SECURITIES LAW360

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Going To Trial Against The SEC

Monday, July 30, 2007 —The Enforcement Division of the U.S. Securities and Exchange Commission investigates hundreds of cases every year, involving allegations ranging from insider trading, false statements in financial reports or company press releases, to fraudulent investment schemes.

Some of these allegations prove meritless and the investigation is closed without any enforcement action being initiated. Most cases are settled by consent decrees whereby the company or individual neither admits nor denies the SEC's allegations but accepts some penalty, such as an injunction against future securities violations, a financial penalty, and/or a bar from serving as an officer or director of a publicly traded company or from working in the brokerage business.

As a result of these settlements, only a relatively small number of cases actually go to trial each year. This is not surprising because a loss at trial may lead to a much heavier penalty than is available through a negotiated settlement.

For example, in an insider trading case, the SEC may offer a pretrial settlement of disgorgement of profit plus a penalty of the same amount. However, if the case goes to trial, the penalty after an SEC courtroom victory may be up to three times the disgorgement amount.

Despite the possible consequences, every year there are a relatively small number of companies and individuals who refuse to buckle under this pressure and instead assert their right to trial in federal court enforcement actions brought by the SEC.

Based on a review of reported cases since 2005, that number is approximately 10–15 cases per year. Not surprisingly, the SEC loses infrequently at trial, as it tends to try only those cases in which its position is strongest.

While this strong trial position often stems from the actual evidence in the case, sometimes it has more to do with intangibles, such as a sympathetic victim who can have a powerful influence over a verdict. Although the SEC does have a substantial track record in the courtroom, it does not "bat a thousand" at trial.

Recent Trial Results

Individual defendants fared better than their corporate counterparts in recent SEC federal trials. In fact, since 2005, only one corporate defendant won at trial, but that victory was short-lived, as the SEC won on appeal. SEC v. Merchant Capital LLC. In that case the appellate court determined that the trial court erred in finding that partnership interests were not "investment contracts" within the meaning of federal securities law.

However, during 2004, the SEC lost two insider trading jury trials against individuals. (In one, SEC v. Borders, the author, Terence J. Lynam, represented the defendant). The SEC lost another insider trading trial in a bench trial in 2005. SEC v. Butler. In another bench trial that year, SEC v. Gane, the company president successfully convinced the court that he did not act recklessly regarding projections concerning the company's products and services.

In another 2005 case, the SEC charged two corporate officers with overstating company earnings and making material misrepresentations in quarterly reports. Following a bench trial in that case, SEC v. Guenthner, the court found in favor of the defendants, stating that "there has been a complete and utter failure of proof by the Commission."

Finally, the defendant in SEC v. Cohen achieved a substantial, but not complete, victory following a 2007 bench trial. The defendant, a CFO of a publicly traded company, was charged with seven counts of various securities law violations relating to the alleged acceleration of revenue to meet earnings goals, which the SEC claimed resulted in material misrepresentations in earnings reports.

The court ruled in favor of the defendant on six of the seven counts, particularly noting failures of proof on materiality and scienter (that is, the intent to deceive, manipulate or defraud). The defendant was found liable on one claim that did not require proof of scienter and was penalized $5,000, but the court refused the SEC's request for a permanent injunction.

In contrast to these defense verdicts, the reported cases indicate that the SEC has achieved an impressive record of 19 victories at trial since the beginning of 2005. By far, the greatest number of these cases (10) involved false earnings reports or similar false and misleading statements.

In addition, the SEC had three trial victories in cases involving fraudulent kickbacks in connection with stock or bond trades. The other six cases concerned the following: insider trading; a fraudulent "pump and dump" stock scheme; fraudulent sale of investment notes that misled investors as to the nature of the investment; fraudulent transfer of funds subject to a freeze order; undisclosed mutual fund market timing; and violation of investment advisor bar.

What to Expect at Trial

In many ways, trying a case against the SEC is no different than trying a case against any other opponent — as long as that opponent is well-prepared and well-financed enough to have left no stone unturned in pretrial discovery and investigation.

The SEC's investigations tend to be lengthy and thorough. Some have criticized the Enforcement Division's long-established structure whereby trials are handled by attorneys from the trial unit, which is separate from the attorneys who conduct the investigations.

Nevertheless, the two different units coordinate before trial, resulting in a stellar trial team. The SEC is guaranteed to leverage all of its resources to the fullest in an effort to win.

Based on the author's experience in successfully trying an insider trading case against the SEC, here are some things to expect at trial:

1. Industry cooperation. Expect the SEC to get the utmost cooperation from the industry. The SEC has easier access to records for trial from a brokerage firm, investment banking firm or any regulated or self-regulated entity such as one of the stock exchanges.

A defendant, on the other hand, may have to work a lot harder to get what he or she needs. Indeed, employees of these entities may not even be willing to talk to defense counsel or answer the simplest questions once they learn it relates to a trial against the SEC.

If the SEC needs witnesses from these entities to testify at trial, it will easily get them, too. Here again, the defendant is at a disadvantage because witnesses who have not been previously deposed are not as willing to talk to defense counsel before they take the stand.

2. Cooperating witnesses. Like cooperating witnesses in criminal cases, the SEC elicits individuals it previously reached settlements with as cooperating witnesses. Of course, the major difference is that a civil case provides the opportunity to depose these witnesses in advance of trial.

If there is a parallel criminal investigation, the SEC will, if requested by the Justice Department, seek a stay of discovery from witnesses who are also cooperating in the criminal investigation, until all the criminal matters are concluded. Just like in a criminal case, defense cross-examination of these witnesses at trial should highlight that they got a "deal" and avoided a greater penalty.

3. Computer support, time lines and charts. The SEC has a contract with a litigation support company that will equip the courtroom with computer screens in order to present documentary evidence in electronic form.

The SEC will also prepare demonstrative exhibits, such as time lines and charts, for use during the trial. Jurors will expect such presentations, and defendants should have an equally compelling and easy-to-follow presentation.

4. Trial brief. The SEC will submit a brief to the trial judge in an attempt to educate the judge about both the facts and the securities law issues that it anticipates will come up at trial. The legal discussion will draw upon a litany of cases that the SEC has previously tried and won.

An effective trial brief from the defendant will be important, not only regarding the contested facts but also on any relevant areas of securities law that may not be as settled as the SEC would suggest.

5. Investigation of defense witnesses. When the defense files its witness list, do not be surprised if the SEC claims that all the witnesses should have been disclosed earlier in response to interrogatories.

The SEC may then seek to investigate these witnesses, by subpoenaing records from them and from third parties regarding, for example, the witnesses' own individual stock trades. Defendants may need to move to quash these subpoenas on the ground that the discovery period has ended, or that the SEC is using trial subpoenas to engage in an impermissible "fishing expedition."

6. Motions in limine. Motions in limine are common in every trial. The SEC may utilize such motions to limit evidence that it believes the defendant intends to offer. For example, in an insider trading case it will argue that testimony from character witnesses is not admissible because the defendant's character is not at issue.

Even though insider trading is actually charged as a fraudulent or deceitful practice under Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934, presumably making character an issue, there is authority to the contrary. A defendant wishing to present character evidence will have to develop an argument that such evidence is actually fair rebuttal to a specific point that the SEC is putting at issue (e.g., the defendant's standard of care).

7. Insider Trading inference. One area that spawned debate in insider trading cases stems from defense arguments that, even though the defendant knew of inside information (i.e., "material nonpublic information"), he nevertheless did not use that information when trading in the security in question.

The SEC objects strongly that this is a defense, and instead has long argued that it need only prove that the defendant traded while in possession of inside information and that it should not have to prove that the defendant was actually using that information when deciding to make the trades.

To ease its burden in this area, the SEC adopted Rule 10b5-1, effective October 23, 2000, which provides that a purchase or sale of a security is considered "on the basis of" material nonpublic information if the person making the purchase or sale was "aware" of material nonpublic information when the transaction occurred; proof of "actual use" of the information is not required.

However, even with the benefit of Rule 10b5-1, the SEC may argue for jury instructions stating that if the jury finds the defendant possessed or is "aware of" nonpublic information, then it is entitled to "a strong inference" that the defendant "used" the information in deciding to trade, subject to the defendant rebutting this "strong inference" with affirmative evidence.

Even though some courts have adopted this "strong inference" standard, defense counsel should be prepared to argue that the SEC should be limited to an instruction that tracks the language of Rule 10b5-1 and goes no further.

Conclusion

Every trial is different, but trying a case against the SEC will present characteristically unique challenges, with a lot at stake for a defendant. Although the SEC wins the majority of the relatively small number of cases it takes to trial each year, it does not win them all. If you proceed to trial, you can expect to encounter some of the scenarios described above.

Some cases are more difficult to win at trial than others. For example, SEC charges of false statements about corporate revenue and earnings are particularly difficult to defend against in today's post-Enron environment. On the other hand, cases such as insider trading charges against individuals have been successfully defeated at trial.

Ultimately, your trial success will depend on how well you meet the particular challenges presented by the case while presenting a compelling theme that convinces the judge or jury to see the matters at issue from your client's perspective. If that can be accomplished, and as the defense verdicts discussed above demonstrate, there are opportunities for success at trial against the SEC.

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Terence J. Lynam brings extensive federal public sector experience to his areas of concentration: white collar criminal and civil litigation. Mr. Lynam represents various corporations and individuals in a broad range of white collar criminal and civil litigation, including federal court jury trials and grand jury investigations. He has represented senior public officials in congressional investigations and criminal investigations and trials, and government contractors in numerous criminal and civil matters. He has represented clients in enforcement matters and trials brought by the Securities and Exchange Commission. Mr. Lynam has also represented clients in matters involving antitrust, bank fraud, criminal environmental violations, export control violations, health care fraud, RICO and the Foreign Corrupt Practices Act, as well as general business litigation.