



Overview of SEC Enforcement Investigations

Richard D. Marshall
Katten Muchin Rosenman LLP
New York
+1.212.940.8765
richard.marshall@kattenlaw.com

Origins of Enforcement Investigations

While an enforcement investigation can start from scores of sources, most such investigations involving private funds originate from a few sources. First, and perhaps most common, an SEC inspection, conducted by the Office of Compliance Inspections and Examinations (“OCIE”) through either its home office in Washington DC or its eleven regional offices, can detect possible violations of law which are then investigated by the Division of Enforcement.

Origins of Enforcement Investigations

An SEC inspection can result in no findings of violations, which is very rare; a deficiency letter, which sets forth the SEC examiner's findings of violations and demands the firm take remedial measures; or a referral to the SEC Division of Enforcement. Often, an enforcement referral comes after the receipt of a deficiency letter. The SEC inspection staff now works very closely with the enforcement staff, so it should be assumed that the enforcement staff will be made aware of all material violations found during inspections.

Origins of Enforcement Investigations

A second and increasingly common source of SEC investigations is a report by a whistleblower. The Dodd-Frank Act greatly expanded the SEC's program to compensate whistleblowers who report potential violations to the SEC. The SEC now receives thousands of such whistleblower reports every year and has awarded millions of dollars to whistleblowers who provide valuable information to its enforcement program. However, only an individual is eligible for a whistleblower award; a legal entity is not eligible for compensation. A related initiative, the cooperation initiative, has greatly expanded the credit the SEC gives to individuals or legal entities that provide valuable information to assist its enforcement program. In certain cases, "partially culpable" whistleblowers have even received civil and sometimes even criminal immunity from prosecution in exchange for their assistance to the SEC.

Origins of Enforcement Investigations

A third common source of SEC investigations is press reports. The SEC monitors the press for stories about possible illegal conduct and refers interesting articles to its enforcement attorneys for investigation. If a private fund becomes aware of press reports suggesting illegal conduct, the firm should assume that the SEC may follow up those reports with an enforcement inquiry.

Overview of SEC investigations

Investigations are conducted by the SEC's Division of Enforcement, which is headquartered in Washington, DC and maintains eleven regional offices in which enforcement investigations are also conducted. The Division of Enforcement employs attorneys, accountants, and market analysts/economists to assist with investigations.

In 2010, the Division of Enforcement created several specialized units. The specialized units function across the Division both at headquarters and in the regional offices. One of these specialized units, the Asset Management Unit, is responsible for the asset management industry, including private-equity funds. Since the creation of the Asset Management unit, enforcement cases against money managers have increased by approximately 50 percent.

Overview of SEC investigations

The SEC conducts two general types of investigations: informal inquiries and formal investigations. The difference between these two types of investigations depends upon whether the SEC staff can compel witnesses to provide information by issuing subpoenas for documents or testimony.

In August 2009, the Commission amended its rules and delegated authority to the Director of the Division of Enforcement to approve formal orders of investigation, thereby permitting the Division to issue subpoenas without Commission approval. The Commissioners retain the power to file an enforcement action and to settle an enforcement action.

Overview of SEC investigations

The staff of the Division of Enforcement can conduct informal inquiries. In these inquiries, the staff does not have the power to compel the production of documents or testimony, except by reliance on their inspection powers. At the earliest stages of an informal inquiry, known as a matter under inquiry (MUI), the staff will typically gather certain minimal background information to assess whether an investigation is warranted.

Prior to opening a MUI, the staff assigned to a MUI conducts a preliminary analysis to determine whether the facts underlying the MUI show that there is potential conduct that violates the federal securities laws. MUIs must be formally opened by the staff and approved by the assigned Associate Director or Regional Director.

Overview of SEC investigations

In order for the SEC staff to have authority to issue investigative subpoenas for the production of documents and to compel testimony, the SEC must have entered a formal order of private investigation. The formal order describes the nature of the investigation that has been authorized; identifies certain relevant facts, the statutory violations that are under investigation, and the relevant time periods involved; designates specific staff members to act as officers for purposes of the investigation; and empowers them to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of documents and other materials. Formal investigative proceedings are nonpublic unless otherwise ordered by the Commission.

Overview of SEC investigations

When a formal order has been entered, the SEC staff will typically compel the production of documents and testimony through the issuance of subpoenas. There are two types of subpoenas: *duces tecum* and *ad testificandum*. A subpoena *ad testificandum* compels only the appearance of a witness to provide testimony under oath. The SEC can compel a person from anywhere in the United States to appear at any of its offices, or elsewhere, to testify. Typically, a witness is compelled to appear where the staff who are conducting the investigation are located, although a person can always request that the testimony be conducted at another location. In addition, if the SEC can effect service of a subpoena in the United States, it can compel a witness who is abroad to testify.

Overview of SEC investigations

The second type of subpoena, a subpoena *duces tecum*, formally compels a witness to appear before the SEC staff to produce documents and to provide testimony. As a matter of practice, the SEC staff frequently will send a letter with the subpoena *duces tecum* indicating that testimony is not required if the required documents are produced.

It is a misdemeanor to fail to comply with a SEC subpoena without “just cause.” In the absence of compliance with its subpoenas, the SEC may institute an action in federal district court seeking an order from a federal judge compelling compliance with the subpoena. Such proceedings can be instituted by the SEC staff without seeking authorization from the Commissioners.

Overview of SEC investigations

Rights of witnesses during formal investigation

Right to formal order

- The SEC's Rules Relating to Investigation provide that upon request, a person subpoenaed to provide evidence or testimony to the SEC has the right to review the formal order of investigation.

Right to counsel

- A person appearing either voluntarily or by subpoena before the SEC has the right to have counsel. Incidental to the right to be represented by counsel are the right to consult with counsel during testimony, the right of counsel to examine the witness, and the right of counsel to take notes during the testimony. In addition, counsel can be accompanied by an expert, such as an accounting expert, to assist in the representation of the witness.

Overview of SEC investigations

Right to evidence provided and transcript of testimony

- A witness who has either provided documentary evidence or testimony during a formal investigation has the right to inspect the official transcript of the witness' testimony.

Statutory rights

- Several statutes afford protections to persons who are asked to provide information in SEC investigations. First, the Privacy Act requires that a person who is asked to provide information to the SEC be given a notice of the statutory authority for the request, the routine uses of the information, and whether the request is voluntary or mandatory. Second, the Right to Financial Privacy Act requires the SEC to provide prior written notice to an individual before it can obtain that individual's records from a bank or similar financial institution. This notice permits the individual to intervene before the bank/financial institution produces the information to the SEC to block production if grounds exist for such an action. Third, numerous other statutes impose other limitations on the SEC. For example, the SEC generally can only obtain telephone records either by subpoena or with the target's consent. Consumer credit reports generally cannot be obtained without either a court order or the subject's consent. Finally, the SEC generally cannot use information it might obtain from the Internal Revenue Service in connection with its enforcement actions.

Overview of SEC investigations

Constitutional rights

- Many of the constitutional protections that are available in a criminal investigation are not available in a SEC investigation because of the civil nature of the process. There are, however, two important rights that are enjoyed in a SEC investigation. First, as noted above, a witness is entitled to be represented by counsel of his or her choice. Second, a witness can assert the Fifth Amendment privilege against self-incrimination. This privilege applies to testimony, the production of documents by an individual, and, in the case of a sole proprietorship or privately owned business, the production of documents by that entity. However, regulated entities, such as an investment adviser, cannot assert the privilege against self-incrimination to block the production of documents, even if they are organized as sole proprietorships.

Overview of SEC investigations

Once the staff has concluded its investigation, there are three possible outcomes. First, if the staff determines not to recommend that the Commissioners authorize the institution of an enforcement action, the staff will close the investigation. (The Dodd-Frank Act requires the SEC either to file charges or close an investigation within 180 days of the Wells notice, subject to certain exceptions. However, a court has recently held that the target of the Wells notice has no remedy if the SEC fails to meet these deadlines.) Second, in unusual circumstances in which the staff believes that a possible wrongdoer would engage in extraordinary action if notified that the staff intends to recommend that the Commission authorize the institution of an enforcement action, the staff can seek such authorization and, with the Commission's approval, file an enforcement action without ever providing the target with advanced notice. Third, and much more common, if the staff intends to seek authorization from the Commissioners to institute an enforcement action, the staff may provide the target with notice of this fact and provide the target with the opportunity to submit a written statement to the Commissioners explaining why an enforcement action should not be instituted. This is known as a Wells notice.

Overview of SEC investigations

The purpose of the Wells notice is to provide the person under investigation an opportunity to challenge the staff's factual and legal allegations. Persons who become involved in preliminary or formal investigations may also, on their own initiative, submit a written statement to the staff and the Commission setting forth their positions in regard to the subject matter of the investigation.

As part of the Wells notice, the staff may advise targets of the general nature of the investigation, including the indicated violations as they pertain to them, and the amount of time that is available for preparing and submitting a statement prior to the presentation of a staff recommendation to the Commission for the commencement of an enforcement action. Prior to issuing a Wells notice, the staff must receive authorization from an Associate Director in the Division of Enforcement or Regional Director. Wells notices must be in writing.

Overview of SEC investigations

The decision to bring an enforcement action must be authorized by the five Commissioners at a nonpublic Commission meeting at which neither the targets nor their counsel can be present. The staff will submit an action memorandum to the Commissioners in which it details the facts as they relate to alleged violations of the securities laws. Prior to an action memorandum receiving Commissioner review it will undergo numerous levels of review and scrutiny by different groups at the SEC, including other Divisions that may have an interest in the subject matter. For example, the Division of Investment Management would likely review an action involving violations of the Advisers Act.

The Commissioners vote on the recommendation set forth in the action memorandum. A majority vote is required by a quorum of the Commissioners to approve an action.

Overview of SEC investigations

If the Commissioners authorize the institution of an enforcement action, a public enforcement proceeding will be instituted. The SEC often issues a press release when it institutes an enforcement action and, generally, makes an effort to ensure that its enforcement actions receive wide publicity. The SEC does not settle an action without the institution of some form of public proceeding. All settlements are posted on the SEC web site and obviously create adverse publicity for the target.

Outcomes of an investigation

There are two types of enforcement actions that the SEC can institute: civil injunctive actions in federal district court and administrative proceedings before SEC administrative law judges. The SEC does not have authority to institute or to prosecute criminal actions; however, the SEC may refer a matter to the Department of Justice for criminal prosecution. In addition, in certain circumstances the Commission may refer a matter to, or grant requests for access to its files made by, other governmental authorities, both domestic and foreign, and self-regulatory organizations. It has become common for several prosecutors, including the SEC, to investigate the same conduct at the same time and to cooperate in their investigations. This is generally permitted unless the SEC misrepresents its cooperation with other prosecutors.

Outcomes of an investigation

- A civil injunctive action is filed in federal district court in the district where venue is appropriate and seeks the entry of a final judgment of permanent injunction and other ancillary relief, such as disgorgement and prejudgment interest. An injunction is an order of the court, punishable by contempt, which directs the defendant to comply with the law. The entry of such an order has several ancillary consequences, including certain disclosure obligations and certain disqualifications. In addition to the entry of an injunction, the SEC can obtain fines and other ancillary relief, such as disgorgement. Such actions are conducted according to the Federal Rules of Civil Procedure. The Federal Rules of Evidence apply in such proceedings. There is a right to a jury trial. To obtain an injunction, the SEC must demonstrate that there is a likelihood of future violations. Appeal from the district court is taken to the Court of Appeals and then to the US Supreme Court.

Outcomes of an investigation

The SEC can also institute an administrative proceeding. This a proceeding before an administrative law judge that is governed by the SEC's Rules of Practice. These rules differ from the Federal Rules of Civil Procedure in several respects. First, the rules limit pre-trial discovery and motion practice. Second, the rules impose short time periods for the completion of the various stages of the proceeding. Third, the Federal Rules of Evidence do not apply. Finally, there are no jury trials in administrative proceedings.

In an administrative proceeding the SEC can obtain several forms of relief, including the revocation or suspension of professional licenses, fines, disgorgement, and cease and desist orders. Failure to comply with an SEC order is a felony. Under section 929P(a) of the Dodd-Frank Act, the SEC has been authorized to impose civil monetary penalties in administrative proceedings, even against non-regulated entities and individuals.

Outcomes of an investigation

A party to an administrative proceeding may appeal to the Commission an initial decision of an administrative law judge. The party seeking review submits a petition for review of an initial decision within the time prescribed by the hearing officer in the initial decision. The petition must state in detail “the specific findings and conclusions of the initial decision as to which exception is taken, together with supporting reasons for each exception.” Following the submission of a petition for review, any other party to the proceeding may file a cross-petition for review within the specified time period.

Consequences of an enforcement action

The adverse consequences of an enforcement action are comparable whether the action is settled or resolved against the target in litigation, although the sanctions imposed as well as media scrutiny are usually less severe when the action is settled.

When an enforcement action is instituted and simultaneously settled, several adverse consequences result. The most obvious and important of these consequences are the sanctions imposed, which are described above.

In addition to the relief that is ordered as part of the proceeding, there will be adverse publicity, which may impair business relationships and may result in the filing of private damage actions. In addition, even if the SEC does not refer the matter to other regulators, the adverse publicity that results from a SEC enforcement action may cause other regulators, such as state securities regulators, to commence investigations.

Consequences of an enforcement action

Second, there are certain important disclosure consequences of a SEC enforcement action, even if it is settled prior to any adjudication. In addition, certain disqualifications may result from the institution of the enforcement action.

Finally, the imposition of an injunction or an administrative order carries with it certain adverse consequences in the event of noncompliance. Failure to comply with an injunction is punishable by the court as contempt. Failure to comply with a SEC administrative order is a felony.

Litigation with the SEC imposes additional burdens. Even if the litigation is ultimately successful, there are costs associated with litigation, including the disruption of business and adverse publicity. In addition, if the litigation is unsuccessful, the adverse findings may collaterally estop the target from litigating the same issues in private damage actions.

Some often-misunderstand potential violations

Several provisions of Advisers Act that frequently arise in enforcement actions involving private funds are often misunderstood. First, the Advisers Act and the Rules thereunder contain anti-fraud prohibitions, but these provisions are broader than might at first appear. Negligent misstatements or omissions under some of these provisions are actionable, which is a lower standard of culpability than is normally associated with a fraud claim. More important, these anti-fraud provisions have been interpreted by the Supreme Court to create a federally enforceable fiduciary duty on investment advisers. This duty - of care, loyalty, and candor – can be violated in situations that are not normally associated with fraudulent conduct.

Some often-misunderstand potential violations

Second, all investment advisers, even if not registered or required to be registered, are subject to the anti-fraud and fiduciary provisions of the Advisers Act. Because of this, certain conduct that predates the registration of some private fund advisers in late March 2012 can be prosecuted by the SEC. There is, however, a five year statute of limitations on the imposition of fines and suspensions or bars with the time period commencing from the date of the fraud, not from the date on which the fraud was discovered or could have been discovered. The SEC frequently requests a tolling agreement at the beginning of an investigation as a means to avoid the running of the statute of limitations during the pendency of its investigation.

Some often-misunderstand potential violations

Third, Section 208(d) of Advisers Act prohibits doing indirectly what cannot be done directly. Because of this provision, certain actions that may be recognized under tax, corporate, and other regulatory provisions may be ignored by the SEC, causing it to look to the substance of the arrangements rather than their form.

Finally, the Advisers Act imposes certain governance requirements. Registered investment advisers must create and accurately maintain numerous categories of records, appoint a chief compliance officer and adopt policies and procedures reasonably designed to prevent violations of law, and supervise its employees. If a supervised person violates the law, that person's supervisor can be sanctioned unless he or she can prove that reasonable supervision was exercised over the wrongdoer.

Katten Muchin Rosenman LLP Locations

AUSTIN

One Congress Plaza
111 Congress Avenue
Suite 1000
Austin, TX 78701-4073
+1.512.691.4000 tel
+1.512.691.4001 fax

HOUSTON

1301 McKinney Street
Suite 3000
Houston, TX 77010-3033
+1.713.270.3400 tel
+1.713.270.3401 fax

LOS ANGELES – CENTURY CITY

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
+1.310.788.4400 tel
+1.310.788.4471 fax

ORANGE COUNTY

100 Spectrum Center Drive
Suite 1050
Irvine, CA 92618-4960
+1.714.966.6819 tel
+1.714.966.6821 fax

WASHINGTON, DC

2900 K Street NW
North Tower - Suite 200
Washington, DC 20007-5118
+1.202.625.3500 tel
+1.202.298.7570 fax

CHARLOTTE

550 South Tryon Street
Suite 2900
Charlotte, NC 28202-4213
+1.704.444.2000 tel
+1.704.444.2050 fax

IRVING

545 East John Carpenter Freeway
Suite 300
Irving, TX 75062-3964
+1.972.587.4100 tel
+1.972.587.4109 fax

LOS ANGELES – DOWNTOWN

515 South Flower Street
Suite 1000
Los Angeles, CA 90071-2212
+1.213.443.9000 tel
+1.213.443.9001 fax

SAN FRANCISCO BAY AREA

1999 Harrison Street
Suite 700
Oakland, CA 94612-4704
+1.415.293.5800 tel
+1.415.293.5801 fax

CHICAGO

525 West Monroe Street
Chicago, IL 60661-3693
+1.312.902.5200 tel
+1.312.902.1061 fax

LONDON

Paternoster House
65 St Paul's Churchyard
London EC4M 8AB United Kingdom
+44.0.20.7776.7620 tel
+44.0.20.7776.7621 fax

NEW YORK

575 Madison Avenue
New York, NY 10022-2585
+1.212.940.8800 tel
+1.212.940.8776 fax

SHANGHAI

Suite 4906 Wheelock Square
1717 Nanjing Road West
Shanghai 200040 P.R. China
+86.21.6039.3222 tel
+86.21.6039.3223 fax

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at kattenlaw.com/disclaimer.

Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com