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"Equalizing" the Negotiation Process with a Trial-Ready SEC

By Thad A. Davis and Nicola M. Paterson – June 29, 2015

The SEC's current "broken windows" approach to securities enforcement has brought on increasingly aggressive resolution tactics. At first blush, trial or settle at the SEC's forced rates may appear to be the only options. But there are other options—ones worth considering if the SEC's settlement offer is extreme enough to push a client past the point of being trial-averse.

> I believe the SEC should strive to be that kind of cop—to be the agency that covers the entire neighborhood and pursues every level of violation. An agency that also makes you feel like we are everywhere.

—SEC Chair Mary Jo White, Remarks at the Securities Enforcement Forum (Oct. 9, 2013)

Over the past few years, the United States Securities and Exchange Commission (SEC) has upped the enforcement ante on multiple fronts. Prosecution tactics have become more aggressive with the SEC increasingly adopting a Department of Justice–style approach, a trial-ready posture, and forcing trial through bet-the-house settlement demands. These demands can include crushing penalty and disgorgement amounts—even for non-fraud violations—and industry bans that are trending upward in duration, at least as a minimum "ask" to resolve matters.

By the numbers, in 2014 the SEC filed a record 755 enforcement actions and went after defendants both large and small for violations both limited and broad. Investigations were on the uptick, with 955 opened in 2014, increasing from 908 in 2013. And there is no sign of let up, with the commission increasing its staffing levels to enhance its efforts. At the center of this investigatory hubbub is the controversial enforcement strategy known as "broken windows." The theory goes that allowing successful law breaking—even minor infractions—to go unpunished causes a breakdown in respect for laws. SEC Chair Mary Jo White announced the SEC's adoption of this strategy in late 2013, and the SEC has made the most of its new remit, conducting a series of industry sweeps to root out scores of low-level, even non-fraud, securities law violators. These sweeps have caught multiple defendants up in the SEC's civil action nets and have been a notable source of settlement figures and press releases. Increasingly aggressive resolution tactics accompany the SEC's new investigatory approaches. Targeting non-scienter violations and making use of oftentimes high-penalty payment demands, the SEC's approach might be described as take-no-prisoners as well as broken windows.

Consider the following scenario: Your client is charged with securities law violations in parallel criminal and civil actions. The criminal case settles with an admission to a low-level "broken window" internal controls violation. Seeking the civil-penalty equivalent to wrap up the case, you offer a similar settlement to the SEC. The SEC responds to this settlement offer with its best-case-scenario penalty, pointing to the fact that in a civil action, it enjoys broader discovery and more lenient proof burdens. Your client wants to fight, and will go to trial if necessary, but would rather preserve resources, yet sees nothing to gain by settling if settlement will bring no better resolution than

rolling the trial dice. The SEC, by contrast, has a comparatively unlimited trial budget and related resources once it pulls the trigger on filing an action. In this environment, what is defense counsel to do? At first blush, trial or settle at the SEC's forced rates may appear to be the only options. But there are other options—ones worth considering if the SEC's settlement offer is extreme enough to push a client past the point of being trial-averse.

Judicial Mediation

Injecting a third-party neutral into settlement discussions with the SEC can bring multifold benefits. If settlement communications have reached an impasse with a widely disparate zone of potential agreement that is forcing trial or further costly discovery, it may be time to consider asking for court assistance. At the federal district court level, this assistance comes in the form of an appointed judicial mediator or settlement judge, often a magistrate. Many courts—the Southern District of New York included—allow parties to request the appointment of a judicial mediator at any time during the proceedings. And courts prefer out-of-court resolution. After all, the fact that the SEC has a broken windows policy does not mean that extra resources have been allocated to the courts to deal with the extra litigation the policy has caused.

Judicial mediators have their own settlement rules and procedures. These usually require the parties to exchange position papers and demand letters prior to the mediation. Getting an insider view into this process and judicial settlement practices and preferences can prove incredibly useful. The SEC does accept settlement proposals emerging from such conferences. But even if the conference does not result in settlement, the off-record procedure can have very valuable information exchange, case focusing, and educational benefits.

The SEC has to pay attention. The appointment of a judicial mediator has equalizer benefits. Instead of being forced to play by the SEC's trial-prep timeline, the parties have to abide by the judicial arbitrator's playbook or face going to the district court judge to explain why they are refusing to do so. A defendant cannot force the SEC to put a settlement demand in writing or even issue a settlement offer at all, but the SEC is far more likely to do so in the face of a judicial requirement. Similarly, a mediation conference is more likely to be attended by SEC superiors. Getting the attention of upper management and providing a preview of potential weaknesses in the trial counsel's arguments and settlement demands to SEC superiors can prove valuable.

Disclosures: an opportunity rather than a forced card show. There are many benefits to be gleaned from mediation disclosure requirements. Typically, these involve the exchange of settlement demands, followed by an exchange of case positions. If the SEC has avoided putting demands into writing until this point, this is an effective method of getting a demand on paper. This may be the first time since the filing of the complaint that the SEC has been forced to put its case posture in writing. Even if the settlement conference ultimately does not result in a settlement, having this summary of the commission's main arguments—especially after key events such as settlement or conviction in a parallel case—is undeniably helpful for strategy development, litigation focus, and discovery purposes.

Drawing attention to weaknesses in the SEC's penalty demand. The case settlement letter presents multiple advocacy opportunities. Tackling an extreme or aggressive settlement demand can be a good place to start. Look for settlement and sentencing comparisons and make the most of them. If you have a settlement or conviction in a parallel criminal case that is much lower than the SEC's demand, then underscore the disparities. If another enforcement agency accepted a much lower penalty settlement—even related to a conviction—then make sure the judicial mediator understands the multiplier effect of the figure demanded by the SEC. Reinforce any disparity arguments with case law rejecting punitive sentences. In an unparallel case, point to equivalent civil settlements recently agreed to by the SEC and sentencing on similar facts. Aside from educating the SEC and the judge on the probability of settlement demands turning into sentencing, attacking the SEC from this perspective has the added benefit of not requiring the revelation of fact-based arguments. This is especially important if the SEC has shown little interest in fact-based explanations and there are case strategy reasons to avoid displaying a fact-response road map.

Private plaintiffs in recent years have added to litigation burdens by piggybacking on enforcement investigations and prosecutions. But in the settlement arena, failed or fumbling private plaintiff allegations can add to the settlement toolbox. Look for related cases: If your client was charged by the SEC and Department of Justice but left out of privately brought cases, make that point clear. If derivative suits and investor related actions have been dismissed or limited, then look for scienter and related arguments to reinforce for the settlement judge that the SEC is likely to face similar issues in dispositive motion practice and trial. The key here is to divorce the SEC from the notion that its civil action proof burden benefits are a win guarantee. And if the SEC will not listen to defense counsel, it may pay attention to that argument if delivered by a judicial mediator.

Playing appropriate offense during the settlement conference. Judicial arbitrators will have individual conference procedural preferences, but typically the judge will hear a position statement from both sides, followed by private discussions with each party, with an opportunity for both sides to then discuss their settlement postures. Make things easy for the judge by giving him or her a clear understanding of where settlement *should* be, the costs of proceeding further in litigation, and the key issues that need to be resolved. The conference argument also provides defense counsel with a dry run for seeing how positions and facts resonate with a judicial audience. Even if the settlement conference does not result in agreement, this alone can be a useful instant feedback exercise, unencumbered by the presence of a jury or strict procedural rules.

Depending on client preference and risk aversion, the settlement conference can also be an occasion for an individual client to have a direct off-the-record audience with the SEC and potentially with higher brass than would normally attend a proffer. The presence of a judicial mediator can provide comfort and guidance to allow the client to make representations without the same fear of retaliation the client may normally have. This opportunity also provides venting and educational benefits by allowing clients to see directly how their position resonates with the SEC and with a judge. Of course, using this option has potential downsides and should be carefully considered. But for a client with self-incrimination concerns, it may be one of the few chances the client has to put the case directly to SEC counsel and to a court.

Disclosing client resource concerns to a judicial arbitrator can also prove tactically advantageous. Courts strongly prefer clients to be represented by counsel, and to go to trial only when necessary. Disclosing cost-related issues to the judicial mediator allows for an independent assessment and a reminder to the parties of trial efficiencies, may positively affect a judicial settlement proposal, and has the added benefit of avoiding having to directly disclose a lack of trial-funding resources to the government.

The judicial mediator settlement proposal. There is no guarantee that a judicial mediator will propose a settlement. And even if the mediator does so, there is no obligation on either side to accept. Consider too that the commission must still approve any settlement proposal—a fact that adds an extra layer of uncertainty to any settlement discussion. But if a proposal is made, it can again have multi-layer benefits, aside from the obvious benefit of potentially resulting in the conclusion of litigation. First, it can educate clients and counsel on realistic expectations. Second, a judicial proposal is more likely to travel up the SEC hierarchy than a defense proposal. Third, an unfavorable proposal is not game over. It allows parties a free-pass, resource-light assessment of the strengths and weaknesses of their arguments with no obligation to accept, and an unfavorable proposal may also provide valuable insight into judicial decision making and procedural preferences that may not have been available or researchable prior to the conference.

Avoiding the Whipsaw: Scheduling Tactics

In concert with making the most of judicial resolution intervention, defense counsel can also make moves to structure proceedings in a way that assists resolution. In situations involving multiple defendants and either ongoing or

potential criminal allegations, the need to protect clients from falling prey to government attempts to whipsaw proceedings is all the more acute.

Press for delayed discovery. In parallel proceedings, the need to delay civil discovery is well understood. But what to do once the criminal proceeding ends? Trial-ready SEC counsel pushing for cranked-up discovery have procedure behind them once a criminal case is resolved. Your client may not have the resources to go through new rounds of discovery and may have fishing expedition concerns. Asking for judicial intervention to limit discovery and identify what the SEC actually needs to address discovery gaps is a method of approaching this situation. Making use of case management conferences and focused requests for judicial resolution is also helpful for the court: Narrowing the issues means narrowing the judicial burden. And, again, this may force the SEC to disclose its case focus. Used in combination with a request for judicial mediation, this can also provide the client with additional time to secure case funds and switch from a criminal to civil defense posture.

Push back against default. In multi-defendant cases, the wake from defaults taken against no-show codefendants looms large—particularly when these codefendants are further up the allegation food chain. An SEC push for default of nonresponsive defendants delays proceedings and can result in optically harmful penalty setting. Asking for judicial intervention to delay defaults until after resolution of active-defendant cases can avoid this outcome. A resolution strategy that places active defendants ahead of defaulters may also prompt the SEC to view quick settlement more favorably—particularly if the SEC has more penalty options against defaulting parties.

Conclusion

Where the downsides of asking for judicial intervention are low and the potential gains are high, requesting judicial assistance to open up resolution options and reorient scheduling is worth considering. “Broken windows” may be here to stay for the moment, but taking a multifaceted approach that makes the most of conflict management opportunities can save client resources and mean the difference between settlement and trial.

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