DechertOnPoint

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A legal update from Dechert's White Collar and Securities Litigation Group

What the Government's Expanded Investigations of Market Manipulation May Mean (and What You Should Do Before and After the Subpoena Arrives)

The Securities and Exchange Commission recently announced what it characterized as a "sweeping expansion of its ongoing investigation into possible market manipulation in the securities of certain financial institutions." This announcement on September 19, 2008 followed earlier statements by the SEC, the Office of the New York Attorney General, and other investigative and regulatory bodies noting the commitment of these agencies to investigating and prosecuting what they believe was abusive short selling that may have contributed to depressed stock prices of major financial institutions.

This *DechertOnPoint* discusses the SEC's investigatory program in this area and provides constructive steps for firms to take prior to and after they receive a subpoena or other inquiry from the SEC Staff.[1] Some important issues raised by the SEC's announcement include the following:

- The Commission has issued a formal order of investigation. This almost certainly is an "omnibus formal order" that authorizes the Staff to investigate broadly issues that relate to short selling and whether particular techniques may violate the federal securities laws. The Commission previously has used omnibus formal orders to initiate investigations that sweep across numerous market participants, for example, in the market-timing investigations. The SEC's action suggests that the SEC Staff will issue subpoenas rather than request information on a "voluntarily" or "informal" basis. The Staff will seek to move quickly and likely will not be receptive to delays in production.

- The SEC will require the submission of information "under oath," likely pursuant to Section 21(a) of the Securities Exchange Act of 1934. This provision authorizes the Commission to require entities and individuals "to file . . . a statement, in writing, under oath . . . as to all the facts and circumstances concerning the matter to be investigated." The scope of these required statements remains to be seen, but likely will include a statement as to whether the person or entity submitting the report engaged in short selling activities only for legitimate investment purposes. Given the inherent uncertainty of the latter phrase, the precise wording of the statement will be important.

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1 Other *DechertOnPoints* have discussed additional SEC initiatives concerning short selling during the current market crisis. *See*, e.g., " SEC and FSA clamp down on short selling of financial firms," Financial Services/Issue 24/September 2008.

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- It will be important for persons or entities submitting reports to ensure that the statements made are accurate. The SEC Staff and other investigators no doubt will test the truthfulness of statements made, with severe consequences, including potentially criminal sanctions, if the statements turn out to be inaccurate or not truthful.

- How firms that potentially are subject to these requests for information should approach document retention and destruction protocols is a critical but complex issue, which we discuss in more detail below. Although the proper course of action is situation-specific, market participants should recognize the inherent risk associated with document retention policies in this environment. Whether document retention/destruction policies should be suspended and whether potentially responsive documents should be identified, must be carefully considered with the assistance of counsel.

How to Respond

It is essential that firms and individuals provide timely and accurate responses to SEC requests, whether pursuant to a subpoena or a request to submit a narrative statement. If there is no violation or if the Staff sees the firm or individual merely as a source of information, a prompt response may end the matter. Often, it is difficult to make this determination at the time of the initial contact, and so every response should be treated as if there is potential exposure. Where there is or may be a violation, an appropriate response (coupled with other demonstrations of "cooperation") places the firm or the individual in a position to argue for a lesser sanction. A representation of full compliance with the Commissions' subpoenas is a standard condition of any settlement.

Document Retention

At the outset, the recipient of the request or subpoena should put in place an effective "litigation hold" instruction to those employees and officers who potentially have responsive materials, directing them to preserve materials that may be responsive. This advice also may apply to firms that have not yet been contacted but anticipate such contact. "[A]nyone who anticipates being a party or is a party to a lawsuit must not destroy unique, relevant evidence that might be useful to an adversary. 'While a litigant is under no duty to keep or retain every document in its possession . . . it is under a duty to preserve what it knows, or reasonably should know, is relevant in the action, is reasonably calculated to lead to the discovery of admissible evidence, is reasonably likely to be requested during discovery and/or is the subject of a pending discovery request.'" *Zubulake v. UBS Warburg, LLC*, 220 F.R.D. 212, 217 (S.D.N.Y. 2003) (citations omitted). In *Zubulake*, "[t]he duty to preserve attached at the time that litigation was reasonably anticipated," i.e., as of internal emails recognizing the potential for a lawsuit. *Id.*

What is the scope of the duty to preserve? "Must a corporation, upon recognizing the threat of litigation, preserve every shred of paper, every e-mail or electronic document, and every backup tape? The answer is clearly, 'no.' Such a rule would cripple large corporations . . . that are almost always involved in litigation." *Zubulake*, 220 F.R.D. at 217. The precise scope of any requisite litigation hold must be determined on a case specific basis; the key players, method of data storage, and existing data retention policy must all be considered.

The process of establishing the litigation hold should include consultation with counsel and coordination with the appropriate information technology employees to ensure that information is not lost, including through routine computer maintenance procedures. Counsel may be able to negotiate with the SEC Staff concerning the scope and method of the production. In light of current economic and political considerations relating to the short selling investigations, the Staff may be less flexible in this context than in others.

The ramifications of inadvertently destroying responsive material can be devastating. In notable cases, firms that allegedly failed to halt the destruction of documents upon learning of various government inquiries have been indicted for obstruction of justice, ultimately leading to the demise of the firm. Stephen M. Cutler, a former Director of the Division of Enforcement has noted that "[T]he Commission is bringing more cases for failures to preserve or produce required documents and records . . . [so] no matter how bad the underlying conduct, you can always make things worse."

Disclosure

The recipient of a request or subpoena should immediately attempt to determine whether it is a likely target (although the SEC does not use that term) or otherwise has potential exposure. Some guidance may

be obtained from the formal order of investigation, but such orders are generally not very detailed (especially when, as here, the Commission has issued an omnibus formal order). The SEC will provide the formal order only to counsel for impacted parties and only on the condition that the order will be kept confidential. Often, firms undertake preliminary reviews of documents and interviews with relevant personnel to determine the extent of potential exposure. The firm's compliance department may perform or assist in the investigation.

A financial services firm that has received an SEC subpoena or request for information should consider whether any disclosure to its clients or other investors is advisable. Disclosure generally is not required at an early stage (especially when the investigation, as publicly disclosed by the government, involves a broad investigation of industry practices). Relevant considerations are whether the entity is a public company (or as is the case with many firms in the financial services industry, has a parent or affiliate that is a public company), whether the entity is potentially a target, whether the firm faces potentially material penalties and collateral damage, whether any prior disclosure has been made concerning the subject matter, and whether rumors or media speculation make corrective or confirmatory disclosure advisable[2]. In addition, an entity that chooses not to disclose the information should consider whether officers, directors, and other insiders with knowledge of the situation possess material non-public information and whether they should be advised not to trade in the company's securities.

Internal Investigations

In the event that the entity concludes that it or certain of its officers or both are potential targets or have potential enforcement exposure, a determination should be made whether separate counsel is advisable. Among other considerations, the interests of the entity and its officers concerning potential cooperation with the SEC may conflict.

The entity that concludes that potential violations may have occurred should consider whether to conduct a more extensive internal investigation. In some cases, the SEC will forestall its own investigation to allow an internal investigation to proceed, and this may result in cooperation credit for the entity later. The obvious downside to an internal investigation is that it provides, in effect, a "roadmap" for the SEC and, if disclosed, to potential private civil claimants and the class action bar concerning any potential violations. An important issue is who should conduct the investigation. Retention of independent counsel, reporting to the Audit Committee or other committee composed of independent directors, may be appropriate. Doing so may enhance the credibility of the investigation in subsequent discussions with the government and may increase the likelihood that a court would deem board decisions based on the findings of such an investigation to be an appropriate exercise of business judgment.

In connection with the production of materials to the SEC, the responding entity should request confidential treatment. Because such documents constitute investigatory records obtained by the Commission in connection with a potential law enforcement proceeding, they are subject to exemption from mandatory disclosure under the Freedom of Information Act. Additional protections may be available under the Privacy Act of 1974. Thus, producing parties typically demand that the materials be kept in a non-public file and that access be restricted to the Commission and the Staff, and that, under normal Commission practice, ten business days' advance notice of any disclosure be made to allow court intervention. These protections however, apply only to requests from the public for disclosure of information under FOIA. The SEC staff retains the ability to question witnesses and otherwise use the information provided, even if their doing so may tend to reveal information the firm regards as proprietary.

Production of documents often may be a precursor to testimony taken by the Staff. The producing entity, with the assistance of counsel, must carefully analyze the documents produced, any issues raised by the documents, and the potential impact of production as quickly as possible. If testimony is requested, it is appropriate for counsel to contact the Staff to determine what information will be sought and to establish a schedule that allows for adequate preparation of witnesses.

This brief introduction flags certain of the considerations that are triggered when an SEC subpoena is anticipated or received. As the forgoing

[2] Dechert attorney William K. Dodds discusses these considerations in greater detail in his article, (*When to Disclose an SEC Investigation: Legal and Strategic Considerations*) Bloomberg Corporate Law Journal, Volume 1, Issue 4 (Fall 2006).

suggests, the resulting process may take many forms and open up numerous additional issues.

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