LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@portfoliomedia.com

Benefits And Dangers Of An SEC Wells Submission

John J. Carney

Francesca M. Harker

Law360, New York (December 17, 2009) — The principle of *Primum non nocere,* or first do no harm, has been a fundamental teaching to medical students for hundreds of years.

This logical proposition, that it is sometimes better to exercise restraint in response to a known danger then to take action that might make matters worse, is valuable advice not just for doctors, but lawyers as well.

This advice is especially timely for counsel defending actions against the U.S. Securities and Exchange Commission in the current heightened enforcement environment.[1]

The SEC has recently adopted new strategies and techniques in an effort to "bring cases faster, with greater impact and, most importantly, to secure litigation victories at trial."[2]

In Securities Act Release 5310, the commission gave public notice of its discretionary practice of allowing those involved in commission investigations to submit a statement setting forth their position on the matter.[3]

This submission, commonly referred to as a "Wells submission," can be a useful opportunity for prospective defendants to sway the commission to reduce potential liability or in some cases even convince the commission to stop their investigation.

Tempted with the possibility of halting litigation before it even begins, many practitioners might not stop to consider the very real dangers a Wells submission presents.

Before submitting a Wells submission, practitioners need to be aware of the commission's position that the submission could be used against their client in a future proceeding by the commission as an admission against interest under Federal Rule of Evidence 801(d)(2); shared with the U.S. Department of Justice in a parallel criminal proceeding; expose the client to potential false statement charges; and be used by third parties in civil litigation.

With the Division of Enforcement focused on becoming leaner, faster and tougher — does this mean that the Wells process, long thought of as an avenue to prevent unnecessary enforcement actions, could become a risk not worth taking?

Baker Hostetler

The Wells Submission Process

In the absence of ongoing fraud or immediate threat to the public, at the conclusion of an investigation the Division of Enforcement will often provide the prospective defendant with a "Wells notice."

The Wells notice informs the individual that the commission is considering recommending an action against them, the potential violations they could be charged with, and the ability of the individual to respond through a Wells submission.[4]

The Wells notice will also warn the person involved in the investigation of the risk of submitting a Wells submission.

The notice often contains language informing the recipient that "any Wells submission may be used by the commission in any action or proceeding that it brings and may be discoverable by third parties in accordance with applicable law."[5]

While including such a warning is not required by the commission, at least one court has refused to admit a Wells submission in part on the grounds that the defendant had not been adequately warned of the potential for the Wells submission to be used against him in later proceedings.[6]

As a matter of practice, the commission maintains that it will reject a Wells submission that attempts to limit the commission's ability to use the submission in later proceedings.[7]

After receiving the Wells notice, the potential defendant and their counsel need to make the determination whether or not to submit a Wells. This decision will often turn on the nature of the argument to be presented to the commission.

Wells submissions are usually not the appropriate vehicle to address heated factual disputes but, rather, are best suited to address legal and policy questions the commission might not have fully considered.

The commission never intended the Wells process to resolve factual issues; "[w]here a proposed administrative proceeding is involved, the commission wishes to avoid the possible danger of apparent prejudgment involved in considering conflicting contentions, especially as to factual matters ... [c] consequently, submissions by prospective defendants or respondents will normally prove most useful in connection with questions of policy, and on occasion, questions of law."[8]

Thus, submissions that focus on litigation risks, disproportionate penalties, or novel policy questions are likely to be the most effective.

The Benefits

While meeting with members of the staff of the Division of Enforcement to discuss the facts and merits of a given case can be quite meaningful, it is the commissioners and not the staff who ultimately vote to decide whether to institute an enforcement action.

The Wells process was created in order for the commission to have an opportunity to hear the prospective defendant's arguments before making a final decision.[9]

Filing a Wells submission allows direct access to the commissioners and their senior advisers outside the Division of Enforcement, including the SEC's Office of the General Counsel.

Accordingly, the Wells submission can be a unique opportunity for defense counsel to advocate before the commission, allowing consideration of all of the possible facts, policy arguments and litigation risks before formal proceedings are initiated against their client.

At their best, Wells submissions can convince the staff not to recommend an enforcement action and persuade the commission not to authorize one, even over the staff's recommendation.

Even if a complete declination is not possible, the submission can also allow the practitioner to argue in favor of dropping certain charges or penalties sought, or may convince the staff to adopt a different posture during settlement negotiations.

Whether by narrowing the charges or successfully avoiding litigation altogether, the Wells submission offers the unique potential to communicate directly with the decision makers, something other federal and state agencies don't regularly offer.

The Dangers

Settlement Discussion vs. Admission

The commission routinely takes the position that statements made in a Wells submission can be used against the defendant in subsequent proceedings under FRE 801(d)(2).[10] The statements can be used either to impeach the defendant or as admissions against interest.

Due to the fact that the commission "routinely seeks to introduce submissions made pursuant to Rule 5(c) as evidence in commission enforcement proceedings, when the staff deems appropriate,"[11] the practitioner drafting the Wells submission must be extraordinarily careful in making any factual statements that could later be used as admissions against the prospective defendant.

To make the decision even more difficult, there is a lack of case law on the topic of the admissibility of Wells submissions, leaving defense counsel to make a decision without a definite answer.

While the commission maintains its admissibility, at least one court has held that submissions containing settlement discussions are inadmissible under Federal Rule of Evidence 801(d)(2).[12]

However, as will be discussed in greater detail below, at least one other court has held that even Wells submissions containing settlement discussions could be admissible if the settlement discussion can be excised from the rest of the submission.[13]

Criminal Proceedings

Now more than ever before, it is common practice for the commission to coordinate with the U.S. Department of Justice in its investigations and to share evidence, including Wells Submissions. [14]

Thus while intended only to be used by the SEC, Wells submissions can and have been used against defendants in collateral criminal proceedings.

Potential defendants have the right to exercise their Fifth Amendment right when testifying before the commission[15] and those who believe they might also face criminal indictment often invoke this protection.[16]

If the potential defendant is in such a situation, counsel must exercise extreme caution when deciding whether to submit a Wells, and if one is submitted, be meticulous to ensure that no statement in the Wells could be interpreted as a waiver of the client's Fifth Amendment rights.

It is important for the practitioner to be aware that while in the litigation proceeding the "Wells" process is taking place. It begins after the staff has completed its investigation but before defense counsel has had the opportunity to benefit from any discovery.

Thus, the submission is drafted at a time when defense counsel does not have access to key facts, including third party documents and sworn statements of other witnesses.

There is the very real concern that as more information comes to light, legal theories and defenses might need to change. Once the Wells is submitted, though, the practitioner becomes wedded to a single theory of the case.

Worse yet, a statement that the practitioner and defendant honestly believe to be fully accurate and true may later turn out to be mistaken. While extremely rare, a knowingly false statement from a Wells submission could then be used in subsequent proceedings not only on impeachment grounds but open the client up to the possibility of criminal false statement charges.[17]

Civil Wars

Years later, even if enforcement proceedings and criminal litigation are declined or successfully defended against, the Wells submission can still come back to haunt the subject of an investigation in third-party civil litigation.[18]

If requested, submissions can be protected under the Freedom of Information Act ("FOIA") while the commission's investigation is open.[19] However, once the investigation is closed, the Wells submissions can be obtained through FOIA requests.[20]

While several Circuits have addressed whether voluntary Wells submissions waive the attorney work product protection,[21] only one case has squarely addressed whether Wells submissions are discoverable in subsequent civil litigation.[22]

In In re Initial Public Offering Securities Litigation, plaintiffs sought discovery of defendants' Wells submission which addressed the same allegations as the current litigation.[23] Defendants objected on the grounds that the Wells submission constituted settlement materials and was therefore not admissible.

The court disagreed, holding Wells submissions as discoverable as long as they are "admissible, because they are relevant to a claim or defense" or will "reasonably lead to the discovery of admissible evidence."[24]

This ruling was based, in part, on the fact that Federal Rule of Evidence 801(d)(2) addresses admissibility of settlement discussions, not discoverability.

Thus, while settlement discussions in a Wells could not be admitted as direct proof of liability, they could theoretically be admitted on other grounds or just for impeachment.

Further, the court noted that offers of settlement are not "intrinsically part of Wells submissions" and are usually easily severable from the rest of the submission.[25]

While there is scant case law discussing admissibility of Wells submissions in third-party civil litigation, the commission's routine use of Wells under Federal Rule of Evidence 801(d)(2) and the Court's ruling make the possibility of admission too risky for any practitioner to ignore.

Minimizing the Dangers

After the Wells process is complete, if the commission, a criminal prosecutor, or other civil litigant seeks to admit the submission under Federal Rule of Evidence 801(d)(2), it is important to be aware of potential challenges to its admission.

Unless the Wells submission was specifically adopted by the potential defendant, the submission is usually treated as a statement against interest by an agent.[26]

Defense counsel should raise agency challenges to limit attribution of the statement to counsel and not to the defendant.

If the submission contains opinions regarding the proper statutory interpretation or professional standards, such as Generally Accepted Accounting Principles, then the admissibility of the Wells should be challenged as expert opinion submitted by an unqualified expert.[27]

While courts interpret the commission and the prospective defendant to be adversarial during the Wells process,[28] the submission is made voluntarily with an eye towards cooperating with the commission during its investigation and statements that were once not prejudicial can become so once litigation has commenced.

Counsel should always consider objecting to admission into evidence under Federal Rules of Evidence 403 on the grounds that the Wells submission is being taken out of context and therefore have an unjust prejudicial effect.

Finally, counsel should be aware of the potential need for limiting instructions when there are multiple Wells submissions from multiple defendants.

In many cases a limiting instruction will not be practicable and defense counsel will need to request the judge to deny admission of the Wells submission or sever the proceedings.

Conclusion

After receiving a Wells notice the practitioner should begin by considering all of the potentially negative ramifications of a Wells submission in the particular scenario.

If the risk of criminal charges is high and there is a significant amount of factual dispute, the Wells process may not ultimately serve your client's interest.

However, if after careful deliberation, the decision is made to submit a Wells, a carefully drafted submission can minimize the collateral risks.

The Wells should focus on policy issues and litigation risks that the commission will face in an enforcement proceeding. While it is common for submissions to begin with a factual summary, this section should be brief and only contain facts that are not open to dispute.

With careful drafting and an eye toward possible downstream litigation, a Wells submission can be a powerful tool for a skilled defense counsel.

However, with the promise of more staff, more aggressive tactics and a hardliner at the helm, the careful SEC defense counsel has to ponder whether a Wells submission intended to be a shield against an unfounded enforcement action could wind up being a sword used against their own client.

— By John J. Carney and Francesca M. Harker, Baker & Hostetler LLP

John Carney is a partner with Baker Hostetler in the firm's New York office and serves as co-leader of the firm's national white collar defense and corporate investigations group. He is a former Securities Fraud Chief, Assistant United States Attorney, U.S. Securities and Exchange Commission Senior Counsel. Francesca Harker is an associate with the firm in the New York office.

The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] Robert Khuzami, Speech by SEC Staff: Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement, (Aug. 5 2009) ("[c]omparing the period from late January to the present to roughly the same period in 2008, the Division has opened 10 percent more investigations ... has been granted 118 percent more formal orders ... has filed 147 percent more TROs ... and has filed nearly 30 percent more actions."

[2] John J. Carney and Jonathan R. Barr, SEC's New Enforcement Program: Rewriting the Rules of Engagement, 242 N.Y. L. Jrnl. 54 (Sept. 16, 2009).

[3] See Commencement of Enforcement Proceedings and Termination of Staff Investigations, SEC Securities Act Release No. 5310 Fed. Sec. L. Rep. (CCH) ¶ 79,010 (Sep. 27, 1972), codified at 17 C.F.R. § 202.5(c).

[4] See Securities and Exchange Commission Division of Enforcement, Enforcement Manual at 2.4 (pg 23), (Oct. 6, 2008).

[5] Id.

[6] In re Allied Stores Corp., Admin. Proc. Rulings Release No. APR-293 (Mar. 21 1988), SEC Docket (CCH) 451, 451-52 (Oct. 1, 1992).

[7] See Enforcement Manual at 2.4 (pg 25), (Oct. 6, 2008).

[8] See SEC Release No. 5310.

[9] Id.

[10] Marc I. Steinberg and Ralph C. Ferrara, 25 Securities Prac. Fed & State Enforcement § 3:59 (2006). Fed. R. Evid. 801(d)(2) delineates conditions under which a statements is not hearsay, including, in relevant part, when a statement is offered against a party and is "(A) the party's own statement, in either an individual or representative capacity or (B) a statement of which the party has manifested an adoption or belief in its truth, or (C) a statement by a person authorized by the party to make a statement concerning the subject, or (D) a statement by the party's agent or servant concerning a matter within the scope of the agency or employment, made during the existence of the relationship ..."

[11] SEC Form 1662.

[12] In re Allied Stores Corp., SEC Docket (CCH) 451, 451–52.

[13] In re Initial Public Offering Securities Litigation, 2004 WL 60290, 64 Fed. R. Evid. Serv. 420 (S.D.N.Y. Jan. 2004).

[14] SEC Form 1662.

[15] Id.

[16] Thierry O. Desmet, The Pitfalls of Wells Submissions: A Summary After In Re Initial Public Offering Securities Litigation, 33 No.1 Sec. Reg. L. Jrnl. 1, 5 (Spring 2005).

[17] 18 U.S.C. Sec. § 1001. See U.S. v. Grenier, 513 F.3d 632 (6th Cir. 2008) (defendant prosecuted under 18 U.S.C. § 1001 for false statements made in a Wells submission).

[18] In re Initial Public Offering Securities Litigation, 2004 WL 60290.

[19] See 5 U.S.C.A. § 552(b)(7)(A).

[20] See 5 U.S.C.A. § 552; 17 C.F.R. § 200.83; In the Matter of FOIA Request of First National City Bank, SEC FOIA Release No. 36, 8 SEC Docket 322 (Nov. 4, 1975).

[21] See In re Steinhardt Partners, L.P., 9 F.3d 230 (2d Cir. 1993); see also Westinghouse Elec. Corp. v. Republic of the Philippines, 951 F.2d 1414 (3d Cir. 1991); In re Subpoena Duces Tecum, 738 F.2d 1367 (D.C. Cir. 1984); Diversified Indus. Inc. v. Meredith, 572 F.2d 596, 606 (8th Cir. 1977) (en banc).

[22] In re Initial Public Offering Securities Litigation, 2004 WL 60290.

[23] Id. at *2.

[24] Id. at *4.

[25] Id. at *3.

[26] Fed. R. Evid. 801(d)(2)(c–d).

[27] Fed. R. Evid. 702 ("Testimony by Experts: If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise ..."

[28] In re Initial Public Offering Securities Litigation, 2004 WL 60290.