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Failure to Cooperate: Offense or Defense

The Securities and Exchange Commission (SEC) over the past few years has instituted and simultaneously announced the settlement of a number of proceedings in which companies have agreed to pay large civil fines that the SEC or its staff has publicly stated were imposed, at least in part, to penalize the companies for their failure to sufficiently cooperate with the staff while it was pursuing its investigation.

But these settlements and the SEC's public statements concerning them raise significant questions regarding the nature of the penalties being imposed and the authority of the SEC to impose them.

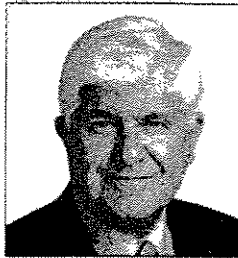
This article will focus on two points. First, there is no specific provision of the federal securities laws that identifies lack of cooperation in an investigation as a statutory violation; hence, the question: where is the SEC's authority to impose these penalties? Second, the ad hoc, subjective determination by the SEC staff that a company (and/or its counsel) have been "uncooperative" raises the question of where a line gets drawn between legitimate lawyering to defend a client in an investigation, on the one hand, and activities rising to the level of obstruction, and, moreover, who should be making that determination.

The Cases

Settled cases that have included penalties that the SEC has expressly linked to a company's alleged non-cooperation can be found as early as 2002. For example, in April 2002, the SEC filed an action against Xerox Corp. that Xerox simultaneously agreed to settle by paying a \$10 million penalty. The SEC publicly stated that the penalty was due to the alleged underlying fraudulent conduct but also was "in part, a sanction for the company's lack of full cooperation in the investigation." SEC Press Release 2002-52 (April 11, 2002).

In September 2002, the SEC filed an enforcement action against Dynegy Inc., in connection with alleged accounting improprieties. Dynegy agreed to the entry of a cease-and-desist order and to pay a \$3 million penalty, which Stephen M. Cutler, then the director of the SEC's Division of Enforcement, stated was imposed due to "the Commission's dissatisfaction with Dynegy's lack of full cooperation in the early stages of the Commission's investigation...." SEC Press Release 2002-140 (Sept. 24, 2002).

In September 2003, the SEC brought an enforcement action against AIG, which agreed to a \$10 million penalty related to its alleged involvement in an accounting fraud by Brightpoint Inc. The SEC publicly stated that the \$10 million penalty reflected both "the gravity of [AIG's] misconduct" and the fact that, "in the course of the Commission's investigation, AIG did not come clean" and "withheld documents and committed other



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abuses." SEC Press Release 2003-111 (Sept. 11, 2003).

Over the past year, the SEC has entered into similar settlements with increasing frequency, and the public statements of SEC officials have more clearly asserted that the SEC was imposing penalties for the settling companies' failures to cooperate. For example, in May 2004, the SEC filed an action against Lucent Technologies Inc. related to its allegedly fraudulent recognition of about \$1.148 billion of revenue and \$470 million in pre-tax income during Lucent's fiscal year 2000. As part of the settlement, Lucent agreed to pay a \$25 million penalty. The SEC's press release announcing the settlement expressly stated that Lucent's \$25 million penalty was "for its lack of cooperation," and it described in detail the specific ways in which the SEC perceived Lucent to have been uncooperative. SEC Press Release 2004-67 (May 17, 2004).

In June 2004, the SEC brought an action against Gemstar-TV Guide International Inc. alleging that it materially overstated its revenues by nearly \$250 million from 1999

through 2002. Gemstar agreed to settle the case by, among other things, paying a \$10 million civil penalty, and the SEC's press release announcing the settlement explicitly noted that the size of the penalty was, in part, due to Gemstar's initial failure to cooperate with the SEC. SEC Press Release 2004-86 (June 23, 2004).

The SEC also reached similar settlements—with penalties attributed at least in part to failures of cooperation—with Symbol Technologies Inc. (SEC Press Release 2004-74 (June 3, 2004)), Halliburton Co. (SEC Press Release 2004-104 (Aug. 3, 2004)), and Flowserve Corp. (SEC Press Release 2005-41 (March 24, 2005)).

A Lack of Authority

It is axiomatic that the SEC has authority to do only that which Congress has authorized it to do. See, e.g., *SEC v. Sloan*, 436 US 103 (1978) (holding that the SEC had no authority to impose successive 10-day suspensions in trading of a corporate stock). Prior to 1990, there was no statutory power conferred on the commission to seek, or for the courts to impose, civil monetary penalties for violations of the federal securities laws. But in 1990, Congress, in the Securities Enforcement Remedies and Penny Stock Reform Act, authorized civil penalties in some circumstances and specified various tiers related to the severity of the violation and impact on investors. See §20(d) of the Securities Act of 1933; §21(d)(3) of the Securities Exchange Act of 1934; and §21B of the 1934 Act.

Thus, the power to impose penalties was not given to the SEC until 56 years after its formation and, even then, only for violations of the statutes and in specifically tiered amounts. Lack of cooperation is nowhere stated to be a factor for consideration.¹

Congress did, however, arm the SEC and its staff with substantial power not only to investigate, but to "enforce" compliance with its subpoenas and cooperation in its investigations. However, Congress did not leave the judgment to the staff but required the SEC to apply to a federal court under §21(c) of the 1934 Act for an

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order compelling compliance, subject to the uncooperative company/individual being held in contempt and subject to a \$1,000 fine and/or imprisonment. There is no provision for multimillion-dollar fines.

Given the apparent absence of any statutory authority supporting the SEC's imposition of penalties for failures to cooperate, it is left to consider whether these penalties can be rationalized in some other way. Arguably, they are not penalties for lack of cooperation, but rather instances when the SEC declines to reward cooperation; a fine distinction indeed!

For some time, the SEC has had a policy of rewarding companies for affirmatively cooperating with its investigations. In 2001, it issued a "Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions," in which it set forth the criteria it would use going forward in deciding how much to credit self-policing, self-reporting, remediation and cooperation. In that statement, the SEC noted that the mitigating effect of cooperation would vary with the specific circumstances of each case. (SEC Securities Exchange Act of 1934 Release No. 44969, "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions," Oct. 23, 2001) (the "Seaboard Report").²

Thus, these settlements arguably may be regarded as not involving a penalty for non-cooperation but simply as involving situations where the SEC has declined to use its discretion to reduce otherwise applicable penalties for substantive violations of the securities laws because the defendant did not provide the type of cooperation contemplated in the Seaboard Report. This explanation is consistent with the fact that the SEC generally has only sought penalties for failures of cooperation where substantive violations of the securities laws have also been charged. The SEC has not attempted to seek penalties for failures of cooperation where the underlying investigation has not yet reached any conclusions or where the investigation found no underlying securities law violations.³

This fact suggests that, notwithstanding the bold statements in the SEC's press releases, the SEC is not fully confident that it has the authority to penalize companies for failing to cooperate with its investigations.

It is also telling that the final judgments in these actions that we have been able to review do not attribute any portion of the penalties to failures of cooperation. There is, therefore, a significant incongruity between these formal legal documents and the public statements of the SEC and its staff. For example, in the press release announcing the SEC's settlement with Xerox, the SEC noted that the \$10 million penalty against Xerox reflected "in part, a sanction for the company's lack of full cooperation in the investigation." SEC Press Release 2002-52. (April 11, 2002). But both the Final Judgment of Permanent Injunction and Other Relief and the Consent and Undertakings of Defendant Xerox Corp. state only that the \$10 million penalty is pursuant to §21(d)(3)(B)(iii) of the Exchange Act and §20(d)(1) of the Securities Act. Neither the final judgment nor the Consent refers to any lack of cooperation by Xerox with the SEC's investigation.

This disconnect is even more stark in the *Lucent Technologies Inc.* case. The SEC's press release stated that "as part of the settlement, Lucent agreed to pay a \$25 million penalty for its lack of cooperation." The release went on to discuss each of the specific actions by Lucent that the SEC considered to be uncooperative, including Lucent's provision of incomplete document productions, public statements made to Fortune magazine in violation of an agreement with the SEC, and Lucent's expansion of the scope of employees who could be indemnified against the consequence of SEC enforcement actions.

This fact says that, despite bold SEC press releases, the SEC is not confident it has the authority to penalize companies for failing to cooperate with its investigations.

SEC Press Release 2004-67 (May 11, 2004). But both the Final Judgment and the Consent of Defendant Lucent to the Entry of Judgment state that the \$25 million penalty is "pursuant to Section 21(d) of the Exchange Act." Neither the Final Judgment nor the Consent refers to any of the alleged noncooperative conduct discussed in the press release at all, nor does either document in any way indicate that the \$25 million penalty was imposed due to Lucent's failure to cooperate with the SEC's investigation.

Conclusion

Although the SEC appears not to have relied formally on any general power to sanction companies for failing to cooperate with its investigations and therefore may not have demonstrably exceeded its statutory authority, its approach has successfully imposed de facto penalties for noncooperation.

This is particularly evident from the fact that none of the complaints, the consents or the final judgments that we have seen from these actions even attempt to detail or itemize the particular number of securities law violations involved so as to justify the multimillion-dollar fines imposed under the framework mandated pursuant to §21(d)(3)(B)(iii) of the Exchange Act or §20(d)(1) of the Securities Act. Instead, the size of the penalties appears to have been dependent entirely on the SEC staff's ad hoc and subjective judgment of the defendant's conduct.

While the SEC, of course, would have less latitude in a case that was contested rather than settled, it is nevertheless troubling that these de facto penalties for noncooperation have been imposed without any articulated standards for what constitutes a failure to cooperate and without evaluation by any independent, unbiased arbiter of what the appropriate penalty should be.

Under its current approach, the SEC staff (subject to persuading the commission to agree) appears to consider itself free to determine what lack of cooperation rises to the level of obstruction of its investigations for which severe penalties may be imposed, as contrasted with the staff's dissatisfaction with vigorous defensive actions by counsel seeking to protect clients who are the focus of regulatory investigations for activities that may or may not have violated any statute.

There is a real danger that this practice by the SEC staff, apparently endorsed by the commission, will have a chilling effect on the ability of companies and individuals to properly defend themselves in regulatory investigations. While there is obviously an obligation to obey the law, as articulated by Congress, subject to penalties for its violation, it is not a crime (or a violation) to not cooperate with the government.

Indeed, the U.S. Supreme Court has just reaffirmed the propriety of withholding documents from the government under a claim of privilege or even refusing to give testimony. *Arthur Andersen LLP v. United States*, —Sct—, 2005 WL 1262915 at *4-5 (May 31, 2005). Yet, the SEC staff has repeatedly requested companies and individuals to waive these rights subject to being found “uncooperative.”

Advising companies to choose to cooperate to minimize or eliminate risk of civil prosecution is a positive thing. Turning the coin over and penalizing decisions not to take advantage of these offers, raises significant questions of due process.

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1. In contrast to the SEC, the NASD has explicit authority within its own rules to compel compliance with its investigatory requests and to impose penalties for non-compliance. See NASD Rule 8210 and §V of the NASD's Sanctions Guidelines. See also NYSE Rule 477.

2. There have been many instances where the SEC has stated that it has chosen not to seek penalties against certain companies—or that it has chosen to seek lesser penalties than could be applied—in situations where the companies have been extremely cooperative with the SEC's investigations. For example, in September 2004, the SEC announced that it would not bring any enforcement action against Electro Scientific Industries Inc. in connection with a financial-reporting fraud allegedly committed by its former executives. The SEC chose not to take any action against the company because of its “swift, extensive, and extraordinary cooperation in the Commission's investigation.” SEC Litigation Release No. 18896 (Sept. 24, 2004).

3. One recent instance where the SEC has sought penalties for a failure to cooperate where the underlying investigation was ongoing involved Banc of America Securities Inc. (BAS). On March 10, 2004, the SEC announced a settled enforcement action against BAS for alleged violations of the record keeping and access requirements of the securities laws. The alleged violations occurred during a pending SEC investigation that was seeking to determine whether, among other things, BAS engaged in improper trading of securities prior to the firm's issuance of research concerning such securities. As part of the settlement, BAS agreed to a censure and a \$10 million civil penalty. SEC Press Release 2004-29 (March 10, 2004).

This action stands out as distinct from the others we have discussed because the SEC was able to couch its charges as substantive violations of the securities laws, which the SEC could do because BAS is a broker-dealer subject to §§17(a) and 17(b) of the Exchange Act.