



# SEC Insider's Guide

A Guide to the SEC's Investigative  
and Enforcement Process

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# TABLE OF CONTENTS

- I. OVERVIEW OF THE SEC ..... 1
  - A. Introduction and Mission ..... 1
  - B. Organization of the SEC ..... 2
  - C. SEC Divisions ..... 3
    - 1. Division of Corporation Finance ..... 3
    - 2. Division of Investment Management ..... 4
    - 3. Division of Trading and Markets ..... 4
    - 4. Division of Risk, Strategy, and Financial Innovation ..... 5
    - 5. Division of Enforcement ..... 5
  - D. Other Important Offices ..... 5
    - 1. Office of the General Counsel ..... 5
    - 2. Office of Compliance Inspections and Examinations ..... 5
    - 3. Office of International Affairs ..... 6
- II. THE SEC’S LAW ENFORCEMENT ARM: THE DIVISION OF ENFORCEMENT ..... 6
  - A. Overview ..... 6
  - B. How the Securities Laws are Enforced ..... 6
    - 1. Investigations ..... 6
    - 2. Enforcement Actions and Remedies ..... 7
  - C. Specialized Units and Market Intelligence ..... 8
- III. THE INVESTIGATIVE PROCESS ..... 8
  - A. Matters Under Inquiry ..... 9
  - B. Informal Investigations ..... 9
  - C. Formal Investigations ..... 9
- IV. SOURCES OF INVESTIGATIONS ..... 10
  - A. Complaints and Tips From the Public ..... 10
  - B. Referrals From Self-Regulatory Organizations ..... 10
  - C. Other Sources of Potential Violations ..... 11
- V. SUBPOENA OF DOCUMENTS AND TESTIMONY ..... 11
  - A. The Power to Issue Subpoenas ..... 11
  - B. Challenges to Subpoenas ..... 11
- VI. PRIVACY AND CONFIDENTIALITY OF INVESTIGATIONS ..... 12
  - A. Confidentiality of Information ..... 12
  - B. Freedom of Information Act ..... 12

C.	The Privacy Act of 1974.....	12
VII.	PRIVILEGES .....	13
A.	Attorney-Client Privilege .....	13
B.	Work-Product Doctrine.....	14
C.	Self-Evaluative Privilege .....	14
D.	Waiver .....	14
VIII.	COOPERATING WITH THE SEC .....	15
A.	Proffer Agreements.....	15
B.	Cooperation Agreements.....	15
C.	Deferred Prosecution Agreements.....	16
D.	Non-Prosecution Agreements .....	16
E.	Grants of Immunity.....	16
IX.	CLOSING AN INVESTIGATION .....	17
A.	Wells Process.....	17
1.	Wells Notice .....	17
2.	Wells Submission .....	17
B.	Closing Investigations Resulting in an Enforcement Action.....	17
C.	Closing Without Further Action.....	18
D.	Termination Letters .....	18
X.	STATUTE OF LIMITATIONS IN ENFORCEMENT ACTIONS .....	19
A.	The Discovery Rule .....	19
B.	Fraudulent Concealment/Equitable Tolling .....	19
C.	Tolling Agreements .....	19
XI.	ENFORCEMENT ACTIONS AND REMEDIES .....	19
A.	Civil Actions.....	20
1.	Civil Injunction .....	20
2.	Disgorgement.....	20
3.	Civil Penalties .....	20
4.	Barring Service as an Officer or Director .....	20
B.	Administrative Proceedings.....	21
1.	Cease and Desist Proceedings .....	21
2.	Civil Monetary Penalties .....	21
3.	Revocation of Licenses and Bars from the Industry.....	22
4.	Proceedings to Correct Filings .....	22
5.	Disciplining Professionals.....	22

<b>XII. SEC COOPERATION WITH OTHER AGENCIES .....</b>	<b>22</b>
<b>A. Parallel Proceedings .....</b>	<b>22</b>
<b>B. Informal Referrals to Other Authorities .....</b>	<b>22</b>
1. Referrals to Criminal Authorities.....	22
2. Referrals to Self-Regulatory Organizations.....	22
3. Referrals to the Public Company Accounting Oversight Board .....	23
4. Referrals to State Agencies .....	23
5. Referrals to Professional Licensing Boards .....	23
<b>C. Sharing Information Obtained During Investigations .....</b>	<b>23</b>

# SEC INSIDER'S GUIDE

## A GUIDE TO THE SEC'S INVESTIGATIVE AND ENFORCEMENT PROCESS

by

**JORDAN A. THOMAS\***

### I. OVERVIEW OF THE SEC

#### A. Introduction and Mission

The Securities and Exchange Commission (the "SEC" or the "Commission") is an independent federal agency established pursuant to the Securities and Exchange Act of 1934 (the "Exchange Act" or the "'34 Act"). The SEC was established to enforce the Exchange Act and the Securities Act of 1933 (the "Securities Act" or "'33 Act"), both of which were enacted in the wake of the Great Depression to restore investor confidence in the capital markets.

The SEC's mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. To this end, the Commission is empowered with broad authority over all aspects of the securities industry. This includes the power to investigate and prosecute violations of the securities laws, as well as the power to regulate and oversee brokerage firms, transfer agents, clearing agencies, and stock exchanges, such as the New York Stock Exchange and NASDAQ.

In particular, it is the responsibility of the SEC to:

- interpret the federal securities laws;
- issue new rules and amend existing rules;
- oversee the inspection of securities firms, brokers, investment advisors, and ratings agencies;

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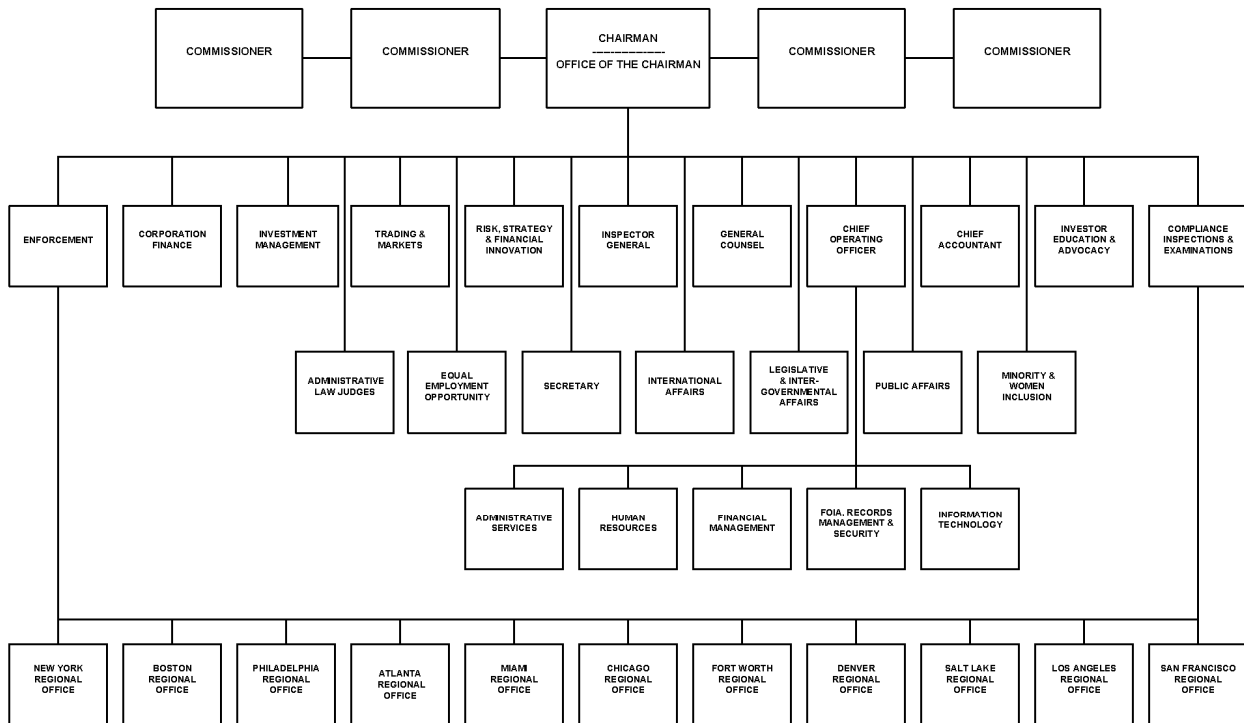
He also is the editor of [secwhistlebloweradvocate.com](http://secwhistlebloweradvocate.com), a website dedicated to helping organizations establish a culture of integrity and courageous whistleblowers to report possible securities violations—without regrets.

- oversee private regulatory organizations in the securities, accounting, and auditing fields; and
- coordinate U.S. securities regulation with federal, state, and foreign authorities.

## B. Organization of the SEC

The SEC is headed by a bi-partisan five-member Commission, comprising of a Chairman and four Commissioners, all of whom are appointed by the President and confirmed by the Senate. The Chairman serves as the Commission's Chief Executive Officer. The SEC is organized into five main divisions: Corporate Finance; Investment Management; Trading and Markets; Risk, Strategy, and Financial Innovation; and Enforcement. The Commission is headquartered in Washington, D.C., and it has 11 Regional Offices throughout the country.<sup>1</sup> The regional offices are responsible for investigating and litigating potential violations of the securities laws. The offices also have examination staff, who examine and investigate regulated entities such as investment advisers, investment companies and broker-dealers. The below SEC organization chart is as of September 30, 2011.

### SECURITIES AND EXCHANGE COMMISSION



Note: The Office of Credit Ratings, the Office of Investor Advocate, and the Office of Municipal Securities, required by P.L. 111-203, are in the process of being established.

<sup>1</sup> The regional offices are located in the following cities: New York; Boston; Philadelphia; Atlanta; Miami; Chicago; Denver; Fort Worth; Salt Lake City; San Francisco; and Los Angeles.

In fiscal year 2011, the SEC's budgetary authority amounted to \$1,673 million, consisting of an appropriation for salaries and expenses in the amount of \$1,185 million, carryover balances of \$36 million for the expenses of the Commission, and \$452 million in the Investor Protection Fund. In addition, in fiscal year 2011, the agency employed a staff of 3,844 full-time equivalents (FTE), including 3,806 permanent and 38 temporary FTEs.

## **C. SEC Divisions**

### **1. Division of Corporation Finance**

The Division of Corporation Finance assists the Commission in overseeing the corporate disclosure of important information to the investing public. Under the securities laws, corporations must disclose important information to investors when their stock is initially sold, and then on a continuing and periodic basis thereafter. The division's staff routinely reviews these disclosure documents that publicly-held companies are required to file with the Commission. The documents include:

- registration statements for newly-offered securities;
- annual and quarterly filings (Forms 10-K and 10-Q);
- proxy materials sent to shareholders before an annual meeting;
- annual reports to shareholders;
- documents concerning tender offers (a tender offer is an offer to buy a large number of shares of a corporation, usually at a premium above the current market price); and
- filings related to mergers and acquisitions.

These documents disclose information about a company's financial condition and business practices to help investors make informed investment decisions. During the review process, the staff checks to see if publicly-held companies are meeting their disclosure requirements and seeks to improve the quality of the disclosure. In general, a company issuing securities or whose securities are publicly traded must make available all information, whether it is positive or negative, that might be relevant to an investor's decision to buy, sell, or hold the security.

The Division of Corporation Finance also provides administrative interpretations of the '33 Act, the '34 Act, and the Trust Indenture Act of 1939, and recommends regulations to implement these statutes. In addition, the staff provides guidance and counseling to registrants, prospective registrants, and the public to help them comply with the law. For example, a company might ask whether the offering of a particular security requires registration with the SEC. Corporation Finance would share its interpretation of the relevant securities regulations with the company and give it advice on compliance with the appropriate disclosure requirement.

Another responsibility of Corporation Finance is to, together with the SEC's Office of the Chief Accountant, monitor the activities of the accounting profession, particularly the Financial Accounting Standards Board (FASB), which result in the formulation of generally accepted accounting principles (GAAP). Increasingly, the division also monitors the use by

U.S. companies of International Financial Reporting Standards (IFRS), promulgated by the International Accounting Standards Board.

## **2. Division of Investment Management**

The Division of Investment Management is responsible for investor protection and for promoting capital formation through its oversight and regulation of America's \$26 trillion investment-management industry. The investment-management industry includes mutual funds and the professional fund managers who advise them; analysts who research individual assets and asset classes; and investment advisers to individual customers.

The Division's additional responsibilities include:

- assisting the Commission in interpreting laws and regulations for the public and SEC inspection and enforcement staff;
- responding to no-action requests and requests for exemptions;
- reviewing investment company and investment adviser filings;
- assisting the Commission in enforcement matters involving investment companies and advisers; and
- advising the Commission on adapting SEC rules to new circumstances.

## **3. Division of Trading and Markets**

The Division of Trading and Markets has the responsibility for maintaining fair, orderly, and efficient markets by providing day-to-day oversight of the major securities market participants, such as: the securities exchanges (*i.e.*, New York Stock Exchange and NASDAQ); securities firms; self-regulatory organizations ("SROs") including the Financial Industry Regulatory Authority ("FINRA") and the Municipal Securities Rulemaking Board; transfer agents (parties that maintain records of securities owners); securities information processors; and credit rating agencies (*e.g.*, Moody's and Standard & Poor's).

Trading and Markets also oversees the Securities Investor Protection Corporation, a private, non-profit corporation that insures the securities and cash in the customer accounts of member brokerage firms against the failure of those firms (but not losses arising from market declines or fraud).

Additional responsibilities include:

- carrying out the Commission's financial integrity program for broker-dealers;
- reviewing (and in some cases approving, under authority delegated from the Commission) proposed new rules and proposed changes to existing rules filed by the SROs;
- assisting the Commission in establishing rules and issuing interpretations on matters affecting the operation of the securities markets; and
- surveilling the markets.



#### **4. Division of Risk, Strategy, and Financial Innovation**

The Division of Risk, Strategy, and Financial Innovation was established in September 2009 to help identify developing risks to and trends in the financial markets. The emergence of derivatives, hedge funds, new technology, and other factors have transformed both capital markets and corporate governance. Therefore, the Division of Risk, Strategy, and Financial Innovation works to advise the Commission through an interdisciplinary approach that is informed by law, modern finance and economics, and developments in real world products and practices on Wall Street and Main Street.

Among the functions being performed by the division are:

- strategic and long-term analysis;
- identifying new developments and trends in financial markets and systemic risk;
- making recommendations as to how these new developments and trends affect the Commission's regulatory activities;
- conducting research and analysis in furtherance and support of the functions of the Commission and its divisions and offices; and
- providing training on new developments and trends and other matters.

#### **5. Division of Enforcement**

The Division of Enforcement acts as the law enforcement arm of the SEC. The Division of Enforcement recommends that the Commission commence investigations of securities law violations and bring civil enforcement actions in federal court or before an administrative law judge, and it prosecutes these cases on behalf of the Commission. As an adjunct to the SEC's civil enforcement authority, the Division of Enforcement works closely with law enforcement agencies in the U.S. and around the world to bring criminal cases when appropriate.

### **D. Other Important Offices**

In addition to the five major divisions, additional offices provide vital support functions for the Commission. A few important offices are briefly discussed below.

#### **1. Office of the General Counsel**

The Office of the General Counsel serves as the chief legal officer of the Commission and provides independent legal analysis and advice to the Chairman, Commissioners, and operating divisions on all aspects of the Commission's activities. The General Counsel also defends the Commission in federal district courts, represents the Commission in all appellate matters and *amicus curiae* filings, and oversees the SEC's bankruptcy program.

#### **2. Office of Compliance Inspections and Examinations**

This office conducts the SEC's examinations of registered entities and persons such as investment advisers, investment companies, broker-dealers, self-regulatory organizations, credit rating agencies, transfer agents, and clearing agencies. The office conducts inspections to foster compliance with the securities laws, to detect violations of the law, and to keep the

Commission informed of developments in the regulated community. When a deficiency is found, a “deficiency letter” identifying the problems that need correction is issued. Deficiencies that are too serious for informal correction are referred to the Division of Enforcement.

### 3. Office of International Affairs

The Office of International Affairs assists the Chairman and the Commission in the development and implementation of the SEC’s international regulatory and enforcement initiatives. The Office negotiates bilateral and multilateral agreements with international regulatory agencies for Commission approval on such subjects as regulatory cooperation and enforcement assistance, and oversees the implementation of such arrangements. It is also responsible for advancing the Commission’s agenda in international meetings and organizations. Finally, the Office also conducts an assistance program for countries with emerging securities markets, which includes training both in the United States and in the requesting country. Over 100 countries currently participate in this program.

## II. THE SEC’S LAW ENFORCEMENT ARM: THE DIVISION OF ENFORCEMENT

### A. Overview

The Division of Enforcement was created in August 1972 to consolidate enforcement activities that previously had been handled by the various operating divisions at the Commission’s headquarters in Washington. It is the SEC’s largest division and its mission is to protect investors and the markets by investigating potential violations of the federal securities laws and litigating the SEC’s enforcement actions in federal court or in an administrative proceeding. In 2011, the SEC spent approximately \$309.1 million prosecuting violations of the federal securities laws resulting in the collection of \$2.8 billion in sanctions.

Fiscal Year	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
	Actual	Actual	Actual	Actual	Actual
Ordered amounts (in millions)	\$1,601	\$1,030	\$2,442	\$2,846	\$2,806
Collected amounts (in millions)	\$979	\$521	\$1,694	\$1,775	\$1,281

### B. How the Securities Laws are Enforced

#### 1. Investigations

The process of enforcing the securities laws begins with an investigation into a possible violation. The Division of Enforcement handles a number of investigations that vary in their size, complexity, and importance. Devoting appropriate resources to investigations that are more significant helps to ensure high quality investigations and maximize desired program outcomes. In this regard, in order to identify and make effective decisions regarding matters having potential significance, the Director of the Division or his or her designee determines whether a particular investigation is designated as a “National Priority Matter.”

Evidence of possible violations of the securities laws come from many sources, including market surveillance activities, investor tips and complaints, other divisions and offices

of the SEC, the self-regulatory organizations and other securities industry sources, and media reports. In addition, since the creation and implementation of the SEC's new whistleblower program, which was created pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC has begun to receive tips from individuals having knowledge of potential violations.

All SEC investigations are confidential. Facts are developed to the fullest extent possible through informal inquiry, interviewing witnesses, examining brokerage records, reviewing trading data, and other methods. With a formal order of investigation, the Division of Enforcement's staff may compel witnesses by subpoena to testify and produce books, records, and other relevant documents. Following an investigation, the staff present their findings to the Commission for its review. The Commission can authorize the staff to file a case in federal court or bring an administrative action. In many cases, the Commission and the party charged decide to settle a matter without trial.

## **2. Enforcement Actions and Remedies**

If, following an investigation, the Commission believes that there is sufficient evidence of a violation to warrant filing an enforcement action, the Commission will authorize the Division of Enforcement to file a case in either federal court or an administrative proceeding. Whether to bring a case in federal court or within the SEC before an administrative law judge (ALJ) often depends upon the type of sanction or relief that is being sought. For example, the Commission may bar someone from the brokerage industry in an administrative proceeding, but an order barring someone from acting as a corporate officer or director must be obtained in federal court. Often, when the misconduct warrants it, the Commission will bring both proceedings.

**Civil action:** The Commission files a complaint with a U.S. District Court and asks the court for a sanction or remedy. Often the Commission asks for a court order, called an injunction, that prohibits any further acts or practices that violate the law or Commission rules. An injunction can also require audits, accounting for frauds, or special supervisory arrangements. In addition, the SEC can seek civil monetary penalties, or the return of illegal profits (called disgorgement). The court may also bar or suspend an individual from serving as a corporate officer or director. A person who violates the court's order may be found in contempt and be subject to additional fines or imprisonment.

**Administrative action:** The Commission can seek a variety of sanctions through the administrative-proceeding process. Administrative proceedings differ from civil court actions in that they are heard by an administrative law judge. The administrative law judge presides over a hearing and considers the evidence presented by the Division staff, as well as any evidence submitted by the subject of the proceeding. Following the hearing the ALJ issues an initial decision that includes findings of fact and legal conclusions. The initial decision also contains a recommended sanction. Both the Division staff and the defendant may appeal all or any portion of the initial decision to the Commission. The Commission may affirm the decision of the ALJ, reverse the decision, or remand it for additional hearings. Administrative sanctions include cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry, civil monetary penalties, and disgorgement.

## C. Specialized Units and Market Intelligence

In January 2010, the Division of Enforcement announced the creation of specialized units in five priority areas dedicated to particular highly specialized and complex areas of securities law. The Division also created a new Office of Market Intelligence, which is responsible for the collection, analysis, and monitoring of the hundreds of thousands of tips, complaints, and referrals that the SEC receives each year.

The purpose of these specialized units is to address the unique challenges facing the SEC and other law enforcement agencies in combating newer, more sophisticated, and more specialized types of securities fraud. Through enhanced training and improved access to specialists, unit members obtain increased understanding of particular markets, products and transactions. They then use that expertise to adopt a more proactive approach to identifying conduct and practices ripe for investigation, to conduct those investigations with increased efficiency and effectiveness, and to share that expertise with all staff throughout the Division of Enforcement conducting investigations in these specialized areas.

The specialized units are:

- **Asset Management:** this unit focuses on investigations involving Investment Advisors, Investment Companies, Hedge Funds, and Private Equity Funds;
- **Market Abuse:** this unit focuses on investigations involving large-scale market abuses and complex manipulation schemes by institutional traders, market professionals, and others.;
- **Structured and New Products:** this unit focuses on complex derivatives and financial products, including credit default swaps, collateralized debt obligations, and securitized products;
- **Foreign Corrupt Practices:** this unit focuses on violations of the Foreign Corrupt Practice Act, which prohibits U.S. companies from bribing foreign officials for government contracts and other business; and
- **Municipal Securities and Public Pensions:** this unit focuses on misconduct in the large municipal securities market and in connection with public pension funds. The type of misconduct includes offering and disclosure fraud; tax or arbitrage-driven fraud; pay-to-play and public corruption violations; public pension accounting and disclosure violations; and valuation and pricing fraud.

## III. THE INVESTIGATIVE PROCESS

Congress has delegated an enormous degree of discretion to the SEC to conduct investigations. The Commission has the authority to conduct investigations “as it deems necessary to determine whether any person has violated, is violating, or about to violate” the federal securities laws. This authority includes the power to determine the scope of its investigations and the persons and entities subject to investigation. Commission decisions to initiate an investigation are not subject to judicial review.

## **A. Matters Under Inquiry**

When the SEC receives information suggesting a possible securities law violation, it will often conduct a preliminary inquiry to determine whether the allegations should be examined in more detail. The issue will then become a Matter Under Inquiry (“MUI”) and an MUI number will be assigned. MUIs are preliminary in nature and typically involve incomplete information. The threshold determination for opening a new MUI is low because its purpose is to gather additional facts to help evaluate whether an investigation would be an appropriate use of resources. An MUI automatically converts to an investigation when it has been opened for 60 days.

## **B. Informal Investigations**

After an MUI becomes an investigation, the investigation is usually only “informal.” An informal investigation is, generally, a request for voluntary cooperation in providing information to the SEC staff. While the subject individual or entity is under no obligation to comply with such a request, it is usually in that person’s or entity’s interest to do so, as the SEC may look more positively on that individual or entity and it could influence the staff’s ultimate decision about whether to issue a formal order of investigation.

Once notice of an informal inquiry is received, the subject is obligated to preserve relevant documents. The destruction of relevant documents in these circumstances could lead to charges of obstruction of justice. As a general rule of thumb, one should consider the potential relevance of the materials to the matters under inquiry, not the informal or formal nature of the inquiry, when deciding which materials to preserve or disclose. In addition, the SEC will usually request that certain documents be produced—turned over—to the Commission for review. The SEC may also request interviews of relevant individuals. However, the staff cannot compel an individual to give testimony, nor can it require or administer oaths or affirmations if testimony is given.

## **C. Formal Investigations**

At the conclusion of an informal investigation, the investigating staff may seek a formal order of investigation (“Formal Order”) from the Commission. The Commission will issue a Formal Order if it believes that there is a likelihood that a violation of the federal securities laws has occurred or is occurring. A Formal Order designates members of the SEC staff to act as officers of the Commission for purposes of the investigation and may issue subpoenas compelling the production of documents by a company or by individuals and the testimony of witnesses.

A Formal Order serves two important functions. First, it generally describes the nature of the investigation that has been authorized. Second, it empowers staff members 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 always nonpublic unless otherwise ordered by the Commission.

Typically, formal investigations commence with a broad request for the production of documents covering a specified time period, as well as possible subpoenas. Such document requests and subpoenas can often be narrowed by negotiation in order to prevent an undue burden and the production of irrelevant documents. Once documents are collected, if the

SEC staff continues to have questions, it will frequently call witnesses to testify regarding the matter.

According to Commission rules, any person who is compelled to produce documents or testify in a formal investigation shall, upon request, be shown a copy of the Formal Order. A witness may also submit a written request for a copy of the Formal Order. The SEC staff is not required to provide a copy; rather, it is within their discretion to do so.

## IV. SOURCES OF INVESTIGATIONS

### A. Complaints and Tips From the Public

Many SEC investigations and enforcement actions are the result of complaints or tips provided by the public. In 2011, almost 350 investigations resulted from tips collected from the public.

Fiscal Year	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
	Actual	Actual	Actual	Actual	Actual
Division of Enforcement					
Number of investigations	Prior-year data not available			303	349

With the enactment of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), Congress directed that the Commission establishes a program to pay monetary awards to eligible whistleblowers who voluntarily provide the SEC with original information that leads to a successful enforcement action, if the action yields monetary sanctions of over \$1 million. The amount of the award is between 10 percent and 30 percent of the total monetary sanctions collected in the Commission’s action or any related action such as in a criminal case. The exact amount is subject to the SEC’s discretion and depends on various factors. Furthermore, Dodd-Frank expressly prohibits retaliation by employers against whistleblowers and provides them with a private cause of action in the event that they are discharged or discriminated against by their employers.

Public complaints and tips are primarily received through the SEC’s online web form (<http://www.sec.gov/complaint.shtml>) or through contact with staff at any of the SEC’s offices. The vast majority of complaints and tips are submitted online. To qualify as a whistleblower, any individual providing a whistleblower submission to the SEC must do so by either using the online form or by mailing or faxing a Form TCR to the SEC Office of the Whistleblower.

### B. Referrals From Self-Regulatory Organizations

The Division of Enforcement’s Office of Market Surveillance (“OMS”) is the primary point of contact for trading-related referrals by domestic SROs, such as stock exchanges. Each equity and option exchange is responsible for monitoring its own markets and enforcing exchange rules and regulations and the federal securities laws. If the SRO discovers potentially illegal conduct and believes that it has jurisdiction, it will conduct its own investigation. If the SRO determines that it does not have jurisdiction, it will refer the potential violations to the SEC via the SRO Market Surveillance Referral System. OMS reviews all SRO referrals and, in consultation with senior staff in the Division of Enforcement, opens

investigations and distributes the cases to the appropriate staff in the regional and home offices.

### **C. Other Sources of Potential Violations**

Investigations are triggered from a variety of other sources, including reviews of company filings made with the SEC; inspections and examinations of broker-dealers, investment companies, and investment advisors; referrals from state securities agencies; media stories; and from the review of information retained in accordance with the Bank Secrecy Act.

## **V. SUBPOENA OF DOCUMENTS AND TESTIMONY**

### **A. The Power to Issue Subpoenas**

Consistent with its expansive authority to investigate violations of the federal securities laws, the SEC has broad subpoena power. Upon the issuance of a Formal Order, the staff may request any information that is reasonably relevant to the investigation. This power includes the power to subpoena documents, as well as the power to subpoena the testimony of witnesses. Subpoenas may also be issued to other parties that might have relevant information about the transactions under investigation, including banks, telephone companies, internet service providers, broker-dealers, and contract counterparties.

The SEC has the jurisdiction to issue subpoenas anywhere in the United States and may compel witnesses to appear at any designated place of hearing. In addition, the SEC cooperates with many foreign law enforcement agencies so that it can obtain information located within the foreign jurisdiction.

### **B. Challenges to Subpoenas**

A party receiving an SEC subpoena has few options to challenge the subpoena. The party could try and move to squash the subpoena, but such motions are rarely successful because courts generally hold that subpoena enforcement actions are the exclusive forum for challenging SEC subpoenas.

SEC subpoenas are not self-enforcing, and recipients of subpoenas usually will not face any penalty for refusing to obey them. The SEC, however, takes such refusal very seriously, and if the refusal persists, the Director of the Division of Enforcement has the authority to institute a subpoena enforcement action. It is during this subpoena enforcement action that a party can raise challenges to the subpoena.

Common challenges to an SEC subpoena include that the subpoena is overbroad and seeks irrelevant material, that compliance with the subpoena would be unduly burdensome, and that the subpoena calls for privileged material. But courts take an expansive view of a federal agency's—including the SEC's—subpoena power, and the SEC need only show that (i) its investigation will be conducted pursuant to a legitimate purpose; (ii) the inquiry may be relevant to that purpose; (iii) the information sought is not already within the SEC's possession; and (iv) all administrative steps required by law have been followed.

## **VI. PRIVACY AND CONFIDENTIALITY OF INVESTIGATIONS**

### **A. Confidentiality of Information**

In general, it is the policy and practice of the SEC to keep confidential and nonpublic all information it obtains during the course of its investigations. Disclosure of this enforcement-related information to any person outside the SEC is only permitted in limited circumstances in accordance with applicable laws and regulations. For example, Section 24(b) of the Exchange Act permits the SEC to, in its discretion, provide records and other information in its possession to such persons as the Commission by rule deems appropriate if the person receiving such records or information provides assurances of confidentiality. The SEC will sometimes provide information to other regulatory agencies or law enforcement authorities, such as the Department of Justice, to assist those other agencies or authorities in their own investigations into the subject conduct.

### **B. Freedom of Information Act**

Under the Freedom of Information Act ("FOIA"), information and documents submitted to the SEC during an investigation may be disclosed to any member of the public who makes a valid request, unless one of the nine exceptions to disclosure applies. Some of the more relevant exceptions often invoked by the SEC to deny a FOIA request are that the materials requested (i) contain trade secrets or confidential business information; (ii) constitute inter/intra-agency communications; or (iii) were compiled for law enforcement purposes and their production would interfere with an ongoing enforcement proceeding.

To ensure maximum protection from disclosure of information under FOIA, a person submitting information to the SEC—either voluntarily or by subpoena—must request confidential treatment of that information. Information for which confidential treatment is requested must be (i) segregated from other information; (ii) clearly marked as confidential; and (iii) accompanied by a written request for confidential treatment, which specifies the information to be kept confidential. Information may receive confidential treatment to protect personal privacy or sensitive business information, or for one of the nine exceptions to disclosure specified in FOIA. If confidential treatment is granted, the information is protected from disclosure while the investigation or case remains open.

### **C. The Privacy Act of 1974**

The Privacy Act of 1974 provides notice and protection to persons from whom a federal agency, including the SEC, requests information. The Privacy Act governs the procedures applicable to the SEC for obtaining, maintaining, and disseminating information obtained from individuals. The protections apply only to individuals who are citizens of the United States or aliens lawfully admitted for permanent residence. Thus, the Privacy Act does not apply to corporations or non-citizens living abroad.

Under the Privacy Act, the SEC is required to provide each individual asked to provide information with a notice stating:

- the legal authority under which the information is being requested and whether compliance is voluntary or mandatory;



- the principal purposes for which the information will be used;
- the “routine uses” which may be made of the information; and
- the potential consequences of not providing the information.

The Privacy Act also precludes the disclosure of information relating to an individual by the SEC without that individual’s permission unless disclosure is expressly permitted by the Act. In addition, when the SEC does disclose the information, either pursuant to a statutorily-permissible reason or with permission, it must maintain a record of such disclosures, except when the information is disclosed to SEC officers and employees who have an official need for the information or disclosures under FOIA.

## **VII. PRIVILEGES**

The SEC’s authority to conduct investigations and subpoena documents and witnesses, though broad, is subject to certain legal restraints. Most notable among them are the standard evidentiary privileges, such as the attorney-client privilege and the work-product doctrine.

### **A. Attorney-Client Privilege**

Any witness who testifies in an SEC investigation can assert the attorney-client privilege to protect from disclosure certain communications made in connection with obtaining legal advice. The attorney-client privilege arises from the recognition that to obtain adequate legal representation, a client must be able to communicate honestly with his or her attorney without fearing subsequent unauthorized disclosure of those communications.

A communication is protected from disclosure under the attorney-client privilege if:

- the asserted holder of the privilege is, or has sought to become, a client;
- the person to whom the communication was made is a member of the bar or a subordinate in connection with the communication;
- the communication relates to a fact of which the attorney was informed by the client for the purpose of obtaining an opinion of law or services in connection with some legal proceeding, and not for the purpose of committing a crime; and
- the privilege has not been waived by the client.

To maintain a claim of attorney-client privilege, the communication between the attorney and client must be made in confidence and must remain in confidence. The voluntary disclosure of the communication by the client to a third party would result in a waiver of the privilege.

In the case of corporate entities, communications from employees to the corporation’s attorneys fall within the attorney-client privilege if the communications concerned matters within the scope of the of the employees’ corporate duties, and the employees are aware that they are being questioned in order to assist the corporation in obtaining legal advice.

## **B. Work-Product Doctrine**

The work-product doctrine protects from discovery all documents and other materials prepared by a party or his or her attorney in anticipation of litigation. This privilege covers more than just communications, and is thus broader than the attorney-client privilege. Unlike the attorney-client privilege, however, this privilege is not absolute; rather, it can be overcome by showing that there is a substantial need for the materials and a substantial equivalent of the materials cannot be obtained without undue hardship. A voluntary disclosure of protected material to the SEC by the client would result in a waiver of the privilege.

## **C. Self-Evaluative Privilege**

Companies often prepare internal self-evaluations and reports. Sometimes, the SEC might request the production of these internal self-evaluations as part of its investigation into whether the company violated the securities laws. Because these reports often contain sensitive and self-critical information, companies have attempted to protect these evaluations from production.

Some courts have recognized a privilege over these internal self-evaluations and prevented their discovery by the SEC. However, there is no clear judicial consensus that such a privilege exists, and many courts have found that it does not and requires production of the documents. Nor has the Supreme Court recognized the privilege. Thus, companies should generally expect to produce internal self-evaluations to the SEC.

## **D. Waiver**

A person or company that is the subject of an SEC investigation can waive the attorney-client and work-product privileges. The SEC, as well as the Department of Justice, consider the voluntary waiver of these privileges as evidence of cooperation, warranting more favorable treatment in SEC enforcement and Department of Justice charging determinations. In addition, there are times when material otherwise protected by the work-product privilege, such as reports from internal investigations prepared by counsel, could evidence the company's innocence and influence the SEC's decision to end an investigation.

The decision to cooperate and voluntarily waive the privileges must be carefully considered, however, because it is possible that a voluntary waiver to the SEC, for example, could result in the privilege being waived as to any other legal proceeding or investigation. In other words, if a company intends to cooperate with an SEC investigation by producing material otherwise protected by the work-product and attorney-client privileges, and then that company is later investigated by the Department of Justice, it could be determined that the company made a general waiver of the privileges for all purposes. In that case, the Department of Justice would be entitled to receive the otherwise privileged materials.

Courts that have considered this issue of limited and general waivers are divided on the scope of a voluntary waiver and whether it constitutes a general waiver for all purposes. Generally, the issue is resolved in one of three ways:

- the majority view is that a party cannot engage in a "limited" or "selective waiver" of either the attorney-client privilege or work-product

doctrine, and that if party attempts or intends such a limited waiver, it will constitute a general waiver with respect to third parties;

- some courts have permitted a waiver of the attorney-client privilege for one limited purpose only, and of work product that contains mental impressions or opinions of counsel; and
- still other courts have intimated that, if the SEC and a private party make specific efforts to preserve the confidentiality of the material or information produced, a limited waiver will be permitted.

Considering the foregoing, individuals should consider very carefully the advantages and disadvantages of waiving the attorney-client and work-product privileges and cooperating with the SEC.

## **VIII. COOPERATING WITH THE SEC**

In January 2010, the SEC announced a new initiative to encourage greater cooperation from individuals and companies in the Commission's investigations and enforcement actions. The initiative authorizes the Division of Enforcement to use a variety of new tools, used successfully by traditional law enforcement agencies for a long time, to incentivize individuals and companies to fully and truthfully cooperate with SEC investigations and enforcement actions. These new cooperation tools include: proffer agreements; cooperation agreements; deferred prosecution agreements; non-prosecution agreements; and immunity requests.

### **A. Proffer Agreements**

Proffers of information and evidence by witnesses, including potential cooperating witnesses, are an important method used by the SEC to assess the potential value of information and evidence. A proffer agreement is a written agreement providing that any statements made by a person may generally not be used against that individual in subsequent proceedings. The only exceptions are that the Commission may use statements as a source of leads to discover additional evidence and for impeachment or rebuttal purposes if the person testifies or argues inconsistently in a subsequent proceeding. In addition, the Commission may share the information provided by the proffering individual with appropriate authorities in a prosecution for perjury, making a false statement or obstruction of justice.

### **B. Cooperation Agreements**

A cooperation agreement is a written agreement between the Division of Enforcement and a potential cooperating individual or company prepared to provide substantial assistance to an investigation and related enforcement actions. Specifically, in a cooperation agreement, the Division of Enforcement agrees to recommend to the Commission that the individual or company receive credit for cooperating in its investigation and related enforcement actions and, under certain circumstances, to make specific enforcement recommendations. It is important to note, however, that cooperation agreements do not bind the Commission and that the Enforcement Division cannot, and does not, make any promise or representation as to whether or how the Commission may act on enforcement recommendations made by the division. If the agreement is violated, the staff may recommend an enforcement action to the Commission against the individual or company without any limitation.

### **C. Deferred Prosecution Agreements**

A deferred prosecution agreement is a written agreement between the Commission (not simply the Division of Enforcement) and a potential cooperating individual or company in which the Commission agrees not to initiate an enforcement action against the individual or company if the individual or company agrees to cooperate truthfully and fully in the Commission's investigation and related enforcement actions. In addition, the individual or company will have to enter into a long-term tolling agreement, which tolls the running of the applicable statute of limitations so that the Commission would not be barred from later bringing an enforcement action should the individual or company violate the terms of the deferred prosecution agreement. Finally, the individual or company may be required to comply with certain prohibitions or undertakings during a specified period and agree either to admit or not to contest underlying facts that the Commission could assert to establish a violation of the federal securities laws.

If the agreement is violated during the period of deferred prosecution, the staff investigating the matter may recommend an enforcement action to the Commission against the individual or company for the original misconduct as well as any additional misconduct.

### **D. Non-Prosecution Agreements**

A non-prosecution agreement is a written agreement between the Commission and a potential cooperating individual or company providing that the Commission will not pursue an enforcement action against the individual or company. The individual or company must agree to, among other things, cooperate truthfully and fully in the Commission's investigation and related enforcement actions, and comply, under certain circumstances, with express undertakings. If the agreement is violated, the investigating staff retains its ability to recommend an enforcement action to the Commission against the individual or company without limitation.

### **E. Grants of Immunity**

In certain circumstances, individuals may assert their Fifth Amendment right against self-incrimination and refuse to provide testimony or cooperate unless they receive protection against criminal prosecution. When this occurs, the Commission, in appropriate circumstances, may seek statutory immunity or letter immunity in order to obtain witness testimony. For statutory immunity, the Commission obtains a court order compelling the individual to give testimony or provide other information that may be necessary to the public interest. The Commission's request must be approved by the U.S. Attorney General for the order to issue. In contrast, letter immunity is immunity conferred by an agreement between the individual and a U.S. Attorney's Office.

Both types of immunity prevent the use of statements or other information provided by the individual against that individual in any criminal case, except for perjury, giving a false statement, or obstruction of justice. Statutory and letter immunity only prevents the use of testimony and other information in a criminal prosecution, not an enforcement action. Thus, the Commission may still use the testimony or other information in its enforcement actions, including actions against the individual for whom the immunity order or letter was issued.

## **IX. CLOSING AN INVESTIGATION**

### **A. Wells Process**

#### **1. Wells Notice**

A Wells Notice is a letter that the SEC sends to people or firms informing them that the Commission intends to bring an enforcement action for the matters under investigation. The Wells Notice indicates that the SEC staff has determined it may bring a civil action against a person or firm, and provides the person or firm with the opportunity to provide information as to why the enforcement action should not be brought. The SEC is not legally required to provide a Wells Notice, yet it is its practice to do so.

Basically, the Wells Notice should inform a person or firm involved in an investigation that: (i) the Division of Enforcement is considering recommending or intends to recommend that the Commission file an action or administrative proceeding against such person or firm; (ii) the potential violations at the heart of the recommendation; and (iii) the person or firm may submit arguments or evidence to the Division of Enforcement and the Commission regarding the recommendation and evidence.

#### **2. Wells Submission**

As stated above, among other things, a Wells Notice, if made, must inform the party under investigation that they may make a voluntary submission to the Commission regarding the proposed recommendation to bring an enforcement action or proceeding. This voluntary submission is called a "Wells Submission."

The purpose of the Wells Submission is to essentially act as a reply to the arguments made by the Division of Enforcement's staff to the Commission as to why an enforcement action should not be initiated. As such, it is critical that counsel preparing the Wells Submission have a thorough understanding of the SEC staff's view of the evidence and the staff's legal theories. This may require face-to-face meetings with the staff. Careful thought and preparation should be made into the Wells Submission as it is probably the last opportunity to dissuade the SEC from going forward with its recommendation to file formal charges.

The Division of Enforcement staff can reject a Wells Submission if it exceeds the page limit specified in the Wells Notice or if the Wells Submission is not submitted in time and the staff declines to grant an extension. In addition, if the person making the submission seeks to limit the Wells Submission's admissibility under Federal Rule of Evidence 408 or the Commission's ability to use the submission, it could be rejected. If a Wells Submission is accepted, the staff will provide it to the Commission along with its recommendation for an enforcement action.

### **B. Closing Investigations Resulting in an Enforcement Action**

If an investigation results in an enforcement action, the investigation cannot actually be closed until all enforcement actions in the case are complete. This requires (i) a final judgment or Commission order and (ii) that all ordered monetary relief is accounted for, meaning that all disgorgement and civil penalties have been paid in full (or the Commission has authorized the

staff to terminate collection of any unpaid amounts), all funds collected have either been distributed to investors or paid into the Treasury, and all money has been properly recorded.

Further, an investigation cannot be closed if any debts of a defendant or respondent are the subject of collection activity by the Commission or on the Commission's behalf (e.g., by the Department of the Treasury's Financial Management Service or the Department of Justice), or if any funds are being held pending final distribution.

### **C. Closing Without Further Action**

If, after an investigation, the staff decides not to recommend an enforcement action, the investigation will be closed. Generally, the SEC will close an investigation as soon as it is apparent that no further action will be taken. The SEC considers the following factors when deciding whether to close an investigation:

- the seriousness of the conduct and potential violations;
- the staff resources available to pursue the investigation;
- the sufficiency and strength of the evidence;
- the extent of potential investor harm if an action is not commenced; and
- the age of the conduct underlying the potential violations.

Although it is not required to provide notice to the party under investigation that the investigation has been closed, the SEC's policy is to do so via a termination letter.

### **D. Termination Letters**

It is the policy of the Division of Enforcement to notify individuals and entities at the earliest opportunity when the staff has determined not to recommend an enforcement action against them. This notification takes the form of a termination letter. A termination letter may be sent before an investigation is actually closed and before a determination has been made as to every potential defendant or respondent.

A termination letter will be sent to anyone who:

- is identified in the caption of a Formal Order;
- submitted or was solicited to submit a Wells Submission;
- asks for such a notice of termination; or
- reasonably believes that the staff was considering recommending an enforcement action against them.

It should be noted, however, that a notice that an investigation has been closed does not necessarily mean that the party has been exonerated or that no action may ultimately be taken.

## **X. STATUTE OF LIMITATIONS IN ENFORCEMENT ACTIONS**

The relevant statute of limitations for SEC enforcement actions is set forth in 28 U.S.C. § 2462, which is a “catch all” statute of limitations for actions brought by federal agencies in federal court. Under Section 2462, the SEC has five years to bring an enforcement action seeking civil penalties from the date that the claim first accrued. Thus, generally, the SEC has five years to file an enforcement action from the date that the unlawful conduct occurred. There are, however, three primary exceptions.

### **A. The Discovery Rule**

The first exception is known as the discovery rule, which only applies to claims of fraud. The discovery rule holds that the statute of limitations for a fraud claim does not accrue until that claim is discovered, or could have been discovered with reasonable diligence. The reason for this rule is that fraud claims, by their very nature, necessarily involve self-concealing conduct, and a defrauded party might not know that he or she was the victim of fraud for many years after the fraud occurred. Therefore, the discovery rule delays the date of accrual of the claim until the time the SEC discovers, or should have discovered, the fraud.

### **B. Fraudulent Concealment/Equitable Tolling**

A similar yet distinct concept from the discovery rule is the doctrine of fraudulent concealment, also referred to as equitable tolling. Unlike the discovery rule, which delays the accrual of a fraud claim until the fraud’s discovery, the fraudulent concealment doctrine temporarily suspends—*i.e.*, tolls—the statute of limitations clock, even though a claim has already accrued, if the defendant took specific steps to conceal the wrongful conduct. This doctrine applies only to non-fraud claims because it is expected that a victim will know when he or she has been harmed and has a claim. But if the SEC can establish that the defendant took affirmative steps, beyond the wrongful activity itself, to conceal the violation, the fraudulent concealment doctrine may be used to toll the limitations period until the wrongful conduct is discovered.

### **C. Tolling Agreements**

A tolling agreement is an agreement between the Commission and a party under investigation for possible securities violations. By signing a tolling agreement, the party under investigation agrees not to assert a statute of limitations defense in a future enforcement action for a specified time period. Tolling agreements are used when the assigned staff investigating potential violations believes that any of the relevant conduct may be outside the five-year limitations period before the SEC would be able to file or institute an enforcement action. In addition, tolling agreements are signed as part of deferred prosecution agreements, whereby the SEC agrees not to initiate an enforcement action against the individual or company if the individual or company agrees to cooperate truthfully and fully in the Commission’s investigation and related enforcement actions.

## **XI. ENFORCEMENT ACTIONS AND REMEDIES**

The SEC is authorized to bring enforcement actions to punish violations of the federal securities laws. The SEC can do so by either filing a civil action in federal district court, which

will be presided over by a federal district judge and be subject to the Federal Rules of Civil Procedure, or by initiating an administrative proceeding before an Administrative Law Judge.

## **A. Civil Actions**

If the SEC pursues a civil action in federal district court, the SEC may seek, and be awarded in the event the enforcement action is successful, the following remedies:

### **1. Civil Injunction**

The SEC may obtain a civil injunction prohibiting any person or corporation from continuing to violate, and from committing future violations, of the federal securities laws. To obtain an injunction, the SEC must show that the person or corporation has violated or is about to violate the securities laws, and a reasonable likelihood of future violations. Unlike private litigants, the SEC is not further required to show irreparable injury or that there is an adequate remedy at law. When considering whether to issue an injunction, courts generally look to the following factors:

- the nature of the conduct;
- the degree of scienter (bad intent) involved;
- the defendant's ability to violate the law in the future; and
- the degree to which the defendant has recognized the wrongfulness of his or her conduct.

### **2. Disgorgement**

Disgorgement is simply the repayment of money by the defendant of money obtained as a result of the wrongful conduct. It may also include losses avoided as a result of the unlawful conduct. Examples of improperly obtained money that would be subject to disgorgement includes profits made or losses avoided from alleged insider trading; proceeds obtained from allegedly illegal securities distributions; bonuses based upon allegedly improperly recognized revenues.

The SEC will also seek, and received if disgorgement is awarded, prejudgment interest on the disgorged sums.

### **3. Civil Penalties**

The SEC also has the authority to obtain civil monetary penalties from individuals and entities that have violated the securities laws. These penalties are above and beyond and disgorgement that the defendant must pay. The amount of a civil penalty depends upon the nature of the violation and whether or not the defendant is an individual or a organization.

### **4. Barring Service as an Officer or Director**

Finally, the Commission may obtain an order from the district court prohibiting an individual from serving in the future as an officer or director of a public company. Such orders require a showing of egregious misconduct and are usually sought in circumstances where the individual has misappropriated corporate assets.



## **B. Administrative Proceedings**

Administrative proceedings are proceedings that are held before an administrative law judge (ALJ). Decisions of the ALJ can be appealed to the Commission and from there to the United States Court of Appeals. Thus, the trial is entirely an “in-house” proceeding with far more restricted rights of discovery and of appeal than in a standard civil trial. There are technically different types of administrative proceedings, depending on the types of persons who can be prosecuted under them and the types of sanctions being sought. Practically, however, the SEC will generally invoke authority for all types of administrative proceedings so that it could impose the broadest range of sanctions in one proceeding.

### **1. Cease and Desist Proceedings**

The SEC has the authority under federal law to seek cease and desist orders against public companies and their officers in an administrative proceeding. In these proceedings, the SEC may seek several different types of cease and desist orders, including orders:

- requiring that persons who are violating the securities laws “cease and desist” from continuing the unlawful conduct;
- to “cease and desist” causing another person’s violation against persons who are, was, or would be the “cause” of another’s violation of the securities laws;
- compelling disgorgement of ill-gotten gains, as in a civil action, and an accounting of the defendant to ensure that the disgorgement is accurate;
- requiring that affirmative corrective action, such as requiring a corporation to adopt new internal control policies; and
- prohibiting any person from acting as an officer or director of any company with securities registered or required to make periodic filings with the SEC under the Exchange Act.

### **2. Civil Monetary Penalties**

The Commission may also commence an administrative proceeding to impose monetary penalties. This authority is limited to proceedings brought under sections 15, 15B-15D, and 17A of the Exchange Act. In addition, monetary sanctions can only be imposed upon a finding that the respondent party has:

- willfully violated any provision of the federal securities laws (including the rules and regulations thereunder);
- willfully aided, abetted, counseled, commanded, induced, or procured a violation by another person;
- willfully made or caused to made materially false or misleading statements in a report filed with the SEC; or
- has failed reasonably to supervise another person who commits such a violation.

### **3. Revocation of Licenses and Bars from the Industry**

The Commission may also suspend or revoke a securities license from any regulated person, and bar a regulated person from working in the securities industry, in an administrative proceeding. Grounds for such sanctions generally involve willful violations of the securities laws, or willfully aiding and abetting another person's violation, convictions of crimes, and failure to supervise others to prevent violations of the securities laws.

### **4. Proceedings to Correct Filings**

The SEC can order a company that is required to make periodic filings under the Exchange Act to issue corrected filings upon a finding that previously issued filings contained false and misleading statements.

### **5. Disciplining Professionals**

The SEC has the authority to discipline lawyers, accountants, and other professionals who practice before the Commission. Specifically, the Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any professional who is found not to possess the requisite qualifications, to have engaged in unethical or improper professional conduct, or to have willfully violated any provision of the federal securities laws.

## **XII. SEC COOPERATION WITH OTHER AGENCIES**

### **A. Parallel Proceedings**

The SEC is an independent federal agency charged by Congress with upholding the federal securities laws. The SEC has the authority to bring civil, but not criminal, actions to enforce those laws. The federal securities laws, however, provide for both civil and criminal enforcement. Criminal enforcement is handled by the Department of Justice ("DOJ"), and parallel civil and criminal proceedings for the same illegal conduct is not uncommon. As a matter of public policy and in furtherance of its mission, the SEC staff is encouraged to work cooperatively with criminal investigators. Simultaneous proceedings and investigations can also occur with other federal and state regulatory and law enforcement agencies, and certain self-regulatory organizations.

### **B. Informal Referrals to Other Authorities**

#### **1. Referrals to Criminal Authorities**

During the course of inquiries or investigations, the SEC may discover conduct that warrants referral to the DOJ or another criminal law enforcement agency, such as state or foreign criminal authorities. After the informal referral is made, the SEC and the relevant criminal authority will maintain periodic contact and share information where appropriate.

#### **2. Referrals to Self-Regulatory Organizations**

Sometimes, SEC staff will determine that it would be appropriate to refer conduct, or the entire matter, informally to one or more SRO. SROs have authority to discipline its own

members, including by imposing sanctions. Therefore, the SEC will make efforts to appraise SROs when it uncovers conduct that violate the rules of the SRO.

### **3. Referrals to the Public Company Accounting Oversight Board**

Under the Sarbanes-Oxley Act, the Public Company Accounting Oversight Board ("PCAOB") is authorized to conduct investigations and impose sanctions against registered public accounting firms. If Enforcement staff comes across conduct that may warrant a referral to the PCAOB, the staff will consult with the Division's Chief Accountant and determine whether an informal referral is appropriate.

### **4. Referrals to State Agencies**

State securities regulators play an important function in regulating the securities industry and protecting investors. In the course of conducting an inquiry or investigation, the SEC staff may determine that it would be appropriate to refer the matter, or certain conduct, informally to state regulators. On occasion, moreover, it may be appropriate for the state agency to investigate the matter in lieu of an SEC Enforcement investigation.

### **5. Referrals to Professional Licensing Boards**

Investigations may reveal conduct that warrants referral to professional licensing boards, such as a state bar associations or other state professional boards or societies. Referrals for possible professional misconduct are considered Commission action, but the Commission delegated authority to make referrals to the SEC's Office of the General Counsel ("OGC"). The OGC subsequently sub-delegated its authority to the OGC's Office of the Ethics Counsel. Common misconduct that the SEC would likely refer is attorney and accountant misconduct.

## **C. Sharing Information Obtained During Investigations**

Generally, information obtained during the course of an SEC investigation is non-public and may not be disclosed without authorization of the Commission. As discussed, however, members of the SEC staff are authorized to engage in discussions with other governmental entities and SROs about non-public investigations.

In addition, these other governmental authorities and SROs can request access to the Commission's investigation files. If access is granted, it generally provides authority to disclose information already in the SEC's possession, as well as information acquired in the future. Requests are normally granted unless doing so would: (i) interfere with an ongoing Commission investigation; (ii) be adverse to the Commission's enforcement interest; or (iii) be contrary to the public interest.

When the SEC serves subpoenas or information requests during investigations, it also provides SEC Forms 1661 and 1662, which explain how the information that the SEC obtains may be used and state that the SEC can make its files available to other governmental agencies. Thus, recipients of subpoenas or information requests are on notice that information provided to the SEC will be kept confidential only in limited circumstances.