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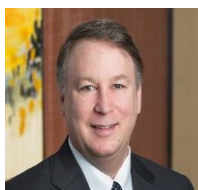
Settling SEC Enforcement Actions

A Lexis Practice Advisor® Practice Note by Daniel M. Hawke, Arnold & Porter



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Introduction

This article discusses the Securities and Exchange Commission (the SEC or Commission) settlement process, focusing on key guiding principles that counsel should have in mind when negotiating with the SEC.

Why settle? Why not fight? These are questions that any party caught up in litigation will eventually face. In the context of an impending SEC enforcement action, however, these questions can be challenging to assess.

If a party is unable to convince the SEC staff (the Staff) that no enforcement action is warranted, the decision whether to litigate or settle with the SEC is akin to a Hobson's choice – in this case, the need to choose one of two equally unpleasant alternatives. For some, the decision to settle is a pragmatic business or personal decision having less to do with the relative merits of the case than with the expense of litigation and desire to put the matter to rest. For others, the decision hinges on mitigating the potential reputational damage a contested action brings and having a voice in the outcome. Still others do not wish to be "at war with their regulator." Whatever the reason, once the decision to pursue settlement negotiations is made, the parties, after months or perhaps years of investigation, must look for ways to compromise and come to a meeting of the minds on terms that are acceptable to both sides.

Settling with the SEC can have significant benefits, including the opportunity to neither admit nor deny the Commission's allegations or findings. Likewise, litigating and going to trial with the SEC, while expensive and stressful, can result in vindication. It can also result in defeat and highly adverse reputational, financial and commercial consequences. Because every case is different, the decision to settle should be driven by a balancing of the facts, law and circumstances of a particular case coupled with a risk assessment and cost benefit analysis of what litigation with the SEC would entail. Ultimately, a party must weigh likely outcomes and decide whether the risk and expense of a contested case is outweighed by the certainty, benefits and cost savings of a negotiated resolution. Faced with the cost and uncertainty of litigation, many parties in SEC enforcement matters opt to settle.

The SEC's settlement process, however, is nuanced and complex – the distinctions between civil and administrative proceedings, the interplay between charges and remedies, and the collateral regulatory consequences of certain enforcement actions are a labyrinth of moving parts that can be perplexing for the uninitiated. But there are a few guiding principles that parties contemplating negotiations with the SEC should have in mind as they consider whether settlement in their particular case is desirable.

Understanding the Staff's Objectives

Perhaps the most important insight a party can have when considering settlement with the SEC is what the Staff's objectives are in bringing the case. As a civil law enforcement agency charged with regulating and policing the markets, the Commission uses its enforcement function to achieve a variety of objectives. While the Staff will not likely discuss its reasons for pursuing a particular case, discerning the Staff's objectives is essential to knowing where it may have flexibility in recommending reduced charges or remedies. Understanding the Commission's priorities, paying close attention to what Commissioners and Division of Enforcement leaders say in speeches and observing recent enforcement activity may provide important clues concerning why the Staff is focused on specific conduct in a case. Even subtle hints, such as the attendance of a senior officer at a routine meeting, can signal that a case is of particular interest to the Division of Enforcement.

Assessing Risk

Parties settle cases for many reasons, including, primarily, based on whether they think they will win or lose. The SEC is no different. The Commission brings roughly 500 stand-alone enforcement actions per year. With so many investigations and cases to manage, an inherent challenge the Commission faces is accurately assessing its litigation risk in any particular case.

A party considering settlement with the SEC should consider two risks that may bear upon the terms on which the SEC may be willing to settle a case. The first and primary risk is litigation risk – what is the likelihood that the SEC will prevail? The Staff goes to great lengths to determine the facts in a case, often painstakingly analyzing the tiniest details to assess whether the Commission can meet its burden of proof. Those details can reveal gaps in the evidence that may enable a party to question the Commission's ability to prove its case. Even in matters where a party has been unsuccessful in convincing the Staff not to recommend an enforcement action, the ability to accurately assess the Commission's litigation risk and instill doubt about whether the Commission can meet its burden of proof is probably the single most important factor towards negotiating a favorable settlement.

The second type of risk that a party should evaluate is programmatic risk – if the Commission loses, what adverse consequences could the case have on the Commission's regulatory and enforcement program? The possibility that a defeat can have programmatic repercussions is an increasingly important factor in many SEC cases today. Recent cases, such as the decisions in Lucia (138 S. Ct. 2044 (2018)) and Kokesh (137 S. Ct. 1635 (2017)), represent examples of cases that had significant programmatic impact on the Commission's enforcement program. While most cases are fact specific and do not create programmatic risk, the ability to identify cases that *do* present such risk can provide incentive for the Staff to consider the possibility of more favorable settlement terms.

Determining Deal Breakers

In SEC cases, the Staff will often communicate early in a negotiation the general terms it will require as conditions of settlement – injunctive relief vs. cease and desist order, disgorgement and pre-judgment interest, a rough estimate of penalty amount, the need for collateral bars if applicable, the need for an independent consultant and undertakings etc. Within each of these remedies, however, parties may not learn what the Staff's deal breakers are until late into a negotiation. So, for example, in cases involving regulated individuals, the possibility of a permanent industry bar is often a deal breaker. Because parties facing industry bars are frequently inclined to litigate if it means they potentially lose the ability to earn a living, the Staff, in appropriate cases, may be willing to offer a time-limited bar. Determining deal breakers as early in a negotiation as possible is critical to staying ahead of the game. Being able to see ahead and anticipate where the other side is likely to compromise is important to knowing where and when to stand firm on a settlement offer.

The Staff Will Not Usually Consider Settlement Until It Is Comfortable that It Knows the Facts

The Commission does not have the resources to litigate every case it seeks to bring. For this reason, the Staff is almost always willing to discuss settlement. In most cases, settlement discussions begin somewhere between the conclusion of witness testimony and the beginning of the Wells process. Often, the Staff will offer a party the opportunity to discuss settlement in lieu of receiving a Wells notice. In other cases, a party might broach an interest in discussing settlement before the Staff has completed taking testimony. Sometimes, in cases where liability is clear, it may be in a party's interest to explore settlement at the earliest possible time -- a quick settlement of a non-fraud or technical compliance violation can greatly reduce the disruption and expense of a protracted

investigation and Wells process. Generally, however, the Staff will not entertain settlement discussions until it is comfortable it knows all the material facts in a matter (which means that a certain amount of document production and testimony is necessary in any case before the Staff is likely to consider resolution).

The SEC Will Not Seek Through Settlement a Result It Could Not Obtain in a Fully Litigated Action

The SEC Staff will generally not recommend to the Commission that it accept in settlement charges or remedies that the Commission could not obtain in a fully adjudicated proceeding. This means that the SEC must have a factual and legal basis for any charges or remedies that it seeks in settlement and cannot simply agree to any claim or remedy that is not factually or legally supported by the investigative record. This is an important limiting principle because it ensures that the Staff cannot leverage the Commission's considerable power to extract settlements on terms that are not supported by the record or that the Commission would not be able to achieve if it were to litigate the matter through to conclusion.

Remedies Should be Horizontally Equitable and Proportionate to the Charges in The Case

A topic of debate among some SEC practitioners is the concept of "horizontal equities" – the idea that similar cases should settle on similar terms. Horizontal equities are rooted in principles of consistency and fairness – all else being equal, a party in one case should expect to settle to charges and remedies that are no worse (or no better) than charges and remedies in another case with similar facts. A corollary to horizontal equities is "vertical equities" – that is, remedies in any case should be proportionate to the charges in that case. This means, for example, that if the Staff is willing to recommend non-scienter based charges to settle a case, it should not then seek a penalty that is so large it implies the party acted with scienter. Consistency across cases and proportionality between charges and remedies can be difficult to achieve and can be influenced by a mix of objective and subjective factors, including relevant Commission precedent and the degree to which a party cooperated with the Staff or undertook remedial actions.

Negotiating a Compromise That the Commission Will Accept

Settlement offers are not accepted until approved by the Commission. When terms of a settlement in principle are reached, both sides have an interest in the Commission approving it. The enforcement staff becomes an advocate for the settlement to the Commission and must navigate the potentially divergent views of individual commissioners in order to get the settlement approved. In such circumstances, the Staff may find itself alternately advocating on behalf of the settling party why the terms of a settlement are sufficient while simultaneously defending the settlement against assertions that the outcome is not tough enough. This dynamic can result in the interests of the Staff and the settling party briefly aligning, if only to ensure that the Staff is armed with the arguments and support it needs to satisfy a majority of the commissioners that they should approve the Staff's settlement recommendation.

Conclusion

Whether to settle or fight with the SEC is a complex decision that can have major benefits, costs or consequences. Understanding the Staff's approaches and constraints when negotiating a settlement is essential to gaining and maintaining negotiating leverage and to anticipating where the Staff may have room to compromise. Knowing the strengths and weaknesses of your case, accurately assessing the Commission's litigation and programmatic risk and holding firm on deal breakers can make the difference in achieving a settlement that both sides will find acceptable.

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