Securities and Exchange Commission Investigations: The Need for Reform

Lewis D. Lowenfels
SECURITIES AND EXCHANGE COMMISSION INVESTIGATIONS: THE NEED FOR REFORM

LEWIS D. LOWENFELS

Under sections which are virtually identical in all the securities acts, the Securities and Exchange Commission is empowered to conduct investigations. The powers granted are quite sweeping. A typical section of the statutes reads as follows:

(a) The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of this title or any rule or regulation thereunder, and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated. The Commission is authorized, in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of the provisions of this title, in the prescribing of rules and regulations thereunder, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this title relates.

(b) For the purpose of any such investigation, or any other proceeding under this title, any member of the Commission or any officer designated by it is empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in the United States or any State at any designated place of hearing.

* Member, New York Bar. A.B., Harvard University, 1957; LL.B., Harvard University, 1961. The author wishes to thank Fern Lowenfels, Seymour B. Goldfeld, Esq., David L. Marks, Esq., Leslie Susser, Esq., and Roger Alan Tolins, Esq. for their helpful suggestions with respect to this article.


As will be seen, the very initiation of an investigation by the Commission under the securities acts is a substantial sanction upon the investigatee. The ordeal of an investigation often leaves the investigatee seriously drained, financially as well as emotionally, with a reputation severely tarnished. Yet the entire set of Rules of the Securities and Exchange Commission Relating to Investigations covers less than two 8 inch by 10½ inch pages and barely mentions any rights granted to the investigatee. Moreover, the Federal Administrative Procedure Act contains virtually nothing which protects the private party at the investigatory level.

It is the thesis of this article that the substantial investigative powers granted to the Commission are subject to abuse; that there is too little protection for the investigatee at the investigatory level. The following sections will attempt to delineate some of the more serious problems which exist under present SEC investigatory practices and also suggest possible changes in Commission procedures which would mitigate some of the more serious abuses.

**The Initiation Of The Investigation**

There are no standards with respect to the initiation of investigations, no uniformity with regard to who is investigated and who is not investigated. When one realizes that the investigation is itself a serious sanction, this lack of uniform standards exposes the entire process to serious abuse. A staff member in one of the Commission's investigative branches has advised the author that one of the fifteen branches in the SEC's Division of Corporation Finance is responsible for initiating approximately one-third of the 1933 Act investigations. Obviously, if a registration statement is assigned to this particular branch for processing, its chances of being subjected to the investigatory process are substantially enhanced. And an SEC investigation, with the endless delay and insidious generating of rumors, can literally drive a young fledgling company to bankruptcy.

When a staff member of the SEC determines that an investigation should be initiated, a report is written, occasionally but not uniformly, reviewed by a senior staff member, and then presented to the Commission itself. The Commission may reject the report, request more information before making a decision, or issue an order initiating the

---

5 There is a separation of functions at the Securities and Exchange Commission between the staff, which conducts the day to day work of the agency, and the Commission itself which functions more in a quasi-judicial and policy-making fashion.
investigation. This process, while not objectionable in theory, has in practice become largely a rubber stamp. If a staff member feels strongly enough to recommend an investigation, the Commission is inclined to concur. As a rule, the staff member who recommended the investigation is then given the power to try to prove his case. He becomes in effect a prosecuting attorney with great powers to examine the investigatee's files, issue subpoenas and depose witnesses. And he has the full power of the United States Government behind him. The investigatee may have done nothing wrong, not a single violation of the securities acts may exist, but the hunch of a staff member and the rubber stamp approval of a hierarchy largely ignorant at this early stage of any relevant facts, is sufficient to initiate the investigation.

The order of the Commission commencing the investigation compounds the burden upon the investigatee. This order is invariably sweeping in nature, granting the staff carte blanche with respect to the investigatee's affairs. This means that if the original hunch of a violation is not easily substantiated the investigator can fish around almost interminably until something is found which will justify the entire exercise.

THE CONDUCT OF THE INVESTIGATION

Once an investigation has been ordered, one of the first steps is usually the serving of subpoenas by the staff. This insures that the investigation, which is supposed to be conducted privately, immediately becomes public knowledge. The rumor mill then begins to grind. Soon virtually everybody who is important to a company or its principals — its creditors, its bankers, its suppliers, its customers, its stockholders — is aware that an SEC investigation is pending. If the press inquires of the Commission or the staff as to what is happening, invariably a "no comment" is forthcoming. This response merely lends fuel to the fire.

Concomitant with the service of subpoenas on third parties is the assembling of the voluminous documents required by the staff from the investigatee itself. Sophisticated legal counsel must be retained to examine these documents before they are handed over to the Government. Often other experts, such as accountants or engineers, must be consulted in connection with the assembling of these materials.

---

6 A staff member in one of the SEC's investigative branches recently stated to the author that he could recall only one instance where the Commission refused to approve a staff member's recommendation for an investigation.

diversion of the principal executives from their daily responsibilities, the substantial professional fees required to be paid, the costs involved in assembling and reproducing documents are a serious and costly burden upon all but the largest and most solvent of companies. Moreover, the subpoenas, like the order of investigation, are sweeping and often encompass almost all of the investigatee's files. Thus the furnishing of documents by the investigatee for examination by the staff can be an endless task.

After examining documents supplied by the investigatee and by third parties, and perhaps after a visit to the offices of the company for a further perusal of files, the investigator will move on to the deposition stage. Meanwhile, the delay is becoming intolerable to the investigatee. If the investigation is bottomed on the Securities Act of 1933 and concerns disclosure under a pending registration statement, the entire financing is held in abeyance pending the conclusion of the investigation. Thus a small company finds itself under increasing pressure to look elsewhere for funds. However, since any proposed source of financing must be told of the pending investigation, alternative sources tend to evaporate. If the investigation is bottomed on the Securities Exchange Act of 1934 and concerns an investment banker, companies tend to look elsewhere for funds and customers seek other financial advisors. The financial community is inclined to avoid a broker-dealer subject to an existing SEC investigation. Meetings with the staff are held in an attempt to expedite matters. These meetings, however, must be held with the staff people conducting the investigation who are actually in an adversary position vis-à-vis the investigatee. Thus, while they may be sympathetic to the investigatee's plight, they are primarily concerned with developing their own case and justifying the raison d'être of their investigation.

Once in the deposition stage the costs and burdens on the investigatee continue to mount. Lawyers are required to represent the investigatee and its principals at these depositions. Outside parties are deposed, reinforcing the adverse publicity and ugly rumors swirling about the company. More often than not the investigatee has other problems — this is what may have attracted the SEC investigation in the first place — and these problems become aggravated by the continuing SEC probe. The psychological burden on the principals involved becomes

unbearable. Entities only tangentially related to the primary investigatee are affected. Indeed, it is not uncommon for other companies in registration having some relation to the primary investigatee to be delayed pending the outcome of the latter's probe.

As the depositions drag on, more documents and more information are requested by the staff. The investigatee continues to cooperate, hoping for some resolution to what seems an interminable bureaucratic morass. Ultimately, upon completion of the depositions, the staff will attempt to analyze the evidence and devise an appropriate remedy or sanction. At this stage, however, the staff becomes singularly non-communicative. The investigatee is left in complete ignorance as regards its fate. And this stage of the proceedings alone may take many additional months. Testimony and documents are reviewed by senior staff members, conferences are held among different members of the staff, summaries of the case are prepared and recommendations made for Commission action. Then, after months of non-communication between investigator and investigatee, the latter may suddenly find that an administrative action has been initiated against it, that a civil complaint has been filed in the appropriate federal court or that the entire matter has been referred to the Department of Justice for possible criminal action. Often the investigatee has no prior warning of such action and no opportunity to refute the staff's position before irreparable harm to business and reputation occurs.¹¹

CRITIQUE

Perhaps the most serious failing of SEC investigations is the lack of stated procedures or guidelines for the staff and the Commission to follow in conducting investigations. Once an administrative hearing is commenced, an elaborate panoply of rules, many of which are specifically designed to protect the private person's rights, become applicable.¹² If the defendant after an administrative hearing determines to seek judicial review, another set of rules and procedures exist.¹³ If a civil complaint is filed by the Commission, or if criminal proceedings are initiated, here again the private party's rights are carefully protected. The investigatory stage, however, is much more free-wheeling. The rights of the investigatee are not protected by written rules and

¹¹ For a very interesting article discussing this problem see Freeman, Administrative Procedures, Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 891 (1967).
regulations as much as by the good judgment, discretion, innate decency and fairness of the staff members conducting the investigation. Thus the rights of the investigatee may vary substantially depending upon who the particular investigators are. Moreover, by virtue of circumstances the investigator becomes more and more of an adversary trying to ferret out the information necessary to prove his case. It is a difficult, if not impossible, task to be concomitantly concerned with all the protections which the investigatee's position demands.

It is submitted that many of the problems described above could be eliminated if each investigation were assigned to a specific independent supervisor for his oversight. A small group of such independent supervisors could be created from the Commission's existing staff. The Commission is careful to separate the role of the advocate and the role of the judge at the administrative hearing level — why not bring some of these protections down to the investigatory level? Each Commission order initiating an investigation could assign the supervision of the investigation to an independent supervisor having no prior acquaintance with the facts or the parties involved. The next step might be a conference between the investigators and the investigatee with the independent supervisor presiding. Here such problems as submission of voluminous documents, service of subpoenas on sensitive third parties, specific information required by the investigators, could be resolved. And both investigator and investigatee would be subject to the preliminary rulings of an independent supervisor functioning as a judge at a conference in chambers.

As the investigation continues, the supervisor would be responsible for preventing inordinate delays or dilatory tactics by either side. If the staff's original suspicions with respect to violations are clearly refuted by the evidence at an early stage, the supervisor would be empowered to recommend to the Commission that the investigation be terminated. This would free the busy staff for other duties, would save the taxpayers' money, and might spell the difference between survival and bankruptcy for the investigatee. Moreover, the supervisor could be empowered to sever the affairs of tangentially related third parties from the primary investigation thereby possibly freeing other registration statements for ordinary processing and clearance. At the deposition stage the supervisor would be available to rule on questions of privilege, admission of questionable documents and relevancy of examination.

After the depositions are completed, the supervisor would move quickly to have the staff assemble all the evidence and render a report
together with a recommendation as to what action should be taken. The investigatee should then be called in, given a copy of the staff's report and recommendation, and an opportunity to present its side of the case together with a proposed remedy. This would not only eliminate the nerve-wracking secrecy and silence which often follows the termination of the deposition stage, but would give investigator and investigatee under the aegis of an independent supervisor an opportunity to devise a more appropriate and imaginative remedy or sanction than might otherwise be possible.\(^\text{14}\)

As regards the pre-investigatory stage, the Commission should issue some sort of informal guidelines to the staff with respect to recommending the initiation of investigations which would make the entire process more even-handed and predictable. The Commission should then proceed to implement these guidelines with a more careful examination of each recommendation submitted by the staff. The investigation itself is too burdensome and costly to both investigator and investigatee to warrant only rubber stamp treatment by the Commission at the stage of initiation. Finally, the order of investigation should be sufficiently broad to allow appropriate inquiries, but sufficiently narrow to prevent a limited investigation from turning into an inquisitorial fishing expedition.

The use of independent supervisors who would develop experience and expertise in the investigatory area to oversee investigations would have a number of additional salutary effects. One immediate result would be the centralization of interim decision-making with respect to each particular investigation. The investigatee would no longer find itself shifted from official to official, from branch to branch, in an attempt to get a progress report or an interim ruling. The "buck" with respect to a particular investigation would stop at a particular supervisor's desk. The use of an independent supervisor would also tend to eliminate a certain amount of the influence peddling and exploitation of personal relationships between outside counsel and staff members which inevitably becomes the bane of any government bureaucracy. When the deposition stage of an investigation has been completed and the veil of secrecy descends, enormous pressure builds up from clients to find out just what is happening. When the staff members directly concerned with a particular investigation become completely non-communicative, other sources of information are sought. A client's Congressman or Senator may be prevailed upon to seek a progress report,

\(^{14}\) See Freeman, supra note 11.
or counsel may attempt to contact an old friend on the staff having nothing whatever to do with the investigation in an effort to glean information. These are not the kinds of practices which the Commission's procedures should encourage. If the investigatee has a legitimate need for an interim progress report, a conference between investigator and investigatee in the presence of the independent supervisor would be a much healthier way of dealing with the problem. Finally, focusing responsibility for the conduct of an investigation would help to ensure that the investigatee does not get caught between the competing jealousies of different branches of the bureaucracy. Often one staff member will tend to focus on one area of inquiry and inform the investigatee that material dealing with other areas of the business may be safely ignored. A short time later another staff member from a different branch of the Commission, also empowered to implement the Commission's investigative mandate, may countermand the previous instructions and request the submission of reams of additional materials previously excluded. The effects upon the investigatee are additional burdens and expenses, as well as disillusionment with the justice and propriety of the entire exercise. And one must never forget that in the case of a public company it is the public stockholders' equity that is bearing the costs of the Commission's investigation.

In conclusion, it is submitted that the changes in Commission procedures suggested in this article could be easily implemented. The Commission already has a sufficient staff from which a small group of independent supervisors to oversee investigations could be chosen. The creation of such a group would help bring the judicial fact-finding approach, which hopefully exists at the administrative hearing level, down to the investigatory level. Also, informal guidelines dealing with initiation of investigations, more searching Commission review of staff recommendations, and more carefully worded orders of investigation should not be difficult to implement. And the results might go a long way toward giving the investigatee the due process of law that its position demands.