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Release of 'Red Book' a Move Toward SEC Transparency

HAROLD K. GORDON
AND TRACY V. SCHAFFER

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Virtually all law enforcement agencies have at one time or another been criticized for a lack of transparency and consistency in their policies and procedures. Some degree of secrecy is warranted, of course, so that those intent on violating the law are not facilitated in their misconduct by knowing too much about the investigative and prosecutorial techniques of those charged with enforcing the law. An agency's policies and procedures should not be overly opaque, however, to the point where those in its regulatory purview cannot determine what conduct is prohibited, or whether a policy or procedure their counsel encountered in one office will be followed in another, or adhered to by a separate set of agency attorneys in the same office.

The Securities and Exchange Commission took a substantial and commendable step in the past couple of months towards greater transparency and consistency. On Oct. 6, 2008, the Office of Chief Counsel of the SEC's Division of Enforcement published its Enforcement Manual, informally known to generations of SEC Enforcement Staff as the "Red Book."^[FOOTNOTE 1] The Red Book historically served as a procedural reference on certain issues for SEC Staff in their investigations of potential violations of the federal securities laws. For the first time, it will now serve as a resource to help standardize the SEC's investigative process by compiling many of the procedures of the SEC's Division of Enforcement in one document available to the public.

Among other topics, the manual enumerates the factors that drive the SEC decision-making process with respect to determining when it is appropriate to open and close preliminary inquiries and investigations, and addresses communications between senior SEC Enforcement Staff and individuals or entities involved in an SEC investigation. In addition, the manual provides guidance on such subjects as the SEC Enforcement Staff's Wells Process pursuant to which individuals or entities against whom the staff is considering recommending an enforcement action are given an opportunity to respond, protection of the attorney-client privilege during investigations, cooperative investigative efforts, and more.

NOTEWORTHY PROVISIONS
OF THE SEC ENFORCEMENT
MANUAL

The following are some of the more noteworthy provisions of the Enforcement Manual. The Enforcement Manual's introduction makes it clear that it is designed as a reference manual for the SEC's Enforcement Staff and does not create any substantive or procedural rights enforceable by anyone investigated by or litigating against the SEC.

1. *Opening Matters Under Inquiry and Investigations*
[FOOTNOTE 2]

The Enforcement Manual sets forth the process that the SEC Enforcement Staff must undertake to open a new inquiry, also known as a Matter Under Inquiry. The manual describes a multi-level approval process. To open a MUI, the assigned SEC Staff must obtain written approval from the assigned Associate Director or Regional Head of Enforcement along with a Deputy Director of the Enforcement Division.

The procedure outlined in the manual for opening a MUI requires the staff to conduct a preliminary analysis to determine whether the known facts show that an SEC Enforcement investigation has the potential to address alleged conduct that violates the federal securities laws. As MUIs are typically premised on incomplete information, including news articles, whistleblowers and complaints from the public, SEC Staff are encouraged to evaluate the credibility of their information before opening a MUI. The manual suggests some basic considerations: (i) the statutes or rules potentially violated; (ii) the egregiousness of the potential violation; (iii) the potential losses involved or harm to investors; (iv) whether the conduct is ongoing; (v)



JONES DAY'S HAROLD
K. GORDON



JONES DAY'S TRACY
V. SCHAFFER

the location of the wrongful conduct, potential wrongdoers, witnesses and victims; and (vi) the resources of the office.

When a MUI has been open for sixty days, the SEC internal system will convert it into an investigation where the Enforcement Staff deems it appropriate.[FOOTNOTE 3] To initiate an investigation, the assigned staff must meet a higher standard of information-gathering and evaluation of certain "threshold issues" and "supplemental factors." [FOOTNOTE 4] Threshold issues include such factors as: (i) whether the facts suggest a possible violation of the federal securities laws involving fraud or other serious conduct; (ii) whether an investment of resources by the SEC Staff is merited by the size of the victim group; and (iii) whether the conduct is ongoing. Examples of supplemental factors are: (i) whether there is a need for immediate action to protect investors; (ii) whether the case fulfills a programmatic goal of the SEC and its Division of Enforcement; and (iii) whether the alleged conduct undermines the fairness or liquidity of the U.S. securities markets.

2. Resource Allocation [FOOTNOTE 5]

To make the best use of the SEC's limited enforcement resources, the Enforcement Manual instructs the staff to "devot[e] appropriate resources to investigations which are more significant." The Home Office Associate Directors and Regional Directors are required to submit to the Division of Enforcement Director quarterly reports with a list of their top ten significant investigations and a rank of their top three critically important investigations. In determining their top investigations, they must consider their importance in the context of current Enforcement Division initiatives, the magnitude of the potential violations, and the resources required to investigate. When allocating resources among competing investigations, the specified supervisors should consider such factors as the investigation's significance, phase, whether there is an urgent need to file an enforcement action, and the level of investigative analysis required.

In an effort to make the best use of SEC resources, the staff "is encouraged to close an investigation as soon as it becomes apparent that no enforcement action will be recommended."

3. Communications With SEC Staff During an Investigation [FOOTNOTE 6]

It is the senior SEC Enforcement Staff who frequently have the initial contact and communications with individuals or entities involved in an SEC investigation related to "potential settlements, strength of the evidence and charging decisions." The manual outlines "best practices" for substantive communications related to active investigations between senior officials of the SEC (Associate Directors and above) and those involved in those investigations or their counsel. Best practices in the manual encourage senior SEC Enforcement Staff to "keep in mind the need to preserve the impartiality of the Division in conducting its fact-finding and information-gathering functions." The manual states that senior officials should be aware that an external communication "has the potential to be an attempt to supersede the investigate team's judgment and experience." Thus, the manual provides that the senior official should share the contents of an external communication about an active investigation communication with the assigned SEC Staff unless the outside party raises issues about the conduct of the staff involved.

4. The "Wells" Process [FOOTNOTE 7]

The manual outlines the steps in the Wells process, including the circumstances under which Enforcement Staff may issue a "Wells notice" to an individual or entity involved in an investigation informing them: (i) that the Enforcement Division is considering recommending

that the SEC file an action or proceeding against them; (ii) the potential violations at the heart of the recommendation; and (iii) that the individual or entity may make a submission arguing why the staff's proposed recommendation is unjustified in whole or in part based on the investigative record, the law, and policy considerations. The manual instructs staff on how to provide a Wells notice, the content of the Wells notice, the approval required at the Deputy Director level, and the factors that determine whether to provide a Wells notice.

Notably, the manual grants the staff the discretion on a case-by-case basis to permit the recipient of a Wells notice to review non-privileged information in the staff's investigative file and, in an effort to address practices some in the defense bar claim have been followed inconsistently in the past, outlines the factors the staff should consider in deciding whether to allow such a review, including: (1) whether the review would help both sides gauge the strength of the evidence; (2) whether the recipient asserted the Fifth Amendment during the investigation; and (3) the stage of the investigation.

In addition, the manual memorializes the SEC Staff's practice of meeting with defense counsel to discuss whether a Wells notice should be issued and engaging in settlement discussions at this earlier stage in the enforcement process.

5. Witness Assurance Letters [FOOTNOTE 8]

In very narrow circumstances, the manual authorizes SEC Enforcement Staff to issue a "witness assurance letter" indicating that "the SEC does not intend to bring an enforcement action against the witness" in exchange for the witness's cooperation, including testimony, documents and information. Such narrow circumstances involve, for example, situations where evidence is necessary to the SEC's investigation, but the SEC lacks jurisdiction over the witness. The manual provides a sample witness assurance letter to guide the staff in applicable situations. In addition, the manual outlines the procedure by which the SEC Staff can work with the Department of Justice to obtain a grant of immunity for a witness in appropriate circumstances.

6. Proffer Agreements [FOOTNOTE 9]

By approval of an Assistant Director or higher-level staff, the staff may enter into written proffer agreements or "Queen for a day" letter-agreements with witnesses, stating that the witness's oral statements at a specific meeting will not be used against the witness in any subsequent enforcement proceeding. However, like such agreements with Department of Justice prosecutors, the manual states that a witness's statements may be used to assist the staff in developing leads to new evidence against the witness, to impeach the witness during cross-examination, or to assist a subsequent criminal proceeding against the witness for perjury or obstruction of justice. The manual provides the staff with a standard proffer agreement.

7. Attorney-Client Privilege and the Work Product Doctrine [FOOTNOTE 10]

The manual discusses the elements, scope and waiver of the attorney-client privilege and work product doctrines, and provides a model confidentiality agreement under which privileged and confidential material can be produced to the staff.

With respect to inadvertent production of privileged or non-responsive documents, the manual refers to new Rule 502 of the Federal Rules of Evidence, signed into law by the President on Sept. 19, 2008.[FOOTNOTE 11] If SEC Staff receive inadvertently produced documents, they should notify a supervisor (Associate Director level or above) and/or an Ethics liaison before returning a document to the

party, because a supervisor may have "a legally sound and defensible basis for keeping the document."

The manual's section on waiver of privilege strongly emphasizes that the staff "should not ask a party to waive the attorney-client or work product privileges and is directed not to do so." A party may, however, freely and voluntarily disclose privileged communications or documents. All decisions about waiver of privilege must be reviewed by the Assistant Director supervising the matter or a more senior official where necessary. The manual makes clear that a privilege waiver is not necessary for a party to obtain credit for cooperation with the SEC Staff. The appropriate question regarding cooperation is whether the party "has disclosed all relevant underlying facts within its knowledge," and the manual recommends that SEC Staff "explore alternative means of obtaining factual information" in an effort to avoid a privilege waiver.

8. Closing Investigations [FOOTNOTE 12]

The SEC Manual provides four factors the staff should consider in deciding to close an investigation: (i) the seriousness of the potential violations; (ii) Staff resources available to pursue the investigation; (iii) sufficiency of the evidence; and (iv) the age of the conduct underlying the potential violations. A goal is to allow resources to be rerouted to more productive investigations.

The "Division's policy is to notify individuals and entities at the earliest opportunity when the staff has determined not to recommend an enforcement action against them to the Commission." The SEC Staff is directed to send a termination letter to anyone: (i) who is identified in the caption of an SEC Formal Order of Investigation; (ii) who submitted or was solicited to submit a Wells submission; (iii) who asks for such a termination letter; or (iv) who reasonably believes that the staff was considering recommending an enforcement action against them.

9. Cooperation With Other Agencies and Organizations [FOOTNOTE 13]

Where other law enforcement agencies and organizations, such as stock exchange self-regulatory organizations or federal, state or local prosecutors, are engaging in related investigative efforts, the manual outlines the procedures for the staff to cooperate and coordinate investigations and information sharing.

Among other things, the manual instructs officials at or above the level of Associate Director on how to refer matters informally to other relevant law enforcement or regulatory entities, including criminal authorities, SROs, the Public Company Accounting Oversight Board, state agencies and professional licensing boards, such as a state bar association.

CONCLUSION

Many of the policies and procedures in the SEC's Enforcement Manual will be familiar to members of the defense bar who appear regularly before the SEC Enforcement Staff. These practitioners may legitimately point to questions and concerns raised by the manual, such as whether centralizing the staff's decision-making regarding the pursuit of investigations and resource allocation will unduly slow the pace of investigations or excessively curtail the discretion of SEC Enforcement Staff outside the SEC's Washington, D.C.-based home office. If implemented effectively, such centralization should hopefully curtail inconsistent staff practices in different SEC offices and expedite the SEC's investigative process.

In addition, time will tell to what extent the staff allows greater access to its investigative record following its issuance of a Wells notice.

This would be a fair and much needed step that should only help the staff and the SEC assess the merits of a proposed staff enforcement recommendation to the extent it permits defense counsel to address more effectively the staff's evidence, inferences and liability theories in a Wells submission.

The same is true of the Enforcement Manual's directive to the staff regarding an entity's or individual's waiver of its privileges and cooperation. Questions will inevitably arise concerning whether a party's disclosure of "all relevant facts within its knowledge" may in certain circumstances embrace in the staff's view material that defense counsel deems privileged or work product protected and how such facts may otherwise be revealed to the staff short of a privilege waiver.

Such questions and concerns are to be expected any time a law enforcement agency publicly releases an enforcement manual for the first time. The SEC Staff undoubtedly had to make difficult decisions in the degree of specificity with which it addressed the policies and procedures discussed in the Enforcement Manual knowing the endless variety of factual circumstances that arise in SEC investigations. A publicly available Enforcement Manual is certainly better than enforcement procedures unknown to all but the most seasoned SEC defense counsel, and is a step in the right direction towards greater transparency, guidance and predictability in SEC investigations.

Harold K. Gordon is a partner and Tracy V. Schaffer is an associate at Jones Day, resident in the firm's New York office. Gordon previously served as a Branch Chief in the Division of Enforcement of the Securities and Exchange Commission. Jones Day associate Emily A. Posner assisted in the research and preparation of this article. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the law firm with which they are associated.

::::FOOTNOTES::::

FN1 See generally Securities and Exchange Commission, Division of Enforcement, Enforcement Manual, Oct. 6, 2008, available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

FN2 See id. at §2.3.1.

FN3 In certain circumstances, however, such as where emergency action is necessary, it may be appropriate to open an investigation without having opened a MUI first. See id. at §2.3.2.

FN4 See id.

FN5 See id. at §§2.1 and 2.6.

FN6 See id. at §3.1.1.

FN7 See id. at §2.4.

FN8 See id. at §3.3.5.3.1.

FN9 See id. at §3.3.5.4.

FN10 See id. at § 4.

FN11 Under new Rule 502(b) of the Federal Rules of Evidence, "when inadvertent disclosure is made to a federal agency, it does not operate as a waiver in a federal or state proceeding if a) the disclosure is inadvertent; b) the holder of the privilege took reasonable steps to prevent disclosure; and c) the holder promptly took reasonable steps to rectify the error." Id. at §4.2.

FN12 See id. at §2.6.

FN13 See id. at §5.