communications, 450 F.3d at 1195 (discussing that, although non-disclosure agreement in that case was of no effect because of its breadth and the discretion that SEC and DOJ had to use and disclose documents to third parties, this may not be so in all cases); Lawrence E. Jaffe Pension Plan v. Household, Intern., Inc., 244 F.R.D. 412, 433 (N.D. Ill. 2006)(holding that there was no waiver of privilege when privileged documents were produced to SEC subject to a non-disclosure agreement that was more stringent that that in Qwest because it specifically identified the lack of intention to waive privilege and limited use and disclosure of documents by DOJ and SEC).
and their counsel should be aware of this trend towards considering any waiver in SEC proceedings a blanket waiver for purposes of subsequent proceedings. They should also take care to draft and press for the most specific and enforceable non-disclosure agreements possible. Finally, they should also be consider whether any privilege waiver may constitute a breach of the duty of loyalty.

C. Formal SEC Proceedings

After concluding an investigation and prior to recommending action to the Commission, the SEC may, but is not required to, issue a Wells Notice to a target. A Wells Notice is a letter from the Enforcement Division to the target and/or her counsel informing them whether the SEC intends to pursue charges, what charges will be pursued and providing an opportunity to respond prior to the filing of charges. When considering whether and how to respond to a Wells Notice, counsel should be conscious that the response, like other documents produced during the investigation, may be available to any private litigants.

---

36 17 C.F.R. § 202.5(c).

37 The Enforcement Manual defines a Wells Submission as:

… a communication from [SEC] staff to a person involved in an investigation that: (1) informs the person the staff has made a preliminary determination to recommend that the Commission file an action or institute proceedings against them; (2) identifies the securities law violations that the staff has preliminarily determined to include in the recommendation; and (3) provides notice that the person may make a submission to the Division [of Enforcement] and the Commission concerning the proposed recommendation.

---

Research (compiled before recent developments) suggests that the SEC may seriously consider the content of a response to a Wells Notice. Jean Eaglesham, SEC Drops 20% of Probes After “Wells Notice,” WALL ST. J., Oct. 9, 2013,
http://online.wsj.com/articles/SB1001424052702304500404579125633137423664.
1. The Order Instituting Proceedings and the Answer

If the Commission decides to proceed with an administrative enforcement action, the action will be governed specifically by the SEC Rules of Practice ("ROPs") and, more generally, by the Administrative Procedure Act. A formal investigation begins with the Securities and Exchange Commission issuing an Order Instituting Proceedings ("OIP"). In addition to including the elements identified in Rule 200(b), the OIP also identifies the time within which the Administrative Law Judge ("ALJ") must file an initial decision with the Commission. The Commission may identify either a 12-day, or a 210-day or a 300-day time period for filing the initial decision. ROP 360(a)(2) also provides time frames within which the hearing, briefing and decisions should be issued. When a 300-day OIP is issued, for example, the hearing should be scheduled within four months of the issuance of the OIP, two months are allowed for parties to obtain the hearing transcripts and prepare briefs and the Administrative Law Judge is allowed approximately 4 months to prepare a decision. The shorter time period OIPs have comparable deadlines.

The OIP may also specify the time within which an Answer must be filed or a party may elect to file and serve an Answer. An Answer must specifically admit, deny or state that a party does not have, and is unable to obtain, sufficient information to admit or deny each

---

39 ROP 200.
40 ROP 360(a)(2).
41 Id.
42 Id.
43 Id.
44 ROP 220(a).
allegation in the [OIP].” Affirmative defenses must also be asserted in the Answer and all allegations not denied are deemed admitted. There is no “12(b)(6)” process for challenging the sufficiency of the OIP. However, “a party may with an answer make a motion for a more definite statement of specified matters of fact or law to be considered or determined.” As the text of this Rule shows, a motion for a more definite statement must be filed with an Answer and does not extend the time within which the Answer is to be filed. Moreover, the legal or factual matter to be restated must be “specified;” generalized demands for more specificity will not comply with the rule.

2. **Prehearing Conferences, Submissions and Disclosures.**

If a 300-day OIP has been issued, the respondent has only four months to prepare her case and less time if a shorter term OIP was issued. Therefore, respondent’s counsel should be aware of the pre-hearing procedures and document disclosure requirements. The SEC staff is required to begin making certain documents available to the respondent within seven days of service of the OIP. These documents include:

1. All subpoenas issued by the SEC’s Division of Enforcement in connection with the investigation;
2. All other written requests for documents or interviews;
3. The documents produced in response to written requests for documents;
4. All transcripts generated as part of the investigation, and;
5. Any final examination or inspection reports prepared by the Office of Compliance Inspections and Examinations, or the Division of Investment

---

45 ROP 220(c).
46 Id.
47 ROP 220(d).
48 ROP 230(d).
Management if the Enforcement Division intends to use such report at the hearing.\textsuperscript{49}

A respondent may also request, and the Enforcement Division must produce, exculpatory \textit{Brady}\textsuperscript{50} material.\textsuperscript{51} A respondent should also consider requesting \textit{Bagley} material that would impeach the Enforcement Division’s witnesses.\textsuperscript{52} Although the Enforcement Division is not required to automatically produce them, a respondent may request any statements obtained from witnesses that the Enforcement Division intends to call at the hearing.\textsuperscript{53} Finally, upon request, the ALJ may order the Enforcement Division to produce a privilege log of documents that it withheld from production.\textsuperscript{54}

The respondent’s counsel should be prepared to discuss disclosure and discovery at the first Prehearing Conference.\textsuperscript{55} At that conference, the ALJ may address any aspect of the investigation including the clarification of issues, witness and exhibit list exchanges, stipulations, scheduling, document production required by Rule 230 and settlement.\textsuperscript{56} If a conference is not

\textsuperscript{49}ROP 230(a)(1)(vi).
\textsuperscript{51}The Rule provides:

Nothing in this paragraph (b) authorizes the Division of Enforcement in connection with an enforcement or disciplinary proceeding to withhold, contrary to the doctrine of \textit{Brady v. Maryland}, 373 U.S. 83, 87 (1963), documents that contain material exculpatory evidence. ROP 230(b)(2).
\textsuperscript{53}ROP 231(a).
\textsuperscript{54}ROP 230(c).
\textsuperscript{55}See ROP 221.
\textsuperscript{56}ROP 221(c).
scheduled promptly, respondent’s counsel should consider requesting one and being prepared to
discuss the various disclosure and discovery issues addressed by ROP 230.

3. **Discovery Limitations on Subpoenas and Depositions**

A respondent cannot issue subpoenas as a matter of right. Subpoenas are issued by the
ALJ or one to whom she has delated the authority to issue subpoenas after a request is made in
writing or at a hearing. The ALJ or other hearing officer may refuse to issue the subpoena or
narrow its scope if she finds that it is “unreasonable, oppressive, excessive in scope or unduly
burdensome.” The ALJ can also require the party requesting issuance of the subpoena to show
its “general relevance and reasonable scope of the testimony or other evidence sought.”

Depositions are also limited. The purpose of the deposition is not to conduct discovery; it
is to preserve the hearing testimony of someone who will outside of the United States or so sick
or infirm that they cannot travel to the hearing. A respondent may also file a motion for leave

57 ROP 232(a).
58 ROP 232(b).
59 Id.
60 The governing rule provides:

(a) Procedure. Any party desiring to take the testimony of a witness by
deposition shall make a written motion setting forth the reasons why such
deposition should be taken including the specific reasons why the party believes
the witness will be unable to attend or testify at the hearing; the name and
address of the prospective witness; the matters concerning which the prospective
witness is expected to be questioned; and the proposed time and place for the
taking of the deposition.

(b) Required Finding When Ordering a Deposition. In the discretion of the
Commission or the hearing officer, an order for a deposition may be issued upon
a finding that the prospective witness will likely give testimony material to the
proceeding; that it is likely the prospective witness, who is then within the United
to take a deposition by written questions.\textsuperscript{61} Such a motion is subject to the same limitations and standards as a motion for an oral deposition.\textsuperscript{62} The proposed questions must be submitted with the motion.\textsuperscript{63}

4. The Hearing

The ALJ is not bound by the Federal Rules of Evidence, although she may be guided by them.\textsuperscript{64} The standard for the admissibility for evidence is provided by the ROPS and provides that, “The Commission or the hearing officer may receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious.”\textsuperscript{65} This permissive standard allows the ALJ to admit hearsay and make her own determinations about the weight and sufficiency of challenged evidence.\textsuperscript{66}

After the hearing, the ALJ will issue an initial decision with conclusions of fact and law.\textsuperscript{67} The Proposed Findings that the parties submit prior to the ALJ’s initial decision require “citations to specific portions of the record.”\textsuperscript{68} Given the limitations on discovery and motion

\begin{itemize}
\item States, will be unable to attend or testify at the hearing because of age, sickness, infirmity, imprisonment, other disability, or absence from the United States, unless it appears that the absence of the witness was procured by the party requesting the deposition; and that the taking of a deposition will serve the interests of justice.
\end{itemize}

\textsuperscript{61} ROP 233(a)(b).
\textsuperscript{62} Id.
\textsuperscript{63} ROP 234(b)
\textsuperscript{64} General provisions regarding the conduct of the hearing are stated in ROPS 300-351.
\textsuperscript{65} ROP 320.
\textsuperscript{66} In re Calais Resources, Inc., SEC Dkt. No. 34-67312 (June 29, 2012) at 7 n.19.
\textsuperscript{67} ROP 360(b).
\textsuperscript{68} ROP 326
practice, the hearing is the respondent’s only opportunity to make the record necessary to rebut the SEC’s charges or claims.\textsuperscript{69} Finally, counsel should be aware that these matters are still considered civil.\textsuperscript{70} Therefore, the Enforcement Division need only prove its case and its claims for penalties by a preponderance of the evidence.\textsuperscript{71}

D. **Appeals of SEC Proceedings**

1. **Appeals of an Administrative Law Judge’s Initial Decision to the Commission**

   \textbf{a. Timing}

   Respondents may appeal an ALJ’s initial decision to the Commission by filing a Petition for Review of an Initial Decision.\textsuperscript{72} The filing of a petition for review with the Commission is a prerequisite for any judicial review of the ALJ’s findings.\textsuperscript{73} The initial decision should include a date, not to exceed 21 days after service of the decision, within which an appeal to the Commission may be filed.\textsuperscript{74} The ALJ’s initial decision becomes final on the appeal date unless: a) a timely appeal to the Commission is filed, or; b) a party files a motion to correct a manifest error of law.\textsuperscript{75} If a motion to correct is filed, the initial decision becomes final 21 days after the ALJ’s order resolving the motion.\textsuperscript{76}

\textsuperscript{69} Although the ALJ’s initial decision may be appealed to the entire Commission subject to a \textit{de novo} standard of appeal, the appeal is still on the record made before the ALJ. As is discussed below, appeals from a determination of the Commission are directed to the United States Court of Appeals where the respondent resides or the Court of Appeals for D.C. Circuit which will uphold the Commission’s findings so long as they are supported by substantial evidence. 15 U.S.C. § 78y(a).


\textsuperscript{71} Id.

\textsuperscript{72} ROP 410.

\textsuperscript{73} ROP 410(e); 5 U.S.C. §704.

\textsuperscript{74} ROP 360(b).

\textsuperscript{75} ROP 360(d).
b. The Contents of a Petition for Review

The contents of a petition for review of an initial decision are defined by ROPs 410(b) and (c). ROP 410(b) requires:

The petition shall set forth the specific findings and conclusions of the initial decision as to which exception is taken, together with the supporting reasons for each exception. Supporting reasons may be stated in summary form. Any exception to an initial decision not stated in the petition for review, or in a previously filed proposed finding made pursuant to Rule 340 may, at the discretion of the Commission, be deemed to have been waived by the petitioner.77

Any party may file a cross-petition for review within 10 days after another party files her petition for review.78 ROP 410(c) requires that any party asserting inability to pay disgorgement, interest or a penalty must include a sworn financial disclosure statement.79

c. The Commission’s Review of the Petition

The Commission only reviews the record made before the ALJ.80 The Commission exercises a plenary scope of review and a de novo standard of review.81 However, because the ALJ is the only one who is able to observe testimony first-hand and make credibility determinations based on that observation, counsel should anticipate that the Commission will defer to the administrative law judge on this issue.

76 ROP 410(b).
77 ROP 410(b).
78 Id.
79 ROP 410(c).
80 See ROP 411(a)(limiting the Commission’s review what is “proper and on the basis of the record.”)
81 The ROP provides that, “The Commission may affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part, and initial decision by a hearing offer and may make any findings or conclusions that in its judgment are proper and on the basis of the record.” Id.
The Commission will issue a scheduling order that includes a briefing schedule after the appeal is filed. Generally, the appellant’s brief is due within 30 days of the issuance of the scheduling order and the appellee’s is due 30 days after that. Litigants should be aware of the page and word limitations included in the ROPs: 14,000 words (30 pages) for opening and response briefs and 7,000 words (15 pages) for reply briefs. Requests for oral argument before the Commission are made by separate motion included with the original briefs.

2. Appeals of the Commission’s Decision to the United States Circuit Court of Appeals.

Judicial review of the Commission’s decision is had before the United States Court of Appeals for the District of Columbia Circuit or the Court of Appeals for the circuit in which the respondent resides. The Courts of Appeals apply deferential standards of review to the Administrative Law Judge’s legal and factual findings. Findings of fact are to be upheld so long as they are supported by “substantial evidence.” Substantial evidence requires only “such relevant evidence as a reasonable mind might accept as adequate to support a conclusion.” If the evidence is susceptible of more than one rational interpretation, the Circuit Court panel must uphold the SEC’s factual findings.

82 ROP 450(a).
83 Id.
84 ROP 450(c).
85 ROP 451(a).
89 Eichler v. SEC, 757 F.2d 1066, 1069 (9th Cir.1985).
The Administrative Procedures Act requires that “[t]he Commission's conclusions of law are to be set aside if arbitrary, capricious, or otherwise not in accordance with law.”\(^{90}\) Review of legal conclusions may differ based on the type of legal conclusion. If the question is one involving the SEC’s application of its own regulations, the appellate court’s review is limited to determining whether the interpretation was “unreasonable” or “plainly erroneous.”\(^{91}\) The SEC’s imposition of sanctions and other forms of equitable relief, including disgorgement orders, is reviewed for an abuse of discretion, \(i.e.,\) whether it is unwarranted by the law or without some justification in fact, “because the relation of remedy to policy is peculiarly a matter for administrative competence ...”\(^{92}\) Therefore, counsel and parties should be aware, while making their record before the Administrative Law Judge, that it may be their only opportunity to make a record and the appellate review of any decision based on that record will be highly deferential.

### III. CONCLUSION AND SUGGESTIONS

The SEC’s Rules of Procedure, and the Administrative Procedures Act, create a litigation forum that moves quickly, has limited discovery, is initially and primarily adjudicated by an employee of the plaintiff and which can result in significant monetary penalties and other forms of equitable relief. If counsel appears in an administrative action expecting to be faced with the same pleading, discovery and scheduling that District Court litigation provides, she will not be able to serve her client well.

The short time frames and limited discovery and appellate review, particularly when considered with the SECs statements regarding how decisions about prosecution and cooperation credit are made, suggest that clients may be best protected by implementing


\(^{92}\) \textit{American Power & Light Co. v. SEC}, 329 U.S. 90 (1946).
meaningful compliance measures prior to anything coming to the SEC’s attention. Such a compliance program might include:

- Clear chains of command and methods for reporting suspected or possible misconduct senior managers and possibly officers, directors, counsel and auditors;

- Written and enforced document and equipment retention and destruction policies that take into account statutory and regulatory retention requirements and technological developments in electronically-stored information;

- Internal compliance and education programs to assure wide knowledge of rules and procedures for documenting and reporting concerns as well as document and equipment retention and destruction;

- Appreciation of the need for and enforcement of prompt litigation and investigation holds on documents and equipment destruction;

- Appreciation and protection of privileged documents until such a time as any decisions regarding privilege waiver are made;

- Review of insurance policies to assure that representation in and/or investigative and legal expenses related to administrative proceedings are included in coverage, and;

- Careful retention of informed and experienced outside professionals include counsel, auditors forensic accountants, corporate governance advisors and electronically stored information consultants.
Although every different matter poses different factual and legal challenges, if one is presented with an SEC investigation, appreciation of the administrative rules and their implications will position counsel to provide the best possible defense to her clients.
Crowdfunding and the JOBS ACT – It Seemed So Simple!

by Daniel R. Formeller, Tressler LLP

The JOBS Act was signed into law in April 2012 with significant fanfare and was thought by most observers to be a vehicle which would stimulate growth through the accelerated process of raising capital to allow start-up companies to grow. Whether this prognostication comes true is yet to be seen but the predictions that the Act would simplify the process of getting from start-up to an initial public offering certainly have not become a reality.

To entrepreneurs, the JOBS Act seemed like the answer to their needs in raising capital from a larger pool of investors and in providing a streamlined ramp in the process of preparing and filing for the initial issuance of publicly traded stock. The reality appears to be something else altogether. We need look no further than the mechanics of Title III of the Act to understand the alchemy of turning simple into complex.

Title III of the JOBS Act puts in place the “crowdfunding exemption” to federal and state securities laws. Crowdfunding is the term used to describe the process of raising funds through the internet in small increments but from many investors. Even these de minimis investment amounts, however, were previously subject to federal and state securities laws. The exemption was seen as a legislative protection to consumers a/k/a potential investors who may become dissatisfied over their investment and need to seek redress and a legal remedy. With nothing but good intentions (and we know where that path likely leads) the application of this newly created exemption would appear to increase both liability issues and transaction costs.

This legislatively created exemption can be found at Section 4 (6) of the 1933 Securities Act. It covers capital raising campaigns of up to one million dollars during any twelve month period. That simple proscription gets tricky when following the logic and math involved in the remainder of the section. Among other restrictions, there are offsets to the amount for other securities sold by the issuer during that one year period and there are restrictions on the net worth measurements of investors. The simple has become complex. In addition, the crowdfunding issuer must employ a broker or a registered funding portal which is mandated by the legislation. To add to the confusion, the “funding portal” definition can be found in the 1934 Securities Act. (Section 3, subsection 80).

Finally, this new exemption requires a detailed (read that as onerous) disclosure document to be filed with the SEC and distributed to each potential investor and to any brokers or the funding portal. This legislative and regulatory infrastructure increases costs and exposes issuers (their directors and officers) to another layer of potential liability. In effect, rather than an aid to capital investment, this new exemption may be a hindrance.

Late breaking news: On March 25 the SEC adopted final rules that update Regulation A and expand Reg. A offerings. The new rules provide for two distinct tiers of offerings. The first tier has been increased to allow offerings up to twenty million dollars in a twelve month period and Tier 2 allows offerings up to
fifty million dollars in a twelve month period. There are many details including enhanced disclosure rules for Tier 2 offerings.

The rules become effective 60 days after publication in the Federal Register.