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Securities Enforcement: Counseling and Defense

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1 Securities Enforcement: Counseling and Defense Author(s)

Author(s)

SECURITIES ENFORCEMENT: COUNSELING & DEFENSE VOLUME 1

Kenneth B. Winer

Samuel J. Winer

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1 Securities Enforcement: Counseling and Defense Dedication

Dedication

Dedication

To our wives and children for their constant love and support.

Kenneth B. Winer

Samuel J. Winer



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1 Securities Enforcement: Counseling and Defense Acknowledgements

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1 Securities Enforcement: Counseling and Defense About the General Editors

About the General Editors

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1 Securities Enforcement: Counseling and Defense About the Contributing Authors

About the Contributing Authors

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Marc Dorfman is a partner in the Washington, D.C. office of Foley & Lardner LLP. A former trial attorney and special counsel with the U.S. Securities and Exchange Commission's Division of Enforcement, Mr. Dorfman's practice focuses on the defense of SEC and NASD investigations and regulatory enforcement proceedings, including administrative proceedings and proceedings in federal district court. Mr. Dorfman also litigates complex commercial matters including securities class and derivative actions. He also represents parties in securities industry arbitration and appears as an expert witness in securities regulation matters. Mr. Dorfman is an adjunct professor at the Georgetown University Law Center, where he teaches Securities Litigation. He graduated from Yale University (A.B., magna cum laude, 1973) and Harvard Law School (J.D., cum laude, 1976). Mr. Dorfman is a member of the Maryland and District of Columbia Bars and has also been admitted to practice before the U.S. Courts of Appeal for the Second, Third, Fourth, and District of Columbia Circuits.

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1 Securities Enforcement: Counseling and Defense Foreword

Foreword

Foreword

In the current, highly charged environment, a securities enforcement matter can be a traumatic event for an individual or entity. Effective representation of a client requires clear thinking and effective lawyering. It also requires an understanding of the impact that the matter can have on the individual or entity involved and the ability to help the client mitigate that impact.

This book represents decades of experience in securities and law enforcement. The authors have extensive experience as SEC officials, SRO officials, and criminal prosecutors. We designed this book to assist attorneys with a variety of experience. The book will benefit civil litigators, criminal defense lawyers, and corporate counsel who have limited experience defending securities enforcement matters but find themselves involved in an SEC enforcement matter. In this book, we discuss the legal issues, strategies, and tactics involved in representing clients in the full range of securities enforcement matters. This book focuses on the significant differences in the strategies and tactics employed in effectively defending a securities enforcement matter and on the strategies and tactics employed in defending private litigation and criminal investigations. We also discuss legal issues that are especially likely to arise in connection with the defense of securities enforcement matters.

We believe that this book will also benefit lawyers with substantial experience representing entities and individuals in SEC enforcement matters. During the substantial period that this book has been in development, Foley & Lardner LLP attorneys experienced in SEC enforcement matters have found it useful for its detailed legal discussions of difficult procedural issues that arise in SEC investigations.

In general, this book focuses on the procedural aspects of defending a securities enforcement matter. With limited exceptions, we have treated the substantive law relating to potential charges as outside the purview of this book.



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What's New

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HIGHLIGHTS

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Chapter Revisions

Ch. 2, The Securities and Exchange Commission

Ch. 12, Privileges

Ch. 18, Remedies

Ch. 27, International Issues

Recent Developments in Case Law

Noteworthy court decisions have been added throughout the set.

Chapter 2, The Securities and Exchange Commission. Added discussion of newly established national specialized units in each of five priority areas. *See, § 2.03[4].*

Chapter 12, Privileges. Updated discussion and analysis of Work Product Doctrine and Internal Investigations to include recent case law. *See, § 12.03, § 12.04.*

Chapter 18, Remedies. Added discussion and analysis of new "clawback" of certain compensation and stock products. *See, § 18.03[2][d]*

Chapter 27, International Issues. Added discussion and analysis of application of Section 10(b) to extra-territorial transactions. *See, 27.02[1].*



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CHAPTER 1 INTRODUCTION

1-1 Securities Enforcement: Counseling and Defense 1.syn

AUTHOR: Kenneth B. Winer

§ 1.syn Synopsis to Chapter 1: INTRODUCTION

§ 1.01 Overview of Responsible Entities

Kenneth B. Winer



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CHAPTER 1 INTRODUCTION

1-1 Securities Enforcement: Counseling and Defense § 1.01

AUTHOR: Kenneth B. Winer

§ 1.01 Overview of Responsible Entities

Responsibility for securities enforcement resides in a number of different entities. While each entity has a different purview than the others, their purviews overlap. Accordingly, one course of conduct by an individual or company can be of interest to multiple entities with responsibility for enforcing the securities laws. n1

The SEC is responsible for civil enforcement of the federal securities laws. As set forth in Chapter 2, "The Securities and Exchange Commission" and Chapter 4, "SEC Enforcement Program," the federal securities laws authorize the SEC to investigate possible violations of the federal securities laws, to file civil actions, and to institute administrative proceedings against both individuals and entities that violate the federal securities laws or any rules and regulations promulgated thereunder.

As set forth in Chapter 23, "Criminal Prosecutions," the Criminal Division of the United States Department of Justice is responsible for criminal enforcement of the federal securities laws. In this connection, prosecutors are often assisted by investigators from the Federal Bureau of Investigation, the United States Postal Inspection Service, and other governmental entities. Criminal prosecutions are often pursued by Offices of the United States Attorney, especially the U.S. Attorneys for the Southern District of New York, the Eastern District of New York, the Central District of California, and the Northern District of California. In the wake of Enron and WorldCom, President George W. Bush issued an executive order establishing a Corporate Fraud Task Force headed by the Deputy Attorney General to provide direction for the investigation and prosecution of cases of securities fraud, accounting fraud, mail and wire fraud, money laundering, tax fraud based on such predicate offenses, and other related financial crimes committed by commercial entities and directors, officers, professional advisers, and employees thereof. Prosecutors in multiple jurisdictions now jockey to file securities charges. As of January 2009, the task force claimed over 1,300 corporate fraud convictions, including convictions of over 200 CEOs and corporate presidents. n2 A conviction for corporate accounting fraud that in the late 1990's would have resulted in an 87-month sentence could now result in a 235-month sentence. n3

As described in Chapter 25, "SRO Regulatory Matters," each self-regulatory organization ("SRO") is responsible for enforcing its rules and regulations against member broker-dealers and persons affiliated with member broker-dealers. The SROs perform a major role in regulating the broker-dealer community. Each major SRO has authority to investigate possible violations of their rules and bring a proceeding before a hearing constituted by the SRO.

As described in Chapter 22, "State Securities Enforcement," the states are responsible for enforcement of the state securities laws. Each state has an agency that regulates securities professionals and offerings within the state. State regulators have taken a major role in pursuing investment advisers and broker-dealers. Each state also has a public body that regulates certified public accountants. These bodies investigate accountants who were involved in financial statements that have been restated or are otherwise believed to have been materially false. In addition, states have the ability to prosecute individuals and entities who violate their laws governing securities. For example, in 2002, the state attorneys general actively investigated the research departments of a number of broker dealers.

Many securities enforcement matters have the potential to implicate more than one enforcement authority. Much, if not most, of the conduct prohibited by the federal securities laws is also prohibited by the securities laws of one or more states. Similarly, many of the matters brought by the SEC Division of Enforcement could give rise to criminal charges. As illustrated by the research cases and the mutual fund cases, arguably wrongful conduct by persons affiliated with broker-dealers can attract enforcement attention from the state regulators, the SEC, the United States Department of Justice, the SROs and state criminal prosecutors. Moreover, foreign companies that have securities issued with the SEC can become subject to securities investigations and charges not only by state securities regulators, the SEC, the Department of Justice, the SROs and state criminal prosecutors, but by the governments of other countries.

Accordingly, counsel representing individuals and entities in a securities investigation should consider the possibility that one or more other securities investigation, or prosecution, might be initiated by another authority responsible for the civil and/or criminal enforcement of the federal securities laws. Sometimes, one authority will defer its investigation pending the completion of another entity's investigation. For example, the states, the SROs and the SEC often agree among themselves which entity will take the lead in investigating a securities matter. Sometimes, two or more authorities (e.g., the SEC, the Department of Justice, and a foreign authority) will simultaneously pursue a matter, sharing information and conducting at least some interviews jointly.

Counsel also has to be cognizant of the risks posed by securities class actions and derivative claims. Plaintiffs in a private action will often be able to obtain discovery of documents produced and transcripts of testimony provided in securities enforcement matters. In addition, the voluntary disclosure of otherwise privileged information in securities enforcement matters may constitute waiver of the work product doctrine and attorney-client privilege in a private action.

FOOTNOTES:

(n1)Footnote 1. *See* Chapters 2, 4, 22, 23, 24, and 25.

(n2)Footnote 2. President's Corporate Fraud Task Force Adds Six New Members (Jan. 6, 2009) (available at <http://www.justice.gov/opa/pr/2009/January/09-odag-003.html>).

(n3)Footnote 3. "Lawyers Cite Tougher Stance on White Collar Enforcement Efforts," *36 Sec. Reg. & L. Rep. (BNA)* 856 (May 10, 2004).



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CHAPTER 2 THE SECURITIES AND EXCHANGE COMMISSION

1-2 Securities Enforcement: Counseling and Defense 2.syn

AUTHOR: Kenneth B. Winer

§ 2.syn Synopsis to Chapter 2: THE SECURITIES AND EXCHANGE COMMISSION

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§ 2.02 The Commissioners

§ 2.03 The Division of Enforcement

[1] Home Office Staff

[2] Regional Office Staff

[3] Office of Chief Counsel

[4] Specialized Units

[5] Other Divisions and Offices

Kenneth B. Winer



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CHAPTER 2 THE SECURITIES AND EXCHANGE COMMISSION

1-2 Securities Enforcement: Counseling and Defense § 2.01

AUTHOR: Kenneth B. Winer

§ 2.01 Background

The United States Securities and Exchange Commission ("SEC" or the "Commission") is responsible for the administration of the federal securities laws: the Securities Act of 1933 (the "Securities Act"); n1 the Securities Exchange Act of 1934 (the "Exchange Act"); n2 the Investment Company Act of 1940 (the "Investment Company Act"); n3 and the Investment Advisers Act of 1940 (the "Investment Advisers Act"). n4 The federal securities laws give to the Commission "broad powers" n5 to investigate whether any person has violated, is violating, or is about to violate any of the federal securities laws. n6 In responding to an SEC investigation, it is important to understand that the SEC has a strict hierarchical structure with relatively well-defined lines of authority and systems for the supervision and review of investigations.

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C.S. § 77a et seq.*

(n2)Footnote 2. *15 U.S.C.S. § 78a et seq.*

(n3)Footnote 3. *15 U.S.C.S. § 80a-1 et seq.*

(n4)Footnote 4. *15 U.S.C.S. § 80b-1 et seq.*

(n5)Footnote 5. *SEC v. Arthur Young & Co., 584 F.2d 1018, 1023 (D.C. Cir. 1978) .*

(n6)Footnote 6. Section 21(a) of the Exchange Act provides, "The Commission may, in its discretion, make such investigation as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of [the Exchange Act], the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, the rules of the Public Company Accounting Oversight Board of which such person is a registered public accounting firm or a person associated with such a firm, or the rules of the Municipal Securities Rulemaking Board." *15 U.S.C.S. § 78u(a)(1)*. Section 21(b) of the Exchange Act further provides, "For the purpose of any such investigation, or other proceeding under [Title 15], any member of the Commission or any officer designated by it is empowered to administer oaths and affirmations, subpoena [sic] witnesses,

1-2 Securities Enforcement: Counseling and Defense § 2.01

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." *15 U.S.C.S. § 78u(b)*. The other federal securities laws contain similar provisions. *See Securities Act § 78u(b), § 20(a) and 19(b), 15 U.S.C.S. §§ 77(a), 77(b); Investment Company Act § 41(a), 15 U.S.C.S. § 80a-41(a); and Investment Advisers Act § 209(a), 15 U.S.C.S. § 80b-9(a)*.



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CHAPTER 2 THE SECURITIES AND EXCHANGE COMMISSION

1-2 Securities Enforcement: Counseling and Defense § 2.02

AUTHOR: Kenneth B. Winer

§ 2.02 The Commissioners

The SEC consists of up to five Commissioners, including a Chairman, who are nominated by the President and confirmed by the Senate. Biographical information regarding the Commissioners is available on the SEC website. n1

The Chairman and each Commissioner is supported by a legal Staff that includes two or more attorney advisers. The Chairman and the Commissioners play a significant role in establishing the Commission's priorities and in authorizing enforcement actions brought by the SEC. The Commissioners are rarely involved in the day-to-day supervision of investigations.

FOOTNOTES:

(n1)Footnote 1. www.sec.gov.



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CHAPTER 2 THE SECURITIES AND EXCHANGE COMMISSION

1-2 Securities Enforcement: Counseling and Defense § 2.03

AUTHOR: Kenneth B. Winer

§ 2.03 The Division of Enforcement

The SEC Staff is organized by function into Divisions and Offices, the largest of which is the Division of Enforcement. The Division of Enforcement consists of approximately 1,200 Staff members including attorneys and accountants.

All enforcement employees report to the Director of the Division of Enforcement. In April 2009, Robert Khuzami was named Director of the SEC Division of Enforcement. Before that, Mr. Khuzami was General Counsel for the Americas for Deutsch Bank for approximately four years and a prosecutor in the Southern District of New York for eleven years. In July 2009, Lorin Reisner was named Deputy Director. Mr. Reisner is also a former prosecutor in the Southern District of New York.

[1] Home Office Staff

The Home Office of the SEC is located at 100 F Street, N.E., Washington, D.C. 20549. The investigations are supervised by four Associate Directors. Biographical information on the Associate Directors can be found in news releases archived on the SEC website.

Each Associate Director supervises Assistant Directors. Each Assistant Director supervises approximately six attorneys.

The Chief Litigation Counsel supervises all enforcement litigation at the trial or administrative hearing levels. The approximately twenty-five experienced litigation attorneys have first-chair responsibility for all enforcement litigation, with the assistance of the Staff members who conduct the litigation.

[2] Regional Office Staff

In addition to the home office in Washington, D.C., the SEC has offices in New York City, Boston, Philadelphia, Miami, Atlanta, Chicago, Denver, Fort Worth, Salt Lake City, Los Angeles, and San Francisco. Until March 2007, five of these offices were designated as regional offices and each of the other six, designated as a district office, reported to one of the regional offices. In March 2007, this two tier system was abolished and the district offices became regional offices. n1 The regional enforcement efforts are overseen by a deputy director of enforcement who is based in New York City.

There is no bright line test for determining whether an investigation will be conducted by the Home Office or by a regional office. To a large extent, the assignment of investigations is a function of who initiates the investigation. Because the Home Office has more extensive resources than the regional offices, the Home Office often, but not always, assumes responsibility for the largest or highest profile matters.

While the regional offices have a geographic orientation, they operate in a national economy and will typically pursue their cases wherever the leads take them. Accordingly, it is not unusual for attorneys in one region to pursue investigations that are centered in another region.

[3] Office of Chief Counsel

The Division's Office of Chief Counsel coordinates the activities of the Enforcement Staff in the SEC's regional offices and reviews every enforcement recommendation made by the regional offices. The Office of Chief Counsel also addresses legal issues of interest to the Division (e.g., the Privacy Act, the Right to Financial Privacy Act).

[4] Specialized Units

In 2010, SEC Enforcement Director Robert Khuzami established national specialized units in each of five priority areas. The Asset Management Unit focuses on investigations involving investment advisors, investment companies, hedge funds, and private equity securities. The Market Abuse Unit focuses on investigations involving large-scale market abuses and complex manipulations schemes by institutional traders, market professionals, and others. The Structured and New Products Unit focuses on complex derivatives and financial products, including credit default swaps, collateralized debt obligations, and securitized products. The Foreign Corrupt Practices Unit focuses on violations of the anti-bribery provisions of the FCPA. The Municipal Securities and Public Pensions Unit focuses on misconduct in the municipal securities market and in connection with public pension funds.

Each of these specialized units will be staffed by approximately 35-50 professionals, including both attorneys and industry specialists. The units will be located both at the home office in Washington, D.C. and in various SEC regional offices. For example, as of May 10, 2010, the Structured and New Products unit was reported to have staff in the home office and seven of the SEC's eleven regional offices. n2

As Enforcement Director Khuzami explained when announcing the individuals selected to head each of these units:

Through enhanced training and improved access to specialists, unit members will obtain increased understanding of particular markets, products and transactions. They will use that expertise to adopt a more proactive approach to identifying conduct and practices ripe for investigation, to conduct those investigations with increased efficiency and effectiveness, and to share that expertise with all staff throughout the Enforcement Division conducting investigations in these specialized areas. n3

Enforcement Director Khuzami also established a new Office of Market Intelligence that is responsible for the collection, analysis, and monitoring of the hundreds of thousands of tips, complaints, and referrals that the SEC receives each year. The Office uses both human and automated analytics.

[5] Other Divisions and Offices

There are a number of other SEC Divisions and Offices that have significant roles in the enforcement process.

The General Counsel is the chief legal officer of the SEC. Primary duties of the Office of General Counsel include representing the SEC in certain civil, private, or appellate proceedings, preparing legislative material, and providing independent advice and assistance to the SEC Commissioners, the divisions, and the offices. The Office of General

Counsel reviews each memorandum recommending an enforcement action and advises the Commission regarding legal or policy issues raised by the recommendation.

The Division of Corporation Finance oversees corporate disclosure of important information to the investing public. Public corporations are required to comply with regulations pertaining to disclosure that must be made when stock is initially sold and then on a continuing and periodic basis. The Division of Corporation Finance routinely reviews selected disclosure documents filed by public companies. It also provides public companies with assistance interpreting SEC rules and recommends new rules for adoption. The Division of Corporation Finance is a source of referrals and advises the Enforcement Staff and the Commission regarding enforcement matters relating to corporate disclosure.

The Division of Trading and Markets establishes and maintains standards for fair, orderly, and efficient markets. It regulates the major securities market participants including broker-dealers, self-regulatory organizations (SROs), transfer agents, and securities information processors. The Division of Trading and Markets advises the Division of Enforcement and the Commission regarding enforcement matters relating to the operation of the securities markets.

The Division of Investment Management oversees and regulates the investment management industry and administers the securities laws affecting investment companies, including mutual funds, and investment advisers. The Division of Investment Management also administers the Public Utility Holding Company Act of 1935. The Division of Investment Management advises Enforcement and the Commission regarding relevant enforcement matters.

The Office of Compliance Inspections and Examinations administers the SEC's examination and inspection program for SROs, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers. This office conducts inspections to promote compliance with the securities laws, to detect violations of the law, and to keep the SEC Commissioners informed of developments in the regulated community. The office is a source of referrals and sometimes provides expertise to support enforcement investigations.

FOOTNOTES:

(n1)Footnote 1. "SEC Elevates District Offices to Regional Level," Press Release No. 2007-59 (March 30, 2007) (available at <http://www.sec.gov/news/press/2007/2007-59.htm>).

(n2)Footnote 2. "BNA Insights: SEC Launches New Enforcement Unit to Tackle Complex Products," Securities Regulation & Law Report (BNA May 10, 2010).

(n3)Footnote 3. SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence," SEC Press Release 2010-5 (Jan. 13, 2010), available at <http://www.sec.gov/news/press/2010/2010-5.htm>



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CHAPTER 3 OVERVIEW OF SEC ENFORCEMENT INVESTIGATIONS

1-3 Securities Enforcement: Counseling and Defense 3.syn

AUTHOR: Kenneth B. Winer Samuel J. Winer

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CHAPTER 3 OVERVIEW OF SEC ENFORCEMENT INVESTIGATIONS

1-3 Securities Enforcement: Counseling and Defense § 3.01

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§ 3.01 Introduction

Through its Enforcement Staff, the Commission investigates possible violations of the federal securities laws and brings enforcement actions against individuals and entities that it believes have violated, are violating, or are about to violate these laws. The SEC Enforcement Staff consists primarily of lawyers, accountants and investigators. Many of these staff members are based in Washington, D.C. n1

Investigations involving financial statements and other disclosures tend to be complex and to demand more resources than most other types of investigation.

It is not unusual for an SEC inquiry into a company's disclosures or financial reporting to last two or more years. An enforcement investigation can impose substantial burdens on the company being investigated, even if the Enforcement Staff or the Commission ultimately determines that no enforcement action is appropriate. An investigation can consume thousands of employee hours and demand the time and attention of senior personnel who are already fully occupied managing the company. The existence of the investigation and the knowledge that the SEC is looking over the company's shoulder can have an adverse impact on morale. The cost of paying counsel to represent the company and its personnel can be substantial. Business plans might have to be put on hold until the uncertainties generated by the inquiry are resolved.

While SEC investigations are required to be conducted privately, public companies many times disclose the existence of an SEC investigation or the press, on its own initiative, develops sufficient information to support reporting of the investigation in the media. Public disclosure of an investigation into a company's financial and accounting disclosures can have a severe adverse impact on the price of the company's stock, disrupt the company's business, and can prompt a member of the plaintiffs' bar to file a shareholders' class action or a derivative action against the company.

Corporations and individuals accustomed to dealing with the Division of Corporation Finance or the Office of Compliance Inspections and Examinations should recognize the important distinction between these offices and the Enforcement Staff. The Division of Corporation Finance and the Office of Compliance Inspections and Examinations have traditionally viewed themselves primarily as regulators whose function is to help the registrant or regulated entity improve its compliance with the federal securities laws. The Enforcement Staff, in contrast, views itself as a law

enforcement agency whose function is to bring enforcement actions, and increasingly, refer matters for criminal prosecutions.

In this chapter, brief descriptions of the various phases of a typical SEC investigation are set forth, from the initial request for information and documents to its possible conclusions. Other chapters of this book contain more detailed discussions of many of the topics covered in this chapter.

FOOTNOTES:

(n1)Footnote 1. *See* § 2.03[2], *above*.



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CHAPTER 3 OVERVIEW OF SEC ENFORCEMENT INVESTIGATIONS

1-3 Securities Enforcement: Counseling and Defense § 3.02

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§ 3.02 Conduct of the SEC Investigation

[1] Commencement of SEC Investigation

An enforcement investigation can be triggered by any number of factors, including:

- referrals from other SEC divisions or offices (such as the Division of Corporation Finance or the Office of Compliance Inspections and Examinations);
- newspaper reports. The Enforcement Staff regularly reviews the major newspapers and the news wires for leads. If a major publication questions an accounting or disclosure practice at a company or suggests that an issuer has made an improper payment to a foreign government official, there is a significant likelihood that the SEC will open an inquiry to review the practice;
- self-reporting by the company to the SEC. Companies sometimes decide to report to the Enforcement Staff that they or their personnel have engaged in conduct that may be of potential interest to the Enforcement Staff;
- complaints from short-sellers, disgruntled shareholders, employees and competitors. Two developments in 2010 make it likely that such complaints will be an important source of investigations. In 2010, Enforcement Director Robert Khuzami established the Office of Market Intelligence to work with the other Divisions and Offices on a new "Tips Complaints and Referrals" workflow system that is designed to get information quickly into the hands of Staff that need it, to ensure that nothing falls through the cracks, and to provide all Enforcement Staff with access to a data archive that can be: 1) searched for information relevant to their ongoing investigations; and 2) mined for fraud trends. Also, in 2010, Congress, as part of the Dodd-Frank Act, enacted provisions authorizing the Commission to make substantial monetary awards to individuals who provide information to the Staff that result in SEC enforcement action; n1
- referrals from other regulators and law enforcement agencies; n1.1

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- market surveillance by the SEC and the Self Regulatory Organizations, ("SROs"), (e.g., FINRA and NYSE). FINRA, the NYSE, and the other SROs routinely conduct investigations relating to trading in securities. If an SRO identifies serious misconduct by a person who is not associated with a member broker-dealer firm, the SRO can refer the matter to the SEC; n2
- monitoring of the Internet. The SEC Staff searches the Internet for news stories that might warrant an investigation and searches various websites that might identify potential subjects of an investigation;
- wildcatting. As part of its risk-based approach, when the SEC learns of a potential issue at one company (e.g., overstating oil and gas reserves) the SEC may investigate whether comparable companies have that issue; and
- other SEC investigations.

When the Enforcement Staff learns of a possible violation of the federal securities laws, it generally opens an informal inquiry or "matter under inquiry" ("MUI"). A matter under inquiry can be opened only after the Enforcement Division Staff involved conduct a preliminary analysis to determine both whether there have been potential violations of the federal securities laws and whether assignment of the matter under inquiry to a particular office is the best use of Enforcement Division resources. n3

Each matter under inquiry is assigned a designation consisting of two or more letters followed by a number. The letter designation consists of the letter "M" followed by one or two letters identifying the office conducting the probe. Thus a matter under investigation by the Home Office will have the designation "MHO," and a matter under investigation by, for example, the Chicago office will have the designation "MC." While companies should treat informal inquiries seriously, many, if not most, informal inquiries are closed without any enforcement action.

The Enforcement Staff maintains a computer system that tracks matters under investigation for the purposes, among others, of permitting senior members of the Enforcement Staff to monitor time and resources devoted to the matter and reduce the risk that different Staff members will inadvertently initiate different inquiries into the same subject matter. A matter under investigation can be closed by a Branch Chief, usually after consultation with the Assistant Director, or equivalent, and sometimes after consultation with the Associate Director, or equivalent.

Under internal SEC guidelines, a matter under inquiry becomes an investigation either when the Enforcement Staff responsible for the matter takes steps to open an investigation in the system or when a matter under inquiry has been open for sixty days--after sixty days, the Enforcement Division's internal tracking system automatically converts the matter into an investigation without further input from the Enforcement Staff. n4 In either case, the Enforcement Staff, including the assigned Associate Director evaluate the situation to determine whether opening an investigation is appropriate. The Deputy Director may be involved in this determination in some cases. n5 The standard for their evaluation is more detailed than that used for opening a matter under inquiry, and may include review of supplemental factors such as whether the matter involves potential recidivism, and whether the subject matter is a priority for the SEC or the Enforcement Division. n6 It is also possible for the Enforcement Staff to initiate an investigation without having opened a matter under inquiry.

When a matter under inquiry has been converted into an investigation, the designation of the matter changes. For example, the designation of an investigation by the Home Office changes to "HO" and the designation of an investigation by the Chicago office changes to "C."

At the beginning of an investigation, the Enforcement Staff will typically gather information from such sources as (1) public filings, including registration statements and periodic reports; (2) the Internet; (3) news reports; and (4) market

surveillance trading data. The Staff will analyze this information and develop a tentative plan of investigation to assess whether further investigation is appropriate. As the Commission's rules explain:

Where, from complaints received from members of the public, communications from federal or state agencies, examination of filings made with the Commission, or otherwise, it appears that there may be violation of the acts administered by the Commission or the rules or regulations thereunder, a preliminary investigation is generally made. In such preliminary investigation no process is issued or testimony compelled. n7

In order to issue subpoenas and compel testimony or document production in the course of an investigation, the Enforcement Staff must obtain a Formal Order of Investigation from the Commission. n8 However, as discussed in more detail below, the Enforcement Staff can proceed with informal investigations on the basis of voluntary cooperation from the subjects of investigation, including interviews and document production.

[2] Initial SEC Requests for Documents or Information

As part of this initial assessment, the Enforcement Staff may seek the voluntary production of documents, information and witnesses. Usually, the Staff sends a letter requesting the voluntary production of documents and information. Sometimes, the Staff seeks the information by telephoning a senior officer of the company and asking questions. Usually, company officers should avoid providing answers to substantive questions on this call. If a company officer receives such a call, the officer should listen attentively to the Staff, take detailed notes, express the company's strong interest in cooperating with the Staff, and promise that either a company officer or counsel will promptly contact the Staff to respond to the telephone call.

Comment

It usually is best for the officer not to make specific commitments during the initial contact with the Staff. Counsel can then work with the company to ensure that the information provided to the Staff is accurate, and that the company presents the information in an appropriate manner.

The Staff may ask for information in the form of schedules or chronologies. The Staff also may seek to obtain company documents relevant to the subject matter of the inquiry or to interview company personnel with knowledge of the subject matter. If a witness is interviewed, counsel should consider whether to ask that the interview not be transcribed and not be recorded. If the interview is transcribed, there is a risk that it will be discoverable in a securities class action or other litigation. Even if the interview is not transcribed, however, the witness should be thoroughly prepared and conscious that false statements to the government are subject to criminal penalties. Counsel should take detailed notes of the interview.

If the Staff is able to obtain the materials and testimony it desires without resorting to compulsory process, it might conduct an entire investigation without ever seeking a Formal Order from the Commission. On the other hand, if the Staff encounters difficulty in obtaining documents or testimony on a voluntary basis, it will seek a Formal Order from the Commission. n9 Formal Orders are discussed in Chapter 5.

This early stage of the inquiry is critical -- the failure to resolve the Enforcement Staff's concerns relatively promptly may result in a long, drawn-out investigation of the company. n10 The company has a strong incentive to allay the concerns of the Enforcement Staff. If the requested information is largely exculpatory, the more cooperation that a company provides the more likely it is to avoid a Formal Order and defuse the informal inquiry. Even if the requested information is not exculpatory, the Staff and Commission may consider a company's cooperation in assessing the remedies, if any, to seek against the company. In addition, the extent of a company's early cooperation could influence the Staff's view of current management. Moreover, a refusal to provide nonprivileged information to the Staff on a

voluntary basis is virtually certain to prompt the Enforcement Staff to seek and obtain a Formal Order from the Commission that will authorize the Enforcement Staff to issue subpoenas calling for the production of documents and for testimony. Accordingly, it is usually advisable for the company to comply with requests for voluntary cooperation.

Comment

The company should seriously consider attempting to allay the Staff's concerns as early in the investigative process as is practicable.

Thorough due diligence should be conducted to ensure that information communicated to the Enforcement Division is accurate. This early stage of the investigation is critical, as the failure to resolve the Staff's concerns relatively promptly will likely result in a long, drawn-out investigation of the company's financial disclosures and systems of internal accounting controls.

[3] Document Production

Because the Staff is unfamiliar with how the company operates and compiles and maintains information, document requests that appear clear and reasonable to the Staff often are ambiguous, impose a substantial burden to the company, and set forth an unreasonable return date. It is usually appropriate for counsel to meet with the Staff to discuss the request, attempt to narrow the scope of both the specific document request and the inquiry itself, and attempt to negotiate a more reasonable timetable for production. For example, in an investigation involving the valuation of a portfolio of securities, the Staff might be persuaded that, at least initially, its inquiry should focus on a subset of the securities at issue. Narrowing the focus of the investigation will reduce the burden imposed on the company, help move the investigation to a rapid conclusion, and reduce the risk that the Staff will stumble into discovering additional issues. n11 Great care should be taken that relevant documents, including computerized documents, are preserved. Document production is discussed in Chapter 9.

[4] Testimony

When the inquiry is not defused in the early stages, the Staff usually will question witnesses. It is usual practice for the Staff to question the witnesses under oath and for the witness's testimony to be transcribed by a court reporter. Typically such testimony occurs in a conference room in either a government office building in the region where the witnesses are located, or in the Washington, D.C. offices of the SEC. The witnesses have the right to be accompanied by their counsel. Such testimony frequently lasts a full day, and can last a week or more. n12

The SEC has the power to subpoena testimony from any person within the United States. A discussion of the SEC's subpoena power is set forth in Chapter 6. In an investigation of a company's disclosures, the SEC might take the testimony not only of company employees but also of auditors and other individuals with knowledge of the relevant transactions or events. For example, in an investigation relating to the recognition of revenue, the Enforcement Staff might request documents from the company's customers and question their personnel. The Commission typically does not provide notice to the company of the identity of witnesses whose testimony has been requested. Company counsel typically will be permitted to be present when testimony is given only if company counsel represents the individual witness who is testifying. n13

[5] Auditors

In an informal inquiry or investigation involving financial statements, the Staff will usually request that a company's outside auditors voluntarily produce workpapers and other materials to the Staff. The auditors will typically decline to produce materials voluntarily unless the client authorizes such production. If the client does not authorize the production or the auditors otherwise refuse to produce materials, the Commission will almost certainly issue a Formal Order of investigation. Accordingly, companies usually authorize their auditors to produce workpapers to the Staff

voluntarily.

[6] Formal Order

In some instances, an informal investigation can proceed for months or years without the Staff seeking a Formal Order giving Staff members the power to compel by subpoena the production of documents and the appearance and testimony of witnesses. n14 Even if the company and its employees cooperate, a third party may fail to cooperate. If the Staff decides that they truly need information possessed by that third party, the Commission, the Director of Enforcement, or the Director's delegates can issue a Formal Order of Investigation empowering the Staff to issue subpoenas without further authorization. A Formal Order can be issued even if there is little or no evidence that there has been a violation of the federal securities laws. n15 A Formal Order does not reflect an adjudication of any facts. Formal Orders are discussed in Chapter 5.

[7] Section 21(a) Orders

In addition to authorizing the SEC to issue subpoenas for documents and testimony, Section 21 of the Exchange Act authorizes the SEC to "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." n16 Pursuant to this section, in 2002, the SEC began issuing orders requiring a company to respond to detailed interrogatories to be signed under oath by a senior officer of the company. Responding to these interrogatories can require the company to conduct a massive and costly internal investigation in order to gather and verify the information required by the Staff. In addition, there is considerable concern that the company may be deemed to have waived attorney-client privilege and the work-product privilege if the company responds to the interrogatory based on the investigative work of defense counsel.

To date, no one has challenged the use of these orders, and there is no case law governing these orders. Presumably, a person receiving such an order could decline to respond, or to fully respond, to the order and seek to negotiate the scope of the order with the Staff. If an agreement could not be reached on the scope of the order, the SEC might attempt to bring a proceeding to enforce the order. It is not clear, however, whether the SEC has authority to bring such a proceeding. Although Section 21(c) expressly authorizes the SEC to bring subpoena enforcement proceedings in federal court and federal courts to issue orders requiring compliance with such subpoenas, there is no equivalent provision regarding Section 21(a) orders.

[8] The Wells and Authorization Process

At the conclusion of the fact-gathering phase, the Enforcement Staff will make a tentative decision whether to recommend that the Commission authorize the institution of an enforcement action. If the Staff tentatively decides to recommend an enforcement action to the Commission, they usually will notify counsel to the prospective defendant/respondent of this tentative decision. This notice is known as a "Wells Call." The prospective defendant/respondent will then have an opportunity to submit to the Staff a document setting forth the reasons why the contemplated enforcement action is not warranted. This submission is known as a "Wells Submission." Before filing a Wells Submission, counsel typically will meet with the Staff to learn the bases for the Staff's tentative decision. If the prospective defendant/respondent elects to file a Wells Submission, counsel will often talk with the Staff after the filing in order to reiterate points made in the submission and to learn whether the Staff's position has shifted.

If the Enforcement Staff decides to proceed with the recommendation, they will submit to the Commissioners a memorandum recommending that the Commission authorize the institution of an enforcement action. This memorandum is known as the "recommendation" or "rec" memorandum. The Enforcement Staff will distribute the recommendation memorandum, along with the pertinent Wells Submissions, to the Commissioners and the interested SEC Divisions and Offices, but not to the prospective defendant/respondent. The Commission will vote on the

recommendation memorandum at a meeting that is closed to the public and at which defense counsel will not be present. The Wells process is discussed in Chapter 16.

[9] Enforcement Proceedings

The SEC has authority to seek remedies in federal court and in administrative proceedings. If the SEC concludes that a person has violated, or is about to violate, the federal securities laws, the Commission will likely authorize its Staff to institute one or more enforcement proceedings. The consequences of an SEC enforcement action can be even more severe than those attendant to an investigation. The mere filing of the action generates negative publicity. Moreover, such an enforcement action could result in:

- a court-ordered injunction or an administrative order against the company, company personnel, or the company's auditors, barring them from future violations of the federal securities laws;
- an order barring an individual from serving as an officer or director of a public company;
- an order barring an accountant or attorney or other professional from practicing before the commission;
- an order compelling disgorgement of any unjust enrichment including incentive compensation received as a result of allegedly overstated financial statements;
- an order requiring a company to restate its financial statements or otherwise correct any material misstatement;
- an order imposing fines; and/or
- an order imposing other remedial relief.

When the SEC files a civil complaint or the Staff institutes an administrative action, the charging document becomes public. The SEC routinely issues a press release with the filing of a civil action and makes public both complaints and orders instituting administrative proceedings.

The remedies available to the SEC, settlements, and the collateral consequences of SEC enforcement actions are discussed in Chapters 18, 17 and 20, respectively.

FOOTNOTES:

(n1)Footnote 1. Dodd-Frank Act § 922.

(n2)Footnote 1.1. *See e.g.*, Department of Enforcement, Securities and Exchange Commission, *Enforcement Manual* (2008) at § 2.2.2, pp. 9-13 (discussing referrals from FinCEN, the PCAOB, state securities regulators, Congress, and self regulatory organizations).

(n3)Footnote 2. SROs are important sources for producing leads resulting in investigations of insider trading. The NYSE and FINRA have sophisticated computer systems to monitor fluctuations in the price and trading volume of stocks that trade on the NYSE and Nasdaq stock market, respectively. In particular, the SROs continuously monitor securities traded in their markets to identify unusual increases in volume or unusual price movements in a security prior to the announcement of a material fact. SROs often refer matters to the SEC for possible investigation. Other sources of information that prompt investigations into insider trading include the monitoring of price/volume activity by the SEC, reports in the media, and informants, including employers of those who trade.

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(n4)Footnote 3. *Enforcement Manual* at § 2.3.1, p. 13. A list of factors considered by the Staff in reaching a determination on opening a matter under inquiry is included in the *Enforcement Manual* at p. 14.

(n5)Footnote 4. *Id.* § 2.3.1, at p. 16.

(n6)Footnote 5. *Id.* § 2.3.2, at p. 19.

(n7)Footnote 6. *Id.* § 2.3.2, at p. 17.

(n8)Footnote 7. Rule 5(c), SEC Informal and Other Procedures, *17 C.F.R. § 202.5(a)*.

(n9)Footnote 8. *17 C.F.R. § 202.5(a)*.

(n10)Footnote 9. William McLucas & John Polise, *A Critical Examination of the SEC's Enforcement Process*, Insights, Jan. 1994, at 3.

(n11)Footnote 10. Persuading the Staff to close an investigation can become more difficult as the investigation progresses. The procedures within the Division contribute to this phenomenon. Investigations consuming more than a few weeks of the Staff's time cannot be closed without approval from the Division's more senior management.

(n12)Footnote 11. *See* Chapter 9, *below*.

(n13)Footnote 12. *See* Chapter 10, for a discussion of the preparation for, and defense of, testimony.

(n14)Footnote 13. *See* Chapter 10.

(n15)Footnote 14. In May 2006, the Commission amended its rules governing the Office of General Counsel to make it clear that the Office was authorized to conduct informal inquiries regarding the conduct of attorneys. "Description of Duties of the General Counsel," Release No. 34-5375 (May 3, 2000) (available at <http://www.sec.gov/rules/find/finalarchive2006.shtml>).

(n16)Footnote 15. *See* Chapter 6.

(n17)Footnote 16. *15 U.S.C.S. § 78u(a)(1)*.



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CHAPTER 3 OVERVIEW OF SEC ENFORCEMENT INVESTIGATIONS

1-3 Securities Enforcement: Counseling and Defense § 3.03

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§ 3.03 Initial Steps in Response to an SEC Investigation

As discussed below, there are a number of measures that a company should promptly take upon learning that the SEC is conducting an investigation relating to the company's disclosures or internal controls.

[1] Retaining Counsel Experienced in SEC Investigations

If it appears that the company might have exposure in connection with the SEC investigation, the company should seriously consider retaining counsel with experience in SEC investigations. An SEC investigation poses serious challenges for a public company. Experienced counsel can help guide the company through these proceedings, anticipating potential challenges and identifying options available to the company. They can devote substantial time and resources to the matter. They are also experienced in dealing with the Staff and understand the differences between defending an SEC investigation and defending litigation. Because they typically have limited familiarity with the company they often are in a better position than in-house counsel to meet with the Staff to explore the Staff's concerns.

In January 2003, the SEC adopted new standards of professional conduct for attorneys who appear and practice before the Commission in the representation of an issuer. The standards, which were prompted by Section 307 of the Sarbanes-Oxley Act of 2002, were codified as 17 C.F.R. § 205. The standards are likely to apply to an attorney who represents an issuer in an SEC investigation. n1 The standards contain three sets of provisions, including extensive provisions requiring attorneys and chief legal officers to take certain steps upon becoming aware of "evidence of a material violation." n2 The attorney and the issuer should consider structuring the engagement of defense counsel in a manner that relieves defense counsel of the reporting obligations otherwise imposed by the Part. n3

[2] Notifying Company Spokespeople

If the probe is not publicly disclosed and it appears that the company has exposure, steps must be taken to ensure that the officers and employees responsible for interacting with analysts and the press do not inadvertently deny the existence of the investigation. If a company spokesperson denies the existence of an investigation, it is likely that the company will consider it prudent to correct the denial, even though the existence of the inquiry was not considered material. Moreover, to the extent, if any, that the existence of the investigation is material, a public company might have an obligation to ensure that its spokespeople are aware of the investigation. In *In re Carnation Co.*, n4 the SEC found

that Carnation had violated the anti-fraud provisions of the federal securities laws because the company had failed to ensure that its spokesperson was aware of a material corporate development. When the spokesperson made a false statement regarding the possible sale of the company, the statement was found to be actionable. Of course, widely disseminating to employees information regarding the existence of the investigation greatly increases the possibility of leaks to the press and friends and family of company employees. Disclosure issues associated with an SEC investigation are discussed in Chapter 7, "Disclosure Issues."

Comment

If the probe is not publicly disclosed, steps must be taken to ensure that the officers and employees responsible for interacting with analysts and the press do not inadvertently deny the existence of the investigation.

[3] Notifying Auditors

In most circumstances, the company should promptly notify its auditors of any SEC investigation relating to the company's financial statements or related disclosures. There are several reasons why such notice is appropriate. In light of the company's ongoing disclosure obligations, management usually will want to inform the auditor of this fact so that the auditors can assess the implications, if any, that such an investigation might have on the company's financial statements and related disclosures. Indeed, failure to notify the auditors could in some circumstances be viewed as a violation of Exchange Act Rule 13b2-2 or as evidence that management was acting with fraudulent intent.

In addition, in most investigations relating to a company's financial disclosures, the SEC contacts the company's auditors seeking documents and information. Accordingly, even if management did not promptly notify the auditors, the auditors are likely to learn of the SEC investigation as a result of the SEC contacting the auditors seeking documents and other information.

The cooperation of the auditors is likely to be vital to the development of an effective response to the SEC probe. In investigations into the quality of a company's financial reporting, the auditors are likely to be important witnesses and their workpaper files will contain documents of great interest to the Staff. Moreover, the auditors' expertise will assist the company and its counsel in assessing the company's potential exposure, and the auditors could significantly assist the company in persuading the Staff to terminate or limit its probe.

In addition, failure to give timely notice to the auditors of an SEC investigation can adversely affect the professional relationship between the company and the auditors. While always important, the relationship between a company and its auditors is of particular importance in the context of an SEC investigation.

The auditors may view themselves as prime potential targets of the SEC investigation. Accordingly, management should be prepared for the auditors to react strongly to news that the company is the subject of an SEC investigation. The national office of the auditor is likely to send personnel previously uninvolved in the audit to review the workpapers relating to the review and audit of previously issued financial statements. If these personnel identify deficiencies in the workpapers, the auditors could revisit issues previously addressed by the auditors, or even resign and withdraw its audit report(s), which would have serious consequences for the company's stock price, relationship with creditors, and continued listing on the Nasdaq or the NYSE. Moreover, during the pendency of the SEC investigation, the auditor is likely to be skittish about issuing the required audit reports and completing required quarterly reviews, especially if the issues under investigation implicate the current financial statements of the company.

Moreover, the auditors might decide that information regarding the SEC investigation has triggered obligations under Section 10A of the Exchange Act. Section 10A imposes obligations on an auditor if, in the course of conducting an audit, the auditor detects, or otherwise becomes aware of, information indicating that an illegal act (whether or not

perceived to have a material effect on the financial statements of the issuer) has or may have occurred. Given that the SEC has interpreted Section 10A as having a very low threshold, there is a significant likelihood that notification of the SEC investigation will result in the auditor concluding that the obligations of Section 10A have been triggered and that the auditors are now required, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission --

- to determine whether it is likely that an illegal act has occurred; and
- if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and
- as soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such auditors in the course of the audit, unless the illegal act is clearly inconsequential.

Under Section 10A, if after determining that the audit committee of the board of directors of the issuer, or the board of directors of the issuer in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the auditor in the course of the audit of such auditor, the auditor concludes that --

- the illegal act has a material effect on the financial statements of the issuer;
- the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and
- the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement;

the auditor shall, as soon as practicable, directly report its conclusions to the board of directors. n6

Dealing with auditors can be a major component of an effective response to an SEC investigation. In dealing with auditors, management must focus on the twin realities that while auditors can be an important ally in dealing with the SEC, the auditors can inflict serious damage on a company by refusing to issue an audit report or complete a quarterly review, or by withdrawing a previously issued report.

[4] Notifying Employees

A number of factors should be considered in identifying the employees who should be notified of the investigation. The SEC may choose to contact directly the employees of a company, including senior officers, even though the Staff has been informed that an attorney represents the company in connection with the inquiry. n7 Accordingly, it is prudent to notify company personnel that they might be contacted by the SEC Staff and remind them of their rights and responsibilities if they are contacted by a law enforcement official inquiring about the company. Without pressuring an employee not to cooperate in a law enforcement inquiry, a company may remind an employee that if contacted by a law enforcement official, the employee has the right to decline to be interviewed, to set the time and place of the interview, and to be represented by counsel. The company can remind employees that anything an employee says to a law enforcement official can be used against the employee, the employee's co-workers, and the company. The company should state that while it is within the employee's personal discretion to provide nonprivileged information to the law enforcement official, it is imperative that the employee not provide information that is inaccurate or misleading. The

company can also remind the employee to contact the company promptly after being contacted by a law enforcement official. n8 Upon learning that a law enforcement official has interviewed an employee regarding the company, the company should request that company counsel immediately and thoroughly interview the employee to learn the questions the law enforcement official posed, any documents that the law enforcement official showed to the employee, and the information that the employee provided to the law enforcement official.

The company may decide to notify selected employees of the SEC investigation because company counsel plans to interview them regarding the subject matter of the investigation and because of the need to preserve and gather relevant documents. It is important that the company promptly preserve, gather and review documents, and interview witnesses in response to an SEC investigation. n9 Often, this information gathering can best be accomplished if selected employees are made aware of the SEC investigation. The company should caution these employees to treat the presence of the SEC confidential, and to exercise caution when discussing the SEC investigation with other company employees.

[5] Preserving Documents

Destruction of relevant documents can have a severe impact on an SEC investigation. Even if the SEC has not yet requested the production of documents, destruction of documents can expose a person to criminal prosecution for obstruction of justice. n10 In addition, destruction of documents can make substantially more difficult the defense both of the SEC investigation and of any private litigation. Accordingly, at the first hint that the SEC might be initiating an investigation, the company and its counsel should consider taking steps to suspend document destruction measures and to ensure that relevant documents are maintained. As the criminal prosecutions of Arthur Andersen and Frank Quattrone vividly demonstrate, it is imperative that company personnel not destroy documents for the purpose of obstructing an expected or ongoing SEC investigation.

Comment

At the first hint that the SEC might be initiating an investigation, steps should be taken to suspend document destruction measures and to ensure that relevant documents are maintained.

[6] Notifying Primary Regulators and People Doing Business with Company

The Enforcement Staff frequently contacts the persons doing business with the company. While the Enforcement Staff usually states in its correspondence that it has reached no conclusions and the fact of the investigation does not indicate that anyone has breached any duty under the federal securities laws, such a contact could have serious consequences for the relationship between the company and the individual or entity contacted. The company should consider whether the impact on these individuals and entities being contacted by the SEC Staff would be mitigated if the company contacted them before the SEC. Once again, in informing these persons and entities, the company would be engaging in selective disclosure absent a public announcement, and must proceed with caution and attendant safeguards against improper trading in the company's securities. The company should also be careful not to engage in conduct that the government might construe as obstruction of justice.

[7] Conducting an Internal Investigation

Upon learning that the SEC is conducting an investigation into the company's affairs, company counsel should promptly take steps to gather documents and other information relating to the relevant facts and the extent, if any, of the company's potential exposure. Gathering this material serves several important purposes in addition to assisting the company in designing and mounting an effective response to the investigation. This material can help the board of directors and management fulfill their obligations to the company and its stockholders by informing and driving certain decisions the board and management may be called upon to make with respect to the subject matter of the investigation, including whether the company's outstanding and imminent disclosures are appropriate. In addition, this material can assist the company in framing its disclosure of the investigation and addressing the public's response to that disclosure.

n11

The internal investigation can also assist the company in meeting its ongoing obligations with respect to financial reporting. The SEC investigation and the facts and circumstances leading to such investigation may trigger a need for senior management to take additional measures to obtain reasonable assurance that its recent and upcoming disclosures are not materially misleading. Similarly, the internal investigation assists the management of a regulated entity in discharging management's supervisory obligation. Moreover, a company may receive credit from the SEC and the Department of Justice, if the company conducts an internal investigation and reveals the results of the investigation to the government. n12

An SEC investigation and associated facts can trigger two or more internal investigations. Company defense counsel needs to conduct an internal investigation in order to advise the company and mount an effective defense. The audit committee might retain independent counsel to advise the audit committee and conduct a separate internal investigation. A committee of independent directors might retain a third law firm to advise the committee in assessing whether the company should file an action against the company's officers, auditors, or others.

Comment

Although parallel internal investigations may be unavoidable, careful coordination can reduce the costs and burdens involved. Consideration should be given to coordinating the production and review of documents and the questioning of witnesses. The differing missions of the different internal investigations and differing privilege considerations may, however, limit the ability to coordinate.

[8] Deciding Whether to Disclose the Existence of an SEC Investigation

In general, the SEC does not disclose the commencement of an enforcement probe. Indeed, the United States Supreme Court has held that the SEC is not required to notify the "targets" of nonpublic investigations when the SEC issues a subpoena to a third party. n13 The Enforcement Staff routinely takes the position that the SEC does not identify persons or entities as "targets" or "subjects" of an investigation.

The federal securities laws do not specifically require that companies disclose when they are the subject of an SEC investigation. Disclosure may, nevertheless, be required if the existence of the investigation is material within the meaning of the federal securities laws. Determination of whether an investigation is material is a subjective determination dependent on the facts and circumstances surrounding the investigation. A discussion of the factors to be considered in making this determination is contained in Chapter 7, "Disclosures Issues."

Disclosure of an SEC investigation can have a number of adverse consequences. It can depress the price of the company's stock. It can prompt a derivative action or a securities class action. It can cause concern among customers and suppliers. It can adversely impact employee morale. A company may, nevertheless, voluntarily disclose the existence of SEC investigations for a number of reasons, including (i) the tension between the need to discuss the investigation with numerous employees and the fear of selective disclosure; (ii) fear that news of the investigation will leak; (iii) the need to deal with customers, lenders, and/or suppliers who might be contacted by the SEC; (iv) a reluctance to decline to answer questions posed by analysts, the press or investors; (v) concern that failure to disclose the existence of the investigation in a timely fashion could impair the company's corporate credibility; and (vi) a concern that the activities that attend the commencement of an SEC investigation might otherwise trigger employee anxiety detrimental to the company. In addition, prompt disclosure of the SEC investigation may limit the exposure of the company, its directors, and its officers in the event that others later argue that the existence of the investigation was material and should have been disclosed.

Compounding the difficulty of the decision to make disclosure will be, in many instances, management's honestly held

belief that the Staff's inquiry is based upon misinformation or a misunderstanding that can be quickly corrected. Indeed, in some instances it may appear that the investigation is part of an industry sweep, and is not based on any information specific to the company. Accordingly, management will often be reluctant to issue a press release creating investor uneasiness when there is no indication that the SEC inquiry will result in an enforcement action. Nevertheless, management sometimes may conclude that, even in these instances, disclosure of the existence of the investigation will best serve the investing public and the company.

If the existence of the investigation is disclosed to the press, individuals dealing with the investing public, analysts, and the press should be carefully prepared regarding the appropriate responses to likely questions. A number of factors will militate toward minimizing the extent of the disclosures including concern that: (1) extensive disclosures could waive any attorney-client and work product privileges that might otherwise apply; (2) some of the information disclosed might prove inaccurate or require updating; and (3) information disclosed might assist the plaintiffs' securities bar in drafting complaints that can survive a motion to dismiss. Factors militating toward disclosure typically include a belief that forthright responses will tend to reassure various corporate constituencies and demonstrate that management is in control and addressing the issues. In preparing these responses, the company will need to balance these competing factors.

Comment

If the existence of the investigation is disclosed to the press, individuals dealing with the investing public, analysts, and the press should be carefully prepared regarding the appropriate responses to likely questions. If possible, it is best to appoint one individual to be the company's sole spokesperson in connection with the investigation.

By having only one spokesperson, the company can promote consistency and discourage analysts, reporters, and others from contacting numerous company sources in search of a different angle. The company should take steps to ensure that any public statements regarding the investigation are accurate and consistent with statements that the company is making privately (e.g., to the provider of the insurance policy covering the company's directors and officers ("D&O" insurer)). A further discussion of a company's disclosure obligations is set forth in Chapter 7, "Disclosure Issues."

[9] Notifying D&O Insurer

To invoke coverage, the company or officer must provide written notice of the claim. Promptly putting the D&O insurer on notice of the SEC investigation will assist the company in obtaining reimbursement for professional fees incurred in responding to the inquiry. In addition, even if the policy does not cover fees incurred in connection with an SEC investigation, failure to provide prompt notice of an investigation could impair the ability of the company to obtain coverage for the fees and other expenses incurred in connection with subsequent, related litigation, whether an SEC enforcement action, a securities class action, or a derivative action. D&O insurance is discussed in Chapter 26, "Insurance."

[10] Taking Remedial Action

As a result of the SEC investigation and attendant internal investigation, the company might identify controls and procedures that arguably are deficient or disclosures that arguably are misleading. The company should enhance its controls and procedures and clarify its disclosures so that they fully comply with the requirements of the federal securities laws.

Section 302 of the Sarbanes Oxley Act of 2002 requires the company's CEO and CFO to represent, *inter alia*, that they have designed disclosure controls and procedures to ensure that material information relating to the issuer is made known to the certifying officers. Taking the initiative to enhance its internal controls enables company management to

make this representation, satisfies management's obligations to manage the company with due care, reduces the risk of future violative conduct, and reduces the danger that the Commission will later force the Staff to accept internal control enhancements that are unduly burdensome. In addition, while the Enforcement Staff typically gives companies little credit for remedial measures taken after the Staff has initiated its investigation, the Staff is nevertheless likely to take a dim view of a company and its officers if they fail to take needed remedial action after the Staff has initiated the investigation.

FOOTNOTES:

(n1)Footnote 1. *17 C.F.R. § 205.3(a)*.

(n2)Footnote 2. *17 C.F.R. § 205.3(b)*.

(n3)Footnote 3. *17 C.F.R. § 205.3(b)(6), 17 C.F.R. § 205.3(b)(7)*.

(n4)Footnote 4. *In re Carnation Co., Release No. 22214, 1985 SEC LEXIS 1150, [1984 -85 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,801, at 87,596-597 (July 8, 1985)*.

(n5)Footnote 5. *15 U.S.C.S. § 78j-1*.

(n6)Footnote 6. Section 10A further provides that the auditor must take certain additional steps if the board of directors does not promptly notify the Commission of the receipt of the auditor's report.

(n7)Footnote 7. Some commentators have questioned whether it is ethical for company counsel to attempt to block such contacts by claiming that company counsel concurrently represents individual current and former employees of the company, unless the company has assessed applicable conflict issues and actually formed an attorney-client relationship. *See, e.g., Utah State Bar, Ethics Advisory Opinion Committee, Opinion 04-06 (Dec. 2, 2004)*. The conflict issues are discussed in Chapter 11.

(n8)Footnote 8. This step is particularly important in the current environment in which criminal investigations are unusually likely. For a further discussion of "ambush interviews," see Chapter 23.

(n9)Footnote 9. *See Chapter 9, below*.

(n10)Footnote 10. *See Chapter 23, below*.

(n11)Footnote 11. *See Chapter 8, below*.

(n12)Footnote 12. This issue is discussed further at § 3.04[2], *below*.

(n13)Footnote 13. *SEC v. Jerry T. O'Brien, Inc., 467 U.S. 735 (1984)*.



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Securities Enforcement: Counseling and Defense

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CHAPTER 3 OVERVIEW OF SEC ENFORCEMENT INVESTIGATIONS

1-3 Securities Enforcement: Counseling and Defense § 3.04

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§ 3.04 Development of Defense Strategy

Companies normally hope to achieve a number of goals by responding effectively to a securities investigation including minimizing: (1) the risk of criminal charges; (2) the likelihood of a civil enforcement action; (3) the monetary penalties and other relief sought by the agency; (4) the disruption to the company's operations including disruption of personnel and adverse publicity; and (5) the risk of private litigation (e.g., securities class actions). While there may be some tension between these goals, a company that is subject to a securities investigation should respond proactively to achieve these goals to the extent possible.

[1] Communication with Enforcement Staff

Throughout the investigation, company counsel should attempt to maintain communications with the Staff regarding not only procedural matters, but also the substance of the investigation. Maintaining communications reduces the risk that the Staff will prolong the investigation because of a failure in communication or misunderstanding of the facts. Company counsel can attempt to identify and defuse the Staff's concerns. In addition, either formally in presentations or less formally in telephone calls or conversations during breaks in testimony, defense counsel can attempt to make affirmative points favorable to the Staff. Maintaining communications also increases the likelihood of counsel identifying early an opportunity for favorable resolution to the inquiry.

Sometimes, the Enforcement Staff will, in an effort to accelerate the response to its request for information, disclose to company counsel the concerns that triggered the investigation. In many instances, the Staff's concerns will be based on an incomplete understanding of the facts. In such instances, company counsel should consider arranging subsequent meetings in which the company and its counsel could persuade the Staff that its concerns are unfounded.

[2] Cooperation with the Enforcement Staff

A company that is the subject of an SEC investigation can select from a range of defense strategies. Depending on the facts and circumstances, a company's best strategy may be to conduct a thorough investigation and provide the results to the Staff. In other circumstances, a company's best strategy may be to educate the Staff regarding key issues so that they understand without revealing the results of the internal investigation. In other circumstances, a company might decide to insist on all of its legal rights and provide no documents or information to the Staff except as required by law.

There are potential advantages and disadvantages to each defense strategy. For example, in appropriate circumstances, it might be in the company's interest to report the results of the internal investigation to the SEC or other government authorities. This is often the case where the results of the internal investigation are exculpatory and should allay the concerns identified by the Staff. This may also be the case where it appears likely that the company has substantial exposure to criminal liability.

An informal inquiry can sometimes be defused in the early stages by meetings at which corporate counsel, and sometimes corporate officers and/or the auditors, allay the Staff's concerns. Often this result can be achieved, however, only by production of the requested materials or by the corporate officers or the auditors testifying under oath. If possible, it is beneficial to allay the Staff's concerns before it becomes heavily invested in the inquiry because of the amount of time and effort it has devoted to developing the investigative record. Serious consideration should be given to asking that other relevant government officials (from, e.g., the Division of Market Regulation or the Office of the Chief Accountant) participate in the meeting. Great care should be taken not to provide false information to the Staff in attempting to allay its concerns. False information can undermine the company's credibility, or even result in criminal charges. For example, in December 2005, the owner of a chain of supermarkets was indicted for, among other things, providing false assurances to the NLRB that the company had not hired certain members of a striking union. n1

In 2010, the SEC Enforcement Division modified its Enforcement Manual to provide for deferred prosecution agreements ("DPA") and non-prosecution agreements ("NPA") as tools to encourage individuals and companies to report violations and provide assistance to the agency. Both the DPA and NPA are tools that have long been used by federal criminal authorities and the SEC tools are based on that precedent. As of June 15, 2010, the SEC had not signed any DPAs or NPAs.

As described in the Manual, a DPA is a formal written agreement in which the Commission agrees to forego an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and to comply with express prohibitions and undertakings during a period of deferred prosecution. The paradigmatic reason for a DPA is for the SEC to obtain an undertaking from a prospective defendant/respondent and then dismiss or otherwise resolve the matter without further remedy if the prospective defendant/respondent satisfies the undertakings and had committed no other violations of the federal securities laws.

Similarly, as described in the Manual, NPAs are formal written agreements, entered into under limited and appropriate circumstances, in which the Commission agrees not to pursue an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and comply with express undertakings.

The Enforcement Manual provides that in evaluating the cooperation of an individual, the Commission's general approach is to consider four considerations:

Although the evaluation of cooperation requires a case-by-case analysis of the specific circumstances presented, as described in greater detail below, the Commission's general approach is to determine whether, how much, and in what manner to credit cooperation by individuals by evaluating four considerations: the assistance provided by the cooperating individual in the Commission's investigation or related enforcement actions ("Investigation"); the importance of the underlying matter in which the individual cooperated; the societal interest in ensuring that the cooperating individual is held accountable for his or her misconduct; and the appropriateness of cooperation credit based upon the profile of the cooperating individual. In the end, the goal of the Commission's analysis is to protect the investing public by determining whether the public interest in facilitating and rewarding an individual's cooperation in order to advance the Commission's law enforcement interests justifies the credit awarded to the individual for his or her cooperation. n2

Comment

If possible, it is beneficial to allay the Staff's concerns before it becomes heavily invested in the inquiry because of the amount of time and effort it has devoted to developing the investigative record.

The SEC has taken steps to encourage companies to self-report violative conduct promptly upon discovering it. n3 In October 2001, the SEC issued a report of investigation encouraging companies to institute internal investigations upon learning of possible violations of the federal securities laws and to report to the SEC the results of the investigation. n4 The Commission issued a cease-and-desist order against Seaboard Corporation's controller n5 but did not bring any action against Seaboard Corporation. The Commission issued a report explaining the basis for its decision not to bring an enforcement action against Seaboard. In the report, the Commission stated that among the reasons why it did not bring an enforcement action against Seaboard Corporation were the facts that upon learning of the possible violation, Seaboard Corporation had instituted internal reviews performed by outside professionals unfettered by limitations or interference from interested persons, had taken corrective action, and had voluntarily reported the results of that internal review to the Staff.

The Seaboard § 21(a) Report provides only limited comfort to issuers; the Commission and the Staff have emphasized that even if an issuer takes prompt and effective corrective action and cooperates with the Staff, the Commission might bring an enforcement action against the issuer where the conduct was more egregious or the harm to the investing public more substantial. Many SEC defense counsel suspect that the benefits suggested by the Seaboard § 21(a) Report are largely illusory. n6

Self-reporting can, however, sometimes limit the adverse impact that an SEC investigation would otherwise have on a company's ability to conduct business. For example, a company that has recently restated its financial statements is likely to be occupied with inquiries from numerous corporate constituencies (e.g., lenders, suppliers, customers, employees, the media, analysts). Under these circumstances, an SEC investigation can dangerously disrupt the operations of a company. By contacting the Enforcement Staff, informing them that the company has retained independent counsel to conduct a thorough investigation, providing assurances that relevant documents have been secured, and expressing a willingness to share the results with the Enforcement Staff, the company might be able to persuade the Enforcement Staff to defer the enforcement activities most disruptive to the company.

There are also reasons why a company might refrain from reporting to the Commission that it has conducted an internal investigation and identified possible violations of the federal securities laws. If a company reports itself to the Staff, the company arguably increases the chance that the Staff will open an investigation. Although the SEC Staff monitors SEC filings and news wire reports for announcements of restatements, it does not investigate all potential leads. In addition, it often is difficult for the company to establish the facts with enough confidence to justify a report to the Staff.

Apart from the issue of self-reporting, a company also must determine the extent to which it will cooperate with an ongoing SEC investigation. In general, a company should agree to do that which the Enforcement Staff could likely compel the company to do. In addition, cooperation is often the better policy if the company, after a thorough internal investigation, believes that no violation of the federal securities law has occurred. Cooperation also may be the better approach if the company's priority is to expedite a rapid resolution to the investigation. Cooperation not only assists the Staff in obtaining needed information more rapidly, it might also prompt the Staff to be more open in revealing its concerns, thereby increasing the ability of the company to address the concerns. Cooperation also may be the better policy if the company expects to negotiate a settlement. Given the vast discretion vested in the Staff, the goodwill generated by cooperation may assist the company in negotiating a favorable settlement. n7 Conversely, a failure to cooperate might result in a harsher settlement.

[3] Settlement Discussions

While most companies settle SEC enforcement actions before they are instituted, in appropriate circumstances the company should be prepared to litigate. The Commission takes aggressive positions and consequently loses a substantial number of the enforcement matters that it litigates, especially cases litigated in the federal courts (as opposed to administrative proceedings). In addition, many counsel believe that the Commission is more likely to agree to less onerous settlement terms if the Staff believes that the alternative is litigation.

There are several reasons why companies tend to settle these proceedings. First, adverse findings at the conclusion of a litigated proceeding are likely to be binding upon the defendants in litigation brought by disgruntled shareholders. In the absence of a parallel criminal proceeding, the Staff ordinarily will agree to a settlement in which the defendant-respondent neither admits nor denies the allegations of wrongdoing. n8 Second, litigation with the SEC can impose substantial burdens on the time and energy of corporate executives. Third, if the company and the Staff agree to settlement terms, the Staff ordinarily will provide the company's counsel with an opportunity to discuss language in the complaint or order to be issued in connection with the settlement.

The company should assess whether settlement is in the company's interest and the best time to initiate settlement discussions. Sometimes, an early settlement offer can prompt the Staff to focus and expedite its investigations. While the SEC's rules suggest that the Staff can negotiate a settlement only if the Commission authorized such negotiations (which the Commission ordinarily does not do until it authorizes institution of an enforcement action), defense counsel can initiate settlement discussions at any time. In order for the company to make an informed decision, the company will need the assistance of counsel who can gather and assess the relevant information and advise the company regarding the likely consequences of alternative courses of action. Chapter 17 discusses settlements.

FOOTNOTES:

(n1)Footnote 1. Indictment, United States v. Ralphs Grocery Company, CR No. 05-CR-1210 ALL (C.D. Calif. 12/15/05) (indictment *available at* www.usdoj.gov/USAAO/cac/pr2005/171.htm).

(n2)Footnote 2. SEC Enforcement Manual at 123, available at <http://www.sec.gov/divisions/enforce/enforcement-manual.pdf>.

(n3)Footnote 3. The Department of Justice has taken similar steps. In a January 20, 2003 memorandum, Deputy Attorney General Larry Thompson issued a memorandum setting forth factors that prosecutors should consider in deciding whether to bring criminal charges against a business corporation. In Part IV of the memorandum, "Cooperation and Voluntary Disclosure," the Deputy Attorney General stated that one of those factors is whether the company "failed to promptly disclose illegal conduct known to the organization."

(n4)Footnote 4. *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Rel. No. 44969, 2001 SEC LEXIS 2210*, AAER No. 1470 (Oct. 23, 2001) (the "Seaboard § 21(a) Report").

(n5)Footnote 5. *In re Gisela de Leon-Meredith, Exchange Act Release No. 44970, 2001 SEC LEXIS 2197* (Oct. 23, 2001).

(n6)Footnote 6. A more detailed discussion of the Seaboard § 21(a) Report and related matters is set forth in Chapter 17.

(n7)Footnote 7. The SEC has cited a company's cooperation as a basis for not imposing harsher sanctions on the company. *See e.g.*, "SEC Charges Three Officers of Metlife Inc. Subsidiary New England Financial With Fraudulent Scheme to Hide Expenses," Litig. Rel. No. 19656 (Apr. 13, 2006) (announcing that SEC 'would not bring any enforcement action against MetLife or NEF because of MetLife's extensive cooperation in the Commission's investigation"); "AIG to Pay \$800 Million to Settle Securities Fraud Charges by SEC," News Release No. 2006-19, 2006 SEC NEWS LEXIS 289 (Feb. 9, 2006) (citing AIG's "complete cooperation"); "SEC Charges Former Executives

of Electro Scientific Industries, Inc. With Financial Reporting Fraud; SEC Also Brings Enforcement Action Against Former General Counsel of ESI," *Litig. Rel.No. 18896, 2004 SEC LEXIS 2205* (Sept. 24, 2004) (no enforcement action against company because its swift, extensive, and extraordinary cooperation in the Commission's investigation); "SEC Charges Royal Ahold and Three Top Executives with Fraud," *Litig. Rel. No. 18929, 2004 SEC LEXIS 2330* (Oct. 13, 2004) (imposing no monetary penalty on Royal Ahold). The SEC has cited a company's lack of cooperation in imposing substantial monetary penalties as part of settling with a company. *See, e.g., Bank of America Securities LLC, SEC Admin. Proc. File No. 3-11425, 2004 SEC LEXIS 548* (Mar. 10, 2004) ; "Xerox Settles SEC Enforcement Action Charging Company with Fraud," *SEC Release 2002-52, 2002 SEC LEXIS 896* (April 11, 2002) (explaining that record \$10 million monetary penalty "reflects, in part, a sanction for the company's lack of full cooperation in the investigation"); "Dynergy Settles Securities Fraud Charges Involving SPE's, Round-Trip Energy Trades," *Litigation Release No. 17744, 2002 SEC LEXIS 2415* (Sept. 25, 2002) (explaining that \$3 million monetary penalty "reflects the Commission's dissatisfaction with Dynergy's lack of full cooperation in the early stages of the Commission's investigation."). However, many counsel question whether the SEC gives significant credit for cooperation. *See e.g.,* comments of Thomas Newkirk cited in "D.C. Bar Panelists Share Experiences With Internal Investigations," 2006-89 SEC Today 1 (May 9, 2006).

(n8)Footnote 8. *17 C.F.R. § 202.5(d)* states in part:

[I]t is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact, occur. Accordingly, [the Commission] hereby announces its policy not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings. In this regard, the Commission believes that a refusal to admit the allegations is equivalent to a denial, unless the defendant or respondent states that he neither admits nor denies the allegations.



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CHAPTER 3 OVERVIEW OF SEC ENFORCEMENT INVESTIGATIONS

1-3 Securities Enforcement: Counseling and Defense § 3.05

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§ 3.05 Identification of Whistleblowers

Company management often will be interested in whether a communication from a corporate employee prompted the investigation. In most instances, a company should refrain from investigating whether any current employee complained to the SEC about that company. The SEC Staff might react unfavorably if it learns that the company is trying to identify who alerted the SEC to a suspected problem. In addition, once a company has identified an individual as having contacted the SEC Staff to express concerns regarding the company's disclosures, the protections available to whistleblowers will likely make it difficult for the company to take an action adverse to the employee. The Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010 afford protections to whistleblowers. n1

Comment

Because of the substantial criminal and civil liabilities that can be triggered if a company or individual is found to have retaliated against a whistleblower, a company should consult closely with counsel before taking any adverse action against a person suspected of having provided information to, or otherwise having assisted, a law enforcement investigation.

FOOTNOTES:

(n1)Footnote 1. Sarbanes-Oxley Act § 806, codified at *18 U.S.C.S. § 1514* (damage remedy); Sarbanes-Oxley Act § 1107, codified at *18 U.S.C.S. § 1513(e)* (criminal penalties); Dodd-Frank Act § 922, creating Section 21F of the Exchange Act.



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CHAPTER 3 OVERVIEW OF SEC ENFORCEMENT INVESTIGATIONS

1-3 Securities Enforcement: Counseling and Defense § 3.06

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§ 3.06 Impact of an Investigation on SEC Processing of Registration Statements

The Division of Corporation Finance is responsible for processing registration statements. If there is an ongoing SEC investigation of a company's financial statements or other disclosure, the Division of Corporation Finance typically promptly forwards to the Enforcement Staff any information that the company provides to the Division of Corporation Finance in connection with the registration statement.

In deciding how to process a registration statement, the Division of Corporation Finance will consider the status and subject matter of the investigation and the nature and extent of the disclosure already made. In some circumstances (e.g., where the Enforcement Staff is investigating financial statements that already have been restated), the Division of Corporation Finance might conclude that the investigation does not pose an obstacle to processing the registration statement. In other circumstances, the Division of Corporation Finance may consider it appropriate for the issuer to disclose the fact of the investigation and the facts and circumstances relating to the investigation.

In processing a registration statement, the Division of Corporation Finance often carves out (i.e., does not comment on) disclosures that relate to the subject matter of a formal or informal SEC investigation. When the Division of Corporation Finance carves out a portion of the disclosure filing, the comment letter it issues typically will state that because the Enforcement Staff is currently conducting an investigation (inquiry), the Division of Corporation Finance is unable to review or comment on those matters that are the subject of the investigation and that the comment letter should not be construed as a finding by it that the carved-out disclosures are appropriate. Often, the Division also includes in the comment letter a statement urging the person responsible for the carved-out material to take the steps necessary to ensure that the disclosure filing includes all matters of which an investor should be informed.

In some instances the Division of Corporation Finance issues a "Tandy Letter." The term "Tandy Letter" dates to 1976 and is derived from the name of the first issuer to receive such a letter. The Tandy Letter typically: (1) states that any information that the Division of Corporation Finance obtains in connection with the comment process may be forwarded to the Enforcement Staff; (2) asks that the issuer acknowledge that the issuer is responsible for the disclosure in the registration statement; and (3) asks the issuer to represent that if the Division of Corporation Finance accelerates the effective date of the registration statement, the issuer will not assert the acceleration as a defense in any proceeding initiated by the Commission or any person under the federal securities laws.

In other instances, the Division of Corporation Finance decides that it is not appropriate to accelerate the effective date of the registration statement. In these instances, the Commission may decline to accelerate the effective date of the registration statement or may authorize the Enforcement Staff to seek a stop order precluding the sale of securities pursuant to the registration statement. In addition, a pending SEC investigation can discourage the participants necessary to an offering: Directors might hesitate to sign the company's registration statement; auditors might hesitate to sign the necessary consents and assurances; investment banks might hesitate to underwrite the securities.

An SEC investigation can make it difficult for a public company timely to file its quarterly or annual report. In light of the uncertainties raised by an SEC investigation, management sometimes hesitates to cause a company to file its periodic report. Even if management is otherwise willing to file the company's report, the company's auditors might hesitate to sign off on its review of the company's quarterly financial statements or audit of the company's annual financial statements. Failure to timely file a periodic report can have a number of consequences. n1

In evaluating the terms of a potential settlement, the company should consider the collateral effects that certain settlements can have on the company or its affiliates. For example, the company might be foreclosed from taking advantage of certain safe harbors from the registration requirements of the Securities Act or may be required to disclose negotiated settlements in registration statements and proxy materials.

FOOTNOTES:

(n1)Footnote 1. See R. Hanson, D. Lee, M. Morrow, "Consequences of Untimely Periodic Reports under the Exchange Act," 21 Insights No. 3 at 8 (Aspen Publishers March 2007).



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Securities Enforcement: Counseling and Defense

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CHAPTER 3 OVERVIEW OF SEC ENFORCEMENT INVESTIGATIONS

1-3 Securities Enforcement: Counseling and Defense § 3.07

AUTHOR: Kenneth B. Winer Samuel J. Winer

§ 3.07 REPRESENTATION OF INDIVIDUALS

An SEC investigation can have a severe adverse impact on an individual, including an individual who initially believed that the SEC investigation posed little or no risk. An SEC investigation can jeopardize an individual's reputation and career opportunities. The cost of responding to an SEC investigation can be financially devastating. Accordingly, it is often prudent for an individual to consult with experienced SEC defense counsel before answering questions posed either by the SEC Staff or attorneys conducting an internal investigation on behalf of the company.

It is often appropriate for defense counsel to perform several tasks when retained by an individual who has been asked, or experts to be asked, to provide information in connection with an SEC investigation. If the individual has already given testimony to the SEC, counsel will generally be able to obtain a copy of the transcript of the individual's testimony. n1 In the rare circumstances where counsel cannot obtain a copy of the transcript, he should be able to obtain an opportunity to review at the SEC offices the transcript and the testimony exhibits n2. If the witness has been interviewed, it is likely to be difficult to obtain copies of any notes or memoranda of the interview, especially if the interview was recent. It is therefore important to work with the individual to prepare a memorandum as soon as possible summarizing the questions posed and the answers provided in the interview.

Counsel should attempt to obtain information in order to ascertain the individual's exposure. In addition to interviewing the individual and reviewing the individual's documents, counsel can review relevant media reports and SEC filings. Counsel can also discuss with the individual whether counsel should reach out to other counsel involved in the matter, including relevant company counsel. Other counsel can be extremely useful in providing insights into the risks posed by the investigation and in providing copies of, or access to, relevant documents. If counsel to the individual talks to other counsel, they are likely to pose questions to the individual's counsel. Before sharing information with other counsel, counsel to the individual should discuss with the individual the extent to which it is appropriate to share information with other counsel.

To the extent that counsel to other individuals or entities offer to provide copies of, or access to relevant documents, it is often appropriate to act on the offer speedily. Investigations are fluid affairs and offers that are made might later be withdrawn.

If the company is conducting an internal investigation, it is often appropriate to seek information from the attorneys conducting the internal investigation. Some investigators believe that the investigation process is facilitated if a witness is provided a meaningful opportunity to prepare for the interview and that giving defense counsel access to documents and guidance regarding the investigators' concerns therefore improves both the quality of the investigation and the speed with which the investigation can be conducted.

Similarly, it might be possible to obtain useful information from members of the SEC Staff. While SEC Staff members are often reluctant to provide individuals with advance access to documents produced to the Staff by other individuals and entities, the Staff sometimes provides valuable guidance regarding their current view of the matter.

In many instances, a company will agree to indemnify officers and employees for reasonable legal fees generated in responding to an investigation relating to the company's disclosure or practices subject to the officer or employee signing an undertaking. Indeed, the by-laws of the company may require that the company indemnify officers for reasonable legal fees and other expenses incurred as a result of an SEC investigation regarding the company's disclosures or conduct. Counsel should review the undertaking and be prepared to negotiate with the company over the terms, if appropriate.

In addition, it is sometimes good to review the company's D & O liability policy to assess whether coverage is available. If it looks like coverage is available, it might be appropriate to discuss with company counsel whether appropriate notice has been provided to the insurance company.

If the individual is asked to produce documents, counsel should advise the individual on whether to comply with the request. If the SEC issues a subpoena calling for the individual's documents, it might be appropriate to discuss the rights of the individual under the *Fifth Amendment*.ⁿ³ If the witness decides to produce documents, counsel should consider assisting the individual in ensuring that the search was reasonable and that all responsive, non-privileged documents are being produced.ⁿ⁴

If the witness is asked to submit to an interview, counsel should assist the individual in deciding whether to agree to an interview and in negotiating the terms. If the witness is subpoenaed for testimony, it might be appropriate to discuss with the individual the rights of the individual under the *Fifth Amendment*.ⁿ⁵ If the individual decides to proceed with the interview or testimony, counsel should assist the individual in preparing for the interview or testimony.ⁿ⁶ In many instances, it may be appropriate before the testimony or interview for counsel to communicate directly with the SEC Staff who are expected to conduct the interview or take the testimony, regarding both procedural matters and the substance of the expected interview or testimony.

Under SEC rules, a witness has a right to be accompanied by counsel in an interview or testimony. In most instances, it is appropriate for defense counsel to participate in the individual's interview or testimony.ⁿ⁷

It may also be appropriate to talk with the SEC Staff following the testimony or interview. While the Staff is often reluctant to provide meaningful feedback, the Staff will sometimes review issues of concern that are best addressed promptly. In addition, for some individuals (executive officers of a public company, securities personnel associated with a broker-dealer), a Wells Call can have significant adverse consequences. Especially in such circumstances counsel should consider (1) submitting to the Staff a whitepaper explaining why the Staff should not decide to issue a Wells Call and (2) urging the Staff to talk to defense counsel before reaching a decision to make a Wells Call.

If the Staff issues a Wells Call, defense counsel should assist the individual in deciding whether to file a Wells Submission and should represent the individual through the Wells Process.ⁿ⁸

Throughout the investigation, if it appears that the individual is a potential defendant, counsel should assist the individual in deciding whether and when to pursue settlementⁿ⁹. Similarly, if it appears that the individual has criminal

exposure, counsel should advise the individual on how best to contain that exposure. n10

FOOTNOTES:

(n1)Footnote 1. *17 C.F.R. 203.6.*

(n2)Footnote 2. *17 C.F.R. 203.6.*

(n3)Footnote 3. The *Fifth Amendment* right against self-incrimination is discussed in Chapter 13.

(n4)Footnote 4. The Production of Documents is discussed in Chapter 9.

(n5)Footnote 5. The *Fifth Amendment* right against self-incrimination is discussed in Chapter 13.

(n6)Footnote 6. The process of preparing for testimony and interviews is discussed in Chapter 10.

(n7)Footnote 7. The role of defense counsel at an SEC interview or testimony is discussed in Chapter 10.

(n8)Footnote 8. The Wells Process is discussed in Chapter 18.

(n9)Footnote 9. The Settlement process is discussed in Chapter 17

(n10)Footnote 10. The Criminal process is discussed in Chapter 23.



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CHAPTER 4 THE SEC ENFORCEMENT PROGRAM

1-4 Securities Enforcement: Counseling and Defense 4.syn

AUTHOR: Kenneth B. Winer

§ 4.syn Synopsis to Chapter 4: THE SEC ENFORCEMENT PROGRAM

§ 4.01 Introduction

§ 4.02 Financial Fraud and Accounting

§ 4.03 Insider Trading

§ 4.04 Offerings

§ 4.05 Regulated Entities

§ 4.06 Other Enforcement Programs

Kenneth B. Winer



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CHAPTER 4 THE SEC ENFORCEMENT PROGRAM

1-4 Securities Enforcement: Counseling and Defense § 4.01

AUTHOR: Kenneth B. Winer

§ 4.01 Introduction

Each year the SEC conducts hundreds of investigations into possible violations of the federal securities laws. In recent years, the SEC has brought approximately 500 enforcement actions each year, counting each filed case as one action regardless of the number of defendants or respondents. In fiscal 2009, the Division of Enforcement reported 664 enforcement actions compared to 671 enforcement actions in fiscal 2008, 656 in fiscal 2007, 574 in fiscal 2006, 630 in fiscal 2005, 639 in fiscal 2004, 679 in fiscal 2003, 598 in fiscal 2002, and 503 in fiscal 2000.

Set forth below is a breakdown of the SEC Enforcement program by topic:

| | FY05 | FY06 | FY07 | FY08 | FY09 |
|---|------|------|------|------|------|
| Financial Disclosure | 29% | 24% | 33% | 23% | 22% |
| Investment Advisers and Investment Companies | 16% | 16% | 12% | 13% | 12% |
| Broker Dealers | 15% | 13% | 14% | 10% | 16% |
| Securities Offerings | 9% | 11% | 10% | 17% | 21% |
| Insider Trading | 8% | 8% | 7% | 9% | 6% |
| Market Manipulation | 7% | 5% | 5% | 8% | 6% |
| Delinquent Filings | | 16% | 8% | 17% | 14% |
| Other | 16% | 7% | 11% | 3% | 3% |

Source: U.S. Securities and Exchange Commission, 2009 Performance and Accountability Report (available at <http://www.sec.gov/about/secpar/secpar2009.pdf#2009review>).

Members of the SEC enforcement staff historically tend not to specialize in one or more specific categories. Rather, they each tended to pursue a number of matters in a variety of categories. In addition, a matter that begins with one

1-4 Securities Enforcement: Counseling and Defense § 4.01

focus can transform to include one or more other focuses. For example, an investigation into financial fraud and reporting can expand to include a focus on insider trading. Nevertheless, it is often helpful for defense counsel to understand the traditional areas of recurring emphasis in order to anticipate the likely direction of the investigation.

In 2010, the Enforcement Division established national specialized units in each of five priority areas: asset management; market abuse; structural and new products, the FCPA; and municipal securities and public pensions.



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CHAPTER 4 THE SEC ENFORCEMENT PROGRAM

1-4 Securities Enforcement: Counseling and Defense § 4.02

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§ 4.02 Financial Fraud and Accounting

The largest component of the SEC enforcement program focuses on frauds involving false information regarding a company's financial condition, performance or prospects in the company's periodic filings, news releases, and other disclosures. These investigations usually involve companies whose securities are registered with the Commission or companies that are selling securities to individual investors. In the wake of Enron and Worldcom, the SEC views its investigations of financial fraud and accounting as essential to restoring confidence in the adequacy and accuracy of information that investment decisions are based on and that drive the country's capital markets. Accordingly, the SEC is opening these investigations at a record pace and seeking much more aggressive remedies.

Investigations into a company's disclosures of its financial condition or performance are often complex, document intensive, and require extensive staff resources. The Commission brings disclosure cases against--among others--issuers, underwriters, accounting firms and/or their employees. The SEC often brings actions against companies for fraud, false filings (including financial statements, other financial information, and the management discussion and analysis), failure to establish and maintain an adequate system of internal accounting controls, and failure to make and keep books and records that accurately and in reasonable detail describe the dispositions of the company's assets. The SEC often brings actions against company personnel for fraud or other violations of the federal securities laws. This includes aiding and abetting a company's violations, causing a violation, lying to the company's auditor, and (if the employee is an accountant or other professional) engaging in improper professional conduct. The SEC brings actions against auditors for fraud, aiding and abetting the violations of the audit client, causing the violations of the client, and improper professional conduct. The SEC also brings actions against third parties who aid and abet or otherwise cause an issuer to make materially false and misleading statements.

In these investigations, the Staff typically seeks documents from the company and the auditors and takes testimony from their personnel. The Staff also may seek documents and testimony from the company's customers, banks, and suppliers and from analysts who cover the company. For example, in an investigation involving revenue recognition the Staff might seek documents from the company, its auditor, and its customers and take testimony of senior executives, members of the accounting department, sales personnel, the customer's purchasing department, and the company's auditor.



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CHAPTER 4 THE SEC ENFORCEMENT PROGRAM

1-4 Securities Enforcement: Counseling and Defense § 4.03

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§ 4.03 Insider Trading

The Division of Enforcement has regularly devoted substantial resources to investigating and prosecuting individuals who engaged in insider trading. Such investigations typically account for 5-10% of the actions brought by the SEC. Violators include insiders (e.g., officers or directors), advisers (e.g., attorneys or investment bankers), and their tippees. In addition, the SEC investigates whether employers knew or recklessly disregarded the fact that an employee was likely to engage in unlawful insider trading and failed to take appropriate steps to prevent such act(s) before they occurred. n1

When beginning an investigation into suspected insider trading, the Staff will (1) identify the disclosure that moved the market (e.g., a merger announcement, an announcement of unexpected earnings, an announcement regarding problems with a product); (2) ask companies and individuals with knowledge of the disclosed matter to provide chronologies of the events leading up to the disclosure; (3) obtain from broker-dealers the identity of the customers who traded in the security in advance of the disclosure; (4) identify trades that appear to be suspicious; (5) seek evidence linking the traders to information regarding the events proceeding the disclosure; and (6) seek and attempt to rebut any exculpatory explanations for the trading. If some of the suspicious trading took place in foreign accounts, the Staff often will seek a court order, or an agreement, freezing assets in the trader's account.

FOOTNOTES:

(n1)Footnote 1. Section 21A of the Exchange Act, *15 U.S.C.S. § 78u-1*.



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CHAPTER 4 THE SEC ENFORCEMENT PROGRAM

1-4 Securities Enforcement: Counseling and Defense § 4.04

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§ 4.04 Offerings

The SEC also brings cases involving the offer and sale of securities in violation of the registration provisions of the Securities Act. A number of these cases involve the issuer's failure to register securities offerings, usually in reliance on an exemption to the registration requirements that the SEC believes is inapplicable under the circumstances. Offering cases often involve false or misleading disclosures concerning, among other things, use of proceeds, risks associated with investments, promised returns, success of prior offerings, and the financial condition or past performance of the issuer. The surge in cases involving securities offerings resulted in large part from the substantial number of Ponzi schemes uncovered in fiscal years 2008 and 2009.



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CHAPTER 4 THE SEC ENFORCEMENT PROGRAM

1-4 Securities Enforcement: Counseling and Defense § 4.05

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§ 4.05 Regulated Entities

Increasingly, the SEC brings enforcement proceedings against regulated entities (such as broker-dealers, investment advisers, and investment companies) and persons affiliated with such companies. n1 These proceedings range from fairly technical violations of one or more of the myriad regulations governing such entities to violations of the anti-fraud provisions of the federal securities laws. These investigations are often triggered by (1) a regulatory inspection in which significant deficiencies were noted; (2) a referral from an SRO or state regulator; (3) press reports; or (4) customer complaints. In conducting these inspections, the Staff may rely on the SEC's inspection powers to inspect the papers and the premises, may interview the personnel involved in the suspected activity, their supervisors, compliance personnel, customers, and counterparties. Historically, approximately 15% of the actions brought by the SEC involved broker-dealers.

The Commission brings enforcement actions against broker-dealers and persons affiliated with broker dealers for violations of the federal securities laws and the rules and regulations promulgated thereunder, including the rules of the SRO's of which the broker-dealer is a member. The investigation can involve the broker-dealers' sales practices, its trading practices, its research activities, the net capital rule, the customer protection rule, misappropriation of customer funds, credit extension rules, the books and records requirements and the reporting requirements.

The Commission brings enforcement actions against investment advisers and their affiliated persons for violations of the federal securities laws for using false testimonials or false and misleading advertisements, receiving performance fees, defrauding clients or prospective clients, and not maintaining the required books and records, and not filing the required reports.

The Commission also brings a number of enforcement actions against investment companies and their affiliated persons. These include, actions for failure by an investment company to register with the Commission, improper transactions or arrangements between investment companies and their affiliated persons, and personal trading by persons affiliated with investment companies.

SEC actions against regulated entities are characterized by a drive for increasingly harsh remedies. Monetary penalties are growing exponentially and the scope and length of suspensions is increasing. The SEC is also increasing its focus on

supervision. In virtually every investigation where it identifies violative conduct, the Enforcement Staff will scrutinize the quality of supervision.

The SEC Staff has conducted a number of enforcement initiatives in recent years with respect to the securities industry. In the wake of the Salomon Brothers' scandal regarding the government bond market, the SEC conducted a broad investigation into the practices of primary dealers in connection with the offerings of government and agency securities. The Enforcement Staff also has conducted investigations of the supervision of problem brokers at both large and small securities broker-dealers, the activities of securities broker-dealers in the municipal bond market, and the activities of market-makers in the Nasdaq Stock Market. More recently, the Enforcement Staff has investigated the activities of research departments of broker-dealers, activities of broker-dealers in connection with initial public offerings and activities of broker-dealers relating to the investment companies.

FOOTNOTES:

(n1)Footnote 1. Chapter 28 and Chapter 29 discuss these issues explicitly.



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CHAPTER 4 THE SEC ENFORCEMENT PROGRAM

1-4 Securities Enforcement: Counseling and Defense § 4.06

AUTHOR: Kenneth B. Winer

§ 4.06 Other Enforcement Programs

The SEC also brings cases involving alleged schemes to manipulate the securities markets. The Commission is charged with ensuring the integrity of the national securities markets, including both the exchanges and over-the-counter markets.

The SEC occasionally brings cases involving corporate control transactions (such as mergers and takeovers).

In addition to these staples of the enforcement program, the Division of Enforcement periodically targets an area of increased emphasis, such as mutual funds, initial public offerings, Nasdaq trading, foreign payments, government securities, financial institutions, insurance companies, municipal securities, penny stocks, the Internet, investment bank research departments, late trading in mutual funds, and market timing mutual funds.



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CHAPTER 5 THE FORMAL ORDER

1-5 Securities Enforcement: Counseling and Defense 5.syn

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§ 5.syn Synopsis to Chapter 5: THE FORMAL ORDER

§ 5.01 Power of the Securities and Exchange Commission to Conduct Investigations

§ 5.02 Issuance of a Formal Order

[1] Function of a Formal Order

[2] Format of a Formal Order

[3] Availability of a Formal Order

§ 5.03 Challenges to a Formal Order

Kenneth B. Winer
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CHAPTER 5 THE FORMAL ORDER

1-5 Securities Enforcement: Counseling and Defense § 5.01

AUTHOR: Kenneth B. Winer Joseph D. Edmondson, Jr.

§ 5.01 Power of the Securities and Exchange Commission to Conduct Investigations

Each of the federal securities statutes grants to the Securities and Exchange Commission ("SEC" or "Commission") broad statutory authority to conduct such investigations as it deems necessary to determine whether any person or entity has violated or is about to violate that statute or the regulations promulgated thereunder. n1 These statutes vest "the SEC with broad authority to conduct investigations into possible violations of the federal securities laws and to demand production of evidence relevant to such investigations." n2 For example, the Securities Exchange Act of 1934 grants to the Commission "or any officer designated by it" the power to "subpoena witnesses, compel their attendance, take evidence, and require the production of books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry." n3 The United States Supreme Court has characterized these powers as "expansive." n4 In addition, the Exchange Act authorizes the Commission to obtain trading information from any broker or dealer either registered in the United States or transacting business through a registered broker-dealer. n5

FOOTNOTES:

(n1)Footnote 1. *See* Securities Act of 1933, § 20(a), 15 U.S.C.S. § 77t(a); Securities Exchange Act of 1934, § 21(a), 15 U.S.C.S. § 78u(a); Public Utility Holding Company Act § 18(a), 15 U.S.C.S. § 79r(a); Trust Indenture Act § 321(a), 15 U.S.C.S. § 77uuu(a); Investment Company Act § 42(a), 15 U.S.C.S. § 80a-41(a); Investment Advisers Act § 209(a), 15 U.S.C.S. § 80b-9(a).

(n2)Footnote 2. *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735, 741 (1984) . For a more extensive discussion of the power of the SEC to conduct investigations, see Chapter 6, *below*.

(n3)Footnote 3. Exchange Act § 21(b), 15 U.S.C.S. § 78u(b). *See also* Securities Act § 19(b), 15 U.S.C.S. § 77s(c); Investment Company Act § 42(b), 15 U.S.C.S. § 80a-41(b); Investment Advisers Act § 209(b), 80b-9(b).

(n4)Footnote 4. *O'Brien*, 467 U.S. at 743 .

(n5)Footnote 5. Exchange Act § 17, 15 U.S.C.S. § 78q.



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CHAPTER 5 THE FORMAL ORDER

1-5 Securities Enforcement: Counseling and Defense § 5.02

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§ 5.02 Issuance of a Formal Order

In some instances, an inquiry can proceed for months or for years without the Division of Enforcement Staff asking the Commission to delegate subpoena power to them. Indeed, the Staff might conduct and complete an enforcement probe without even converting an informal inquiry into a formal investigation. Historically, the SEC delegated subpoena power to the Staff by issuing a Formal Order of investigation. In August 2009, the Commission promulgated a rule - effective for one year - authorizing the Director of the Enforcement Division to issue a Formal Order of Investigation. n1 Robert Khuzami, the Enforcement Director, in turn delegated that authority to senior officers through the Division. n2 In order to reduce the risk that the Commission will issue such an order and in this fashion more deeply commit the Staff to the pursuit of a full-blown investigation, companies often cooperate voluntarily with the Staff during an informal inquiry. n3 One commentator who practices extensively before the Staff has identified a number of reasons why a company should try to keep an investigation informal:

Counsel should try to keep the investigation informal because in so doing, he has greater control over the scope and timing of the investigation. He also gains additional time to gather facts and has the opportunity to arrange off-the-record interviews and protect documents by arranging informal access and inspection. Moreover, absent a formal order, the necessity for disclosure of the existence of the inquiry may be reduced. Finally, informal inquiries are more likely to be closed at the staff level without recommendations of enforcement than are formal investigations. n4

In general, auditors will not voluntarily provide information and materials to the SEC without the explicit consent of the audit client. If the Commission's Staff requests that an auditor voluntarily produce materials, and the auditor declines to do so, the Commission will usually issue a Formal Order authorizing the Staff to issue subpoenas.

Comment

It usually is appropriate for the audit client to provide its consent to the auditor in order for the auditor to provide information and materials to the SEC.

[1] Function of a Formal Order

If any witness or person possessing relevant documents does not cooperate, the Staff is likely to seek subpoena power from the Commission, even if the company, its employees, and auditors are cooperating. In addition, the Staff often obtains a Formal Order in anticipation that subpoenas will be necessary because one or more witnesses will refuse to cooperate voluntarily and/or because it will seek telephone records (most of which require subpoenas), customer records from financial institutions, or assistance from foreign countries.

Through the Formal Order of investigation, the SEC designates Staff members as officers of the Commission and delegates to them the power to issue subpoenas. According to the Supreme Court, "The purposes of such an order seem to be to define the scope of the ensuing investigation and to establish limits within which the Staff may resort to compulsory process." n5 Once the Commission has issued the Formal Order, the Staff members named in the Formal Order as officers of the Commission have the power to issue subpoenas, without further authorization from the Commission.

A Formal Order "launches the formal investigation, defines its scope, and establishes limits within which investigative Staff may resort to process." n6 When the SEC investigation is closed, the Staff may no longer issue subpoenas or otherwise investigate matters described in the order. n7

In the ordinary course, the Staff does not provide advance notice to the persons being investigated of its intent to seek a Formal Order. Accordingly, counsel rarely has an opportunity to attempt to persuade the Commission that issuance of a Formal Order is inappropriate. After the Formal Order has been issued, the Staff will sometimes notify persons who have previously cooperated in the informal inquiry that a Formal Order has been issued. The extent to which the Staff provides such notice varies. Thus, if the case number assigned to a matter changes (e.g. from a number with a MHO prefix to a number with an HO prefix), counsel might wish to ask whether a Formal Order has been issued.

The Commission has the power to issue a Formal Order even if there is little or no evidence that the federal securities laws have been violated. The Formal Order merely authorizes the Staff to issue compulsory process in connection with the investigation; it does not constitute the institution of an adversarial proceeding.

Comment

In general, the decision of the SEC to issue a Formal Order should not be interpreted as indicating that the Staff has reached even a tentative conclusion that the federal securities laws have been violated.

[2] Format of a Formal Order

There are no statutory specifications regarding the format of a Formal Order. Generally, such an order contains only a limited amount of information regarding the scope of the investigation. The caption of the order will usually provide some information regarding the focus of the investigation. For example, if the Staff is focusing on possible misrepresentations by XYZ Corp. or the failure of the corporation to register securities issued in a public offering, the Formal Order is likely to be captioned "In the Matter of XYZ Corporation." If the Staff is focusing on trading in the stock of XYZ Corp., the Formal Order is likely to be captioned "In the Matter of Trading in the Securities of XYZ Corporation." Occasionally, the Staff will seek to amend a Formal Order if the subject of the investigation changes significantly.

The date of the Formal Order is typically the date on which the SEC authorized the issuance of the order. It is not unusual for two or more weeks to elapse between the Commission's authorizing the Formal Order and the actual issuance of the order.

A Formal Order usually contains only a broad and vague description of the conduct to be investigated.

Comment

The Commission's ability to bring an enforcement proceeding is not limited by the scope of a Formal Order. Thus, an investigation into insider trading could result in an enforcement action against the issuer alleging that the issuer made materially false or misleading announcements.

Although Formal Orders are often both vague and broad, it rarely is cost-effective to challenge a Formal Order on these grounds. When asserted, such challenges have met with little, if any, success in the courts. In *SEC v. Arthur Young & Co.*,ⁿ⁸ the Commission asked the federal district court to enforce a subpoenaⁿ⁹ issued to Arthur Young & Co. Arthur Young moved to quash on the grounds, among others, that the Formal Order authorizing the subpoena was fatally lacking in specificity. After discussing the scope of the order, the court rejected this argument.ⁿ¹⁰ As construed by the court, the order challenged by Arthur Young was typical in scope to many Formal Orders issued by the SEC. The Formal Order at issue discussed only the following representations in certain registration statements of a certain registrant:

- interest of management and others in certain transactions,
- financial statements,
- description of business and property, and
- acquisition or disposition of assets.

While these areas are broad, the Formal Order challenged in *Arthur Young* arguably was much more specific than some Formal Orders recently issued by the SEC, which the Staff has construed to include authorized investigations of virtually entire industries (e.g., the government securities industry, the municipal bond industry, or market makers in the Nasdaq Stock Market). Accordingly, it is possible that a challenge to one of the broad Formal Orders would be treated more favorably by the courts.

Comment

Even if this argument prevailed, however, the Commission would usually be able to amend the Formal Order to cure the deficiency without narrowing the effective scope of the investigation.

In recent years, the SEC has adopted a practice of issuing Formal Orders that purported to authorize the Staff to investigate entire industries (e.g., the government securities industry, the municipal bond industry, and Nasdaq market makers). In 1997, the Second Circuit upheld the validity of such a Formal Order.ⁿ¹¹ In *RNR Enterprises, Inc. v. SEC*,ⁿ¹² the Commission had issued a Formal Order authorizing the Staff to investigate the entire mobile telephone industry. Pursuant to this Formal Order, the Staff issued a subpoena to determine whether there had been violations of the federal securities laws in connection with an issuer that had not been established until after the issuance of the order. The recipient of the subpoena, arguing *pro se*, contended, among other things, that the Formal Order improperly encompassed an entire industry. Declaring that this argument was without merit, the Second Circuit held that the federal securities laws do not (1) preclude an industry-wide administrative investigation of possible securities law violations where, as set forth in the Formal Order, information before the SEC shows that violations of federal securities laws may have occurred on an industry-wide basis; or (2) require that the Formal Order identify by name a specific company or person suspected of violating the securities laws.

The Formal Order will also identify the Staff members designated as officers of the Commission in connection with the investigation. Usually, the order will identify a number of Staff persons, including supervisory personnel, in addition to the Staff members expected to actively work on the investigation. Often, supplemental orders will be issued as new

Staff members are assigned to the investigation.

[3] Availability of a Formal Order

The SEC's Rules of Investigation provide for copies of the Formal Order to be made available to witnesses as follows:

Any person who is compelled or requested to furnish documentary evidence or testimony at a formal investigative proceeding shall, upon request, be shown the Commission's order of investigation. Copies of Formal Orders of investigation shall not be furnished, for their retention, to such persons requesting the same except with the express approval of officials in the Regional or District Offices at the level of Assistant Regional Director or District Administrator or higher, or officials in the Division or Divisions conducting or supervising the investigation at the level of Assistant Director or higher. Such approval shall not be given unless the person granting such approval, in his or her discretion, is satisfied that there exist reasons consistent both with the protection of privacy of persons involved in the investigation and with the unimpeded conduct of the investigation. n13

Upon receiving a subpoena from the SEC, counsel should write to the Assistant Director, or equivalent, supervising the investigation and ask for a copy of the Formal Order. Despite the grudging language of the rule, it is rare for the Staff to deny a request by counsel to a subpoenaed party for a copy of a Formal Order. The Staff will usually transmit the Formal Order shortly after receiving and granting the request. Some regional and district offices and some personnel in the home office will release a copy of the Formal Order only if the requestor agrees to certain limitations on the use of the order, such as an agreement that the requestor treat the Formal Order as a confidential document, and not disseminate the Formal Order to anyone except the requesting attorney's client(s). n14

FOOTNOTES:

(n1)Footnote 1. Release No. 34-60448 (Aug. 5, 2009), available at: www.sec.gov/rules/final/2009/34-60448.pdf.

(n2)Footnote 2. Robert Khuzami, "Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement," (August 5, 2009) available at: www.sec.gov/news/speech/2009/spch080509.htm.

(n3)Footnote 3. In addition, the SEC can obtain documents and information from regulated entities pursuant to its examination powers. Exchange Act § 17(b), 15 U.S.C.S. § 78q(b) (broker-dealers, registered securities associations, registered transfer agents, registered clearing agencies, and the Municipal Securities Rulemaking Board); Investment Company Act § 31(c) (registered investment companies).

(n4)Footnote 4. Wallace L. Timmeny, *SEC Proceedings: An Overview* (outline published in ALI-ABA Course of Study, Insider Trading, Fraud and Fiduciary Duty under the Federal Securities Laws, May 2, 1991).

(n5)Footnote 5. *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. at 738 n.1 .

(n6)Footnote 6. *SEC v. Jerry T. O'Brien, Inc.*, 704 F.2d 1065, 1066, n.1 (9th Cir. 1983) , citing *SEC v. Arthur Young & Co.*, 584 F.2d 1018, 1023 (D.C. Cir. 1978) .

(n7)Footnote 7. *Blinder, Robinson & Co. v. SEC*, 748 F.2d 1415, 1418 (10th Cir. 1984) .

(n8)Footnote 8. *SEC v. Arthur Young & Co.*, 584 F.2d 1018 (D.C. Cir. 1978) .

(n9)Footnote 9. The SEC's subpoenas are not self-enforcing. The ability to impose sanctions for noncompliance rests exclusively with the federal courts, not the Staff or the Commission. See § 6.03[2], below.

(n10)Footnote 10. *Arthur Young*, 584 F.2d at 1024-1026 .

(n11)Footnote 11. *RNR Enters., Inc. v. SEC*, 122 F.3d 93 (2d Cir. 1997) .

(n12)Footnote 12. *RNR Enters., Inc. v. SEC*, 122 F.3d 93 (2d Cir. 1997) .

(n13)Footnote 13. Rule 7(a), SEC Rules of Investigation, 17 C.F.R. § 203.7(a).

(n14)Footnote 14. *See, e.g., Enforcement Manual* § 2.3.4.2 at p. 22 (sample representations regarding preservation of confidentiality, which Staff may supply for inclusion in a written request for a copy of the Formal Order).



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CHAPTER 5 THE FORMAL ORDER

1-5 Securities Enforcement: Counseling and Defense § 5.03

AUTHOR: Kenneth B. Winer Joseph D. Edmondson, Jr.

§ 5.03 Challenges to a Formal Order

In general, the issuance of a Formal Order of investigation is not a final "agency action," and is not directly reviewable under § 10(c) of the Administrative Procedure Act. n1 There are very limited circumstances, however, under which a court will permit a Formal Order to be challenged. n2

FOOTNOTES:

(n1)Footnote 1. 5 U.S.C.S. § 551(13). See *Hunter v. SEC*, 879 F. Supp. 494 (E.D. Pa. 1995) (citing *FTC v. Standard Oil Co.*, 449 U.S. 232, 239 (1980) ; *Blinder, Robinson & Co. v. SEC*, 692 F.2d 102, 106 (10th Cir. 1982)) .

(n2)Footnote 2. See *Subpoenas and Their Enforcement*, § 6.03, below .



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CHAPTER 6 SUBPOENAS AND THEIR ENFORCEMENT

1-6 Securities Enforcement: Counseling and Defense 6.syn

AUTHOR: Kenneth B. Winer Joseph D. Edmondson, Jr.

§ 6.syn Synopsis to Chapter 6: SUBPOENAS AND THEIR ENFORCEMENT

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§ 6.02 Formal Orders of Investigation

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CHAPTER 6 SUBPOENAS AND THEIR ENFORCEMENT

1-6 Securities Enforcement: Counseling and Defense § 6.01

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§ 6.01 Introduction

It is difficult to challenge successfully a Securities and Exchange Commission investigation or the enforcement of an SEC subpoena. There are, however, limits on both the ability of the SEC to conduct an investigation and on its subpoena power. This chapter addresses the ability of the SEC and its Enforcement Staff to conduct an investigation and describes the subpoena process in detail; the issuance of subpoenas; the mechanism and standards for challenging the validity of an investigation; and the enforceability of a subpoena.



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CHAPTER 6 SUBPOENAS AND THEIR ENFORCEMENT

1-6 Securities Enforcement: Counseling and Defense § 6.02

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§ 6.02 Formal Orders of Investigation

The various federal securities laws authorize the Commission to conduct formal investigations of past, ongoing, or prospective violations of the securities laws and to issue subpoenas for witnesses and documents. n1 In formal investigations, the Commission typically delegates to specified members of the Staff the power to issue subpoenas for testimony and for documents. The Commission delegates this power by issuing a Formal Order of Investigation.

FOOTNOTES:

(n1)Footnote 1. *See* Chapter 5, *above*. For a sample subpoena, see *Enron Subpoena*, *below* in Appendix B.



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CHAPTER 6 SUBPOENAS AND THEIR ENFORCEMENT

1-6 Securities Enforcement: Counseling and Defense § 6.03

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§ 6.03 Subpoenas

[1] Procedural Aspects of Subpoena Issuance

Once the SEC has issued a Formal Order, any of the Staff members named therein as officers of the Commission can issue a subpoena calling for the production of documents and/or testimony, without obtaining any further authorization from the Commission. The process for serving an investigative subpoena is described in Rule 8 of the Commission's Rules Relating to Investigations n1 and Rule 150 of the Rules of Practice. Service shall be made by delivering a copy of the subpoena to the witness in one of the following ways:

(1) personal service -- handing a copy to the person required to be served; or leaving a copy at the person's office with a clerk or other person in charge thereof, or, if there is no one in charge, leaving it in a conspicuous place therein; or, leaving [a copy] at the person's dwelling house or usual place of abode with some person of suitable age and discretion then residing therein;

(2) mailing the papers through the United States Postal Service by first class, registered or certified, or Express Mail delivery addressed to the person;

(3) sending the papers through a commercial courier service or express delivery service; or

(4) transmitting the papers by facsimile transmission where the following conditions are met:

(i) the persons so serving each other have provided the Commission and the parties with notice of the facsimile machine telephone number to be used and the hours of facsimile machine operation;

(ii) the transmission is made at such a time that it is received during the Commission's business hours as defined in § 201.104; and

(iii) the sender of the transmission previously have not been served in accordance with § 201.150 with a written notice from the recipient of the transmission declining service by facsimile transmission.

n2

Where a person is represented by counsel and counsel has filed a notice of appearance, service shall be made upon counsel in the same manner unless service on the witness is ordered by the Commissioner or the hearing officer. n3 In most circumstances, the Staff serves a subpoena either by overnight delivery or registered mail to the witness or, if counsel to the witness agrees to accept service for the witness, by serving the subpoena on counsel.

The SEC has the ability to subpoena a person to appear anywhere in the United States: "[A]ttendance of witnesses and the production of [books, papers, correspondence, memorandum, and other records] may be required from any place in the United States or any State at any designated place of hearing." n4 Thus, the Division of Enforcement can subpoena a person to appear in Washington for testimony and production of documents even though the witness resides, transacts business, and was served hundreds, or even thousands, of miles away. n5

In many instances, however, the Staff will subpoena a witness to appear at a location that requires the Staff to travel. Even if the Staff subpoenas the witness to appear at the district or regional office where it is located the Staff will often agree, upon request by the witness and/or witness's counsel, to travel either to the city in which the witness is located or a nearby city in which the SEC has a regional or district office. n6

A witness summoned before the SEC is entitled to the same witness fees and mileage as witnesses in the courts of the United States. n7 The witness is also entitled to a subsistence allowance when required to remain away from home overnight. This rate is the same as that paid to federal employees. n8 Except in circumstances in which the witness does not have the money to finance travel costs, the SEC does not tender witness fees and reasonable travel expenses with the subpoena. n9 Rather, the witness may submit a claim for reimbursement after appearing for testimony. The SEC does not reimburse the witness for either the legal fees or the travel expenses incurred by counsel.

The Staff typically compels the production of documents by serving a subpoena *duces tecum*. Typically, the subpoena will call for the originals of documents, but the transmittal letter will state that the witness may instead maintain the originals and produce copies at his or her expense. n10

In March 2006, SEC Chairman Cox announced that the Commission would attempt to develop guidelines that address the issuance of investigative subpoenas to members of the press. This announcement followed a February 27, 2006 statement by Chairman Cox regarding subpoenas that the Commission had issued seeking information from two Dow Jones columnists. Chairman Cox stated that "[u]ntil the appearance of media reports this weekend, neither the Chairman of the SEC, the General Counsel, the Office of Public Affairs, nor any Commissioner was apprised of or consulted in connection with a decision to take such an extraordinary step. The sensitive issues that such a subpoena raises are of sufficient importance that they should be, and will be, considered and decided by the Commission before this matter proceeds further." n11 Although Chairman Cox's statement establishes a precedent that certain sensitive subpoenas should be pre-cleared, the scope of the precedent is unclear.

On April 12, 2006, the Commission issued a "Policy Statement of the Securities and Exchange Commission Concerning Subpoenas to Members of the Press." n11.1 The policy statement set forth procedures for the Staff to follow before issuing a subpoena to a member of the news media.

[2] Enforcement Proceedings

SEC subpoenas are not self-enforcing. If the subpoenaed person refuses to comply with the subpoena, the SEC must apply to the appropriate United States district court for an order compelling compliance. The Supreme Court, in *SEC v. Jerry T. O'Brien, Inc.*, n12 stated that "[s]ubpoenas issued by the Commission are not self-enforcing, and the recipients thereof are not subject to penalty for refusal to obey." n13 The Court went on to state that "the Commission is authorized to bring suit in federal court to compel compliance with its process." n14

Typically, the relief granted by the court is an order compelling compliance with the subpoena. In addition, if the

subpoenaed party's opposition was frivolous, presumably compensation is available under *Federal Rule of Civil Procedure 11*. It is also possible, although extremely rare, for a failure to comply with a subpoena to be treated as a misdemeanor. The federal securities laws make it a misdemeanor, punishable by imprisonment of one year or a \$1,000 fine (or both), if a person "without just cause, fail[s] or refuse[s] to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, and other records, if in his power to do so, in obedience to the subpoena." n15

The SEC has several choices when deciding where to bring the subpoena enforcement action. The SEC may bring a proceeding to enforce a subpoena issued pursuant to the Exchange Act of 1934 in any federal district court within the jurisdiction in which the respondent is found or resides. n16 A proceeding pursuant to the Exchange Act, the Investment Company Act, or the Investment Advisers Act may be brought in any United States district court within the jurisdiction in which the investigation is being conducted or in which the respondent resides or is conducting business. n17 The federal courts have exclusive jurisdiction over actions to challenge SEC subpoenas. State courts lack the power to enforce or enjoin compliance with an SEC subpoena. n18 If a subpoenaed witness refuses to comply with a federal court's order requiring compliance with the terms of the subpoena, that person may be held in contempt.

An additional concern for a subpoenaed party is that the filing of an SEC enforcement proceeding can generate extensive negative publicity. The SEC's application for an order compelling compliance with the subpoena is a public document. The application will often underscore the seriousness of the possible misconduct being investigated by the Staff and the importance of the information possessed by the subpoenaed person to an understanding of such misconduct. It will fully describe the witness's refusal to produce this important information. Accordingly, institution of the enforcement proceeding often results in negative publicity regarding the subpoenaed party.

The Commission has delegated to the Staff the authority to file a subpoena enforcement action. n19 Any decision instituting such a proceeding requires the involvement of senior members of the Enforcement Staff.

Courts frequently order enforcement of SEC subpoenas. The Second Circuit, in *SEC v. Brigadoon Scotch Distributing Co.*, n20 stated that "[t]he Commission must be free without undue interference or delay to conduct an investigation which will adequately develop a factual basis for a determination as to whether particular activities come within the Commission's regulatory authority." n21

The Second Circuit has noted that SEC "enforcement proceedings may be summary in nature, and it is within the discretion of the district court to determine whether or not an evidentiary hearing is required." n22 The court further stated that "[a]n evidentiary hearing is not required in the absence of a meaningful and substantial factual showing." n23

In *SEC v. Howatt*, n24 the First Circuit held that no evidentiary hearing was needed where there was no meaningful evidence that the government was exceeding or abusing its authority. Similarly, the Fifth Circuit, in *United States v. Newman*, n25 noted that to require a hearing the "summoned party must raise ... substantial deficiencies in the summons proceedings."

On the other hand, courts "[have recognized] that discovery may be available in some subpoena enforcement proceedings where the circumstances indicate that further information is necessary for the courts to discharge their duty." n26 In *SEC v. Wheeling-Pittsburgh Steel Corp.*, n27 the Staff commenced an investigation at the request of a United States Senator, acting at the urging of a constituent who happened to be a competitor of Wheeling-Pittsburgh Steel Corp. Wheeling-Pittsburgh requested discovery into the good faith of the Commission, and the Third Circuit held that closely supervised discovery was appropriate given the showing made by the party resisting discovery. n28

Some courts have shown a reluctance to permit such discovery:

[D]istrict courts must be cautious in granting such discovery rights, lest they transform subpoena

enforcement proceedings into exhaustive inquisitions into the practices of the regulatory agencies. Discovery should be permitted only where the respondent is able to distinguish himself from "the class of the ordinary [respondent]" ... by citing special circumstances that raise doubts about the agency's good faith. Even then, district courts must limit discovery to the minimum necessary in the interest of justice by requiring specific interrogatories or affidavits rather than "full-dress discovery and trial." n29

In *SEC v. Cahan & Co.*, n30 the district court considered a motion to intervene in an SEC subpoena enforcement proceeding. The SEC had issued a subpoena to an accounting firm seeking materials relating to certain clients of the firm, which refused to comply with the subpoena because the clients had directed it not to comply. The SEC filed an application to enforce the subpoena, and the clients moved to intervene. The district court noted that:

(1) [i]ntervention under *Federal Rule of Civil Procedure 24* in a subpoena enforcement action is permissive only, not mandatory;

(2) [d]etermination of whether a party should be permitted to intervene requires a court to balance the opposing equities; and

(3) [t]he party seeking to intervene bears the burden of showing that the above balance tips in its favor. n31

The court stated, "Factors to be considered when balancing the equities are whether the party seeking intervention has a significant protectable interest in the material sought, whether the proposed intervenors' interest would be adequately represented, whether the material is privileged, and the interest of the agency requesting the material." n32 The court denied the motion to intervene on the grounds that the movants "cannot show that they have a significant protectable interest in this enforcement action." n33

[3] Ability to Challenge an SEC Subpoena

Absent specific statutory authority, such as found under the Right to Financial Privacy Act, n34 subpoena recipients have little ability to challenge an SEC subpoena in advance of an action by the SEC to enforce it. Some courts have indicated that persons may not institute an action to contest the validity of an agency summons in advance of an action by the agency to enforce it. In *Reisman v. Caplin*, n35 for example, the Supreme Court held that since the opportunity to raise defenses in a subpoena enforcement action constitutes an adequate legal remedy, an investigative subpoena cannot be challenged until the issuing agency seeks to enforce the subpoena. Similarly, the district court in *Bird v. SEC* n36 held that a subpoenaed party cannot maintain an injunctive action challenging the validity of an SEC subpoena because the same issue can be raised in a Commission subpoena enforcement action. n37

Similar views have been expressed by various district courts, declaring that resisting the SEC's application for enforcement of a subpoena is "the exclusive procedure for the interposition of good faith objections to the validity of an investigative subpoena [and] ... [t]he witness may not properly move to quash the subpoena in advance of enforcement proceedings." n38 Additionally, courts have found that they have no jurisdiction to hear complaints regarding SEC subpoenas prior to enforcement, stating that any objections may only be brought when defending an enforcement action. n39 Nevertheless, a few courts have held that in situations where successful defense of a subpoena enforcement action would not prevent the harm, a witness may seek court protection in advance of the action.

In *Ayers v. SEC*, n40 for example, the plaintiffs alleged that they would suffer irreparable harm as a result of third parties such as bankers, joint venturers, and accountants producing trade secrets and SEC investigators implying that the plaintiffs were guilty of fraud and wrongdoing. The court ruled that it had jurisdiction to stay the investigation so long as the plaintiffs could meet the threshold requirement that irreparable harm would occur absent the stay. Here, the potential danger to Ayers's business reputation was sufficient to warrant a stay. n41 The court in *International Waste Controls, Inc. v. SEC* n42 stated that courts have jurisdiction to enjoin SEC investigations where the Commission "has

plainly exceeded its statutory authority or threatens irreparable injury in clear violation of an individual's rights."

FOOTNOTES:

(n1)Footnote 1. *17 C.F.R. § 203.8.*

(n2)Footnote 2. Rule 150(c), SEC Rules of Practice, *17 C.F.R. § 201.150(c).*

(n3)Footnote 3. Rule 150(b), SEC Rules of Practice, *17 C.F.R. § 201.150(b).*

(n4)Footnote 4. *See, e.g., Exchange Act § 21(b), 15 U.S.C.S. § 78u(b).*

(n5)Footnote 5. *But see Bank of Am. Nat'l Trust & Sav. Ass'n v. Douglas, 105 F.2d 100, 107-108 (D.C. Cir. 1939)*, which involves an SEC subpoena served on a San Francisco bank that called for the production in Washington of a large volume of bank records. Finding that compliance with the subpoena would close the bank and that by transferring the production from Washington to San Francisco the SEC may carry on its investigation without unduly and unreasonably hampering the bank, the D.C. Circuit held that the subpoenas were unreasonable and would not be enforced.

(n6)Footnote 6. *See Chapter 2, above*, for the cities and states in which the SEC has regional and district offices.

(n7)Footnote 7. Rule 232(f), SEC Rules of Practice, *17 C.F.R. § 201.232(f).*

(n8)Footnote 8. *See 28 C.F.R. § 21.4(c).*

(n9)Footnote 9. Rule 232(d), SEC Rules of Practice, *17 C.F.R. § 201.232(d)* (requiring such a tender for any subpoena request by a party other than the government).

(n10)Footnote 10. A sample subpoena and transmittal letter is attached in Appendix B.

(n11)Footnote 11. P. Diamond, "SEC to Issue to Develop Guidelines on Issuing Subpoenas to Journalist," 38 Securities Regulation and Law Report 361 (BNA Mar. 6, 2006).

(n12)Footnote 11.1. Release No. 2006-55. (available at <http://www.sec.gov/news/press/2006/2006-55.htm>. *See also, Enforcement Manual* at § 3.2.6, pp. 49-51 (providing text of "Policy statement of the Securities and Exchange Commission concerning subpoenas to members of the news media," *17 C.F.R. § 202.10*).

(n13)Footnote 12. *SEC v. Jerry T. O'Brien, Inc., 467 U.S. 735 (1984)* .

(n14)Footnote 13. *467 U.S. 735, 741* .

(n15)Footnote 14. *467 U.S. 735, 741* .

(n16)Footnote 15. *See Exchange Act § 21, 15 U.S.C.S. § 78u(c). See also United States v. Smith, Litig. Rel. No. 4078, 1968 SEC LEXIS 1182 (S.D.N.Y. July 30, 1968)* , and *Litig. Rel. No. 4379, 1969 SEC LEXIS 1279 (S.D.N.Y. July 22, 1969)* .

(n17)Footnote 16. Exchange Act § 212, *15 U.S.C.S. § 78u(c).*

(n18)Footnote 17. Exchange Act § 21(c), *15 U.S.C.S. § 78u(c)*; Investment Company Act § 42(c), *15 U.S.C.S. § 80a-41(c)*; Investment Advisers Act § 209(c), *15 U.S.C.S. § 80b-9(c).*

(n19)Footnote 18. *See Boyce Box v. Amarillo Nat'l Bank*, [1979 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 96,905 (N.D. Texas 1979) (citing 15 U.S.C.S. § 78aa).*

(n20)Footnote 19. *See* 17 C.F.R. § 200.30-4(a)(10) (delegating authority to the Division of Enforcement).

(n21)Footnote 20. *SEC v. Brigadoon Scotch Distrib. Co.*, 480 F.2d 1047 (2d Cir. 1973) , *cert. denied*, 415 U.S. 915 (1974) .

(n22)Footnote 21. 480 F.2d at 1052-1053 . *See also* Utah-Ohio Gas & Oil, Inc. v. SEC, , [1979-1980 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 97,239 at 96,705 (D. Utah 1980)* (stating that "[f]or the court to exercise a day-to-day supervision of the investigatory activities of the Commission would be wasteful effort beyond both the intent of Congress and the inclination of this Court.").

(n23)Footnote 22. *SEC v. Knopfler*, 658 F.2d 25, 26 (2d Cir. 1981) , *cert. denied*, 455 U.S. 908 (1982) (citations omitted).

(n24)Footnote 23. *SEC v. Knopfler*, 658 F.2d 25, 26 (2d Cir. 1981) , *cert. denied*, 455 U.S. 908 (1982) (citations omitted).

(n25)Footnote 24. *SEC v. Howatt*, 525 F.2d 226, 229 (1st Cir. 1975) .

(n26)Footnote 25. *United States v. Newman*, 441 F.2d 165, 169 (5th Cir. 1971) .

(n27)Footnote 26. *SEC v. Dresser Indus., Inc.*, 628 F.2d 1368, 1388 (D.C. Cir. 1980) .

(n28)Footnote 27. *SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d 118 (3d Cir. 1981) (*en banc*).

(n29)Footnote 28. *SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d 118, 128 .

(n30)Footnote 29. *Dresser*, 628 F.2d at 1388 (citations omitted).

(n31)Footnote 30. *SEC v. Cahan & Co.*, 1995 U.S. Dist. LEXIS 11359 (E.D. Pa. Aug. 10, 1995) .

(n32)Footnote 31. *Cahan & Co.*, 1995 U.S. Dist. LEXIS 11359 at *3-4 .

(n33)Footnote 32. *Cahan & Co.*, 1995 U.S. Dist. LEXIS 11359 at *3-4 .

(n34)Footnote 33. *Cahan & Co.*, 1995 U.S. Dist. LEXIS 11359 at *5 .

(n35)Footnote 34. *See* § 6.07 below.

(n36)Footnote 35. *Reisman v. Caplin*, 375 U.S. 440 (1964) .

(n37)Footnote 36. *Bird v. SEC*, 1980 U.S. Dist. LEXIS 11799, [1980 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 97,506* (D.P.R. May 19, 1980) .

(n38)Footnote 37. *Bird v. SEC*, , [1980 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 97,506* (D.P.R. May 19, 1980) at 97,647 .

(n39)Footnote 38. *E.g., SEC v. Isbrandtsen*, 245 F. Supp. 518, 520 (S.D.N.Y. 1965) .

(n40)Footnote 39. *See, e.g., Fleet/Norstar Fin. Group, Inc. v. SEC*, 769 F. Supp. 19, 20 (D. Me. 1991) (holding that the court did not have subject matter jurisdiction to consider a bank's challenge to an investigative subpoena issued by the SEC, and that since the subpoena was not self-enforcing, the bank's objection could only be addressed in an enforcement action brought by the SEC).

(n41)Footnote 40. *Ayers v. SEC*, 482 F. Supp. 747, 751 (D. Mon. 1980) .

(n42)Footnote 41. *Ayers v. SEC*, 482 F. Supp. 747, 751 (D. Mon. 1980) .

(n43)Footnote 42. *Int'l Waste Controls, Inc. v. SEC*, 362 F. Supp. 117, 120 (S.D.N.Y. 1973) .



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CHAPTER 6 SUBPOENAS AND THEIR ENFORCEMENT

1-6 Securities Enforcement: Counseling and Defense § 6.04

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§ 6.04 Standards for Investigations

The Supreme Court has set forth two tests that courts apply in determining whether to enforce an SEC subpoena. While neither case directly involved the SEC, some courts still look to *United States v. Morton Salt Co.* n1 and *United States v. Powell* n2 for guidance. n3

[1] The *Morton Salt* Test

In *Morton Salt*, n4 the Supreme Court considered the power of an administrative agency to conduct investigations and compel the production of certain records and statements. The Federal Trade Commission ("FTC") sought to compel Morton Salt Co. to submit statements detailing compliance with an earlier court order. Morton Salt Co., in turn, complained that the agency had no authority to require such production, and refused to comply.

In holding that the FTC did, in fact, have the authority to conduct its investigation, the Court articulated a three-part test for determining whether a government investigation of a corporation violates the *Fourth Amendment* proscription of unreasonable searches and the *Fifth Amendment due process clause*. Under this test, an investigation is permissible where: "[1] the inquiry is within the authority of the agency, [2] the demand is not too indefinite and [3] the information sought is reasonably relevant." n5

[2] The *Powell* Test

Powell n6 involved a suit by the Internal Revenue Service ("IRS") to enforce its administrative subpoena calling for a taxpayer's records. In determining that the IRS subpoena in question should be enforced, the Supreme Court applied the following four-part test. It held that the subpoena should be enforced if:

- the investigation is being conducted pursuant to a lawful purpose,
- the investigation may be relevant to that purpose,
- the information sought is not already within the possession of the agency, and

- the administrative steps required have been followed. n7

The Court further stated that subpoenas issued for an improper purpose, or in bad faith, should not be enforced. To do so would constitute an impermissible abuse of its process, the Court said. The Court further noted that any witness making such a claim, however, bears the burden of showing either an improper purpose or bad faith. n8

[3] Applicability of Tests to SEC Subpoena Enforcement

While the Supreme Court has expressly declined to address whether a subpoena issued by the SEC must comport with the standards set forth in *Powell*, n9 a number of lower courts have applied at least one or the other of the two tests, or a variant thereof, to SEC subpoena enforcement actions. n10 For example, the Third Circuit noted in its *en banc* decision in *SEC v. Wheeling-Pittsburgh Steel Corp.* n11 that it requires compliance with the *Powell* n12 standards before ordering enforcement of an SEC subpoena.

FOOTNOTES:

(n1)Footnote 1. *United States v. Morton Salt Co.*, 338 U.S. 632 (1950) .

(n2)Footnote 2. *United States v. Powell*, 379 U.S. 48 (1964) .

(n3)Footnote 3. Enclosed in Appendix B is a Memorandum of the Securities and Exchange Commission in Support of its Application for an Order to Show Cause and For an Order Requiring Obedience to the Subpoena, that the Commission filed in December 2001 against Andrew Fastow, former CFO of Enron. In this Memorandum, the SEC articulated its understanding regarding the scope of its power to subpoena documents.

(n4)Footnote 4. *Morton Salt*, 338 U.S. 632 .

(n5)Footnote 5. 338 U.S. at 652 .

(n6)Footnote 6. *Powell*, 379 U.S. 48 .

(n7)Footnote 7. *Powell*, 379 U.S. 48, 57-58 .

(n8)Footnote 8. *Powell*, 379 U.S. 48, 58 .

(n9)Footnote 9. *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735, 747 n.18 (1984) (noting that "[s]ome lower courts have held or assumed that the SEC must satisfy these [*Powell*] standards in order to obtain enforcement of its subpoenas.").

(n10)Footnote 10. See, e.g., *RNR Enters., Inc. v. SEC*, 122 F.3d 93 (2d Cir. 1997) (applying *Powell*); *SEC v. Howatt*, 525 F.2d 226, 229 (1st Cir. 1975) (applying *Powell*); *SEC v. ESM Gov't Secs., Inc.*, 645 F.2d 310, 313-314 (5th Cir. 1981) (applying *Powell*); *SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d 118, 128 (3d Cir. 1981) (*en banc*) (applying *Powell*); *SEC v. Blackfoot Bituminous, Inc.*, 622 F.2d 512, 514 (10th Cir. 1980) (applying *Morton Salt*); *SEC v. Arthur Young & Co.*, 584 F.2d 1018, 1023-1024 (D.C. Cir. 1978) (applying *Morton Salt* as well as *Powell*); *SEC v. Brigadoon Scotch Distrib. Co.*, 480 F.2d 1047, 1055-1056 (2d Cir. 1973) (applying *Powell*); *SEC v. Wall St. Transcript Corp.*, 422 F.2d 1371, 1375 (2d Cir. 1970) (applying *Powell*); *SEC v. Cahan & Co.*, 1995 U.S. Dist. LEXIS 11359 (E.D. Pa. Aug. 10, 1995) ; *SEC v. Murray Dir. Affiliates, Inc.*, 426 F. Supp. 684, 686 (S.D.N.Y. 1976) . But cf. *In re EEOC*, 709 F.2d 392, 398 n.2 (5th Cir. 1983) (noting that standards for the Internal Revenue Service, like those developed in *Powell*, should not automatically apply to other agencies). See also *SEC v. Kanter*, 1998 U.S. Dist. LEXIS 10902 (N.D. ILL. 1998) (applying both *Morton Salt* and *Powell* tests); *SEC v. Orton*, 1996 U.S. App. LEXIS 28998 (10th Cir. 1996) (applying both *Powell* and *Morton Salt* tests).

(n11)Footnote 11. *SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d 118 (3d Cir. 1981) .

(n12)Footnote 12. *Powell*, 379 U.S. 48 .



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Securities Enforcement: Counseling and Defense

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CHAPTER 6 SUBPOENAS AND THEIR ENFORCEMENT

1-6 Securities Enforcement: Counseling and Defense § 6.05

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§ 6.05 Challenges to SEC Investigatory or Subpoena Power

The decisions in *Morton Salt* n1 and *Powell* n2 set forth several grounds on which to challenge the propriety of an SEC investigation or subpoena. A discussion of some of the more common challenges follows.

[1] Investigation Is Outside the Authority of the SEC

Successfully challenging an SEC investigation on the grounds that it exceeds the Commission's authority is difficult. While subpoenaed witnesses can assert that the SEC has exceeded the scope of its investigative authority, the Supreme Court, in *Oklahoma Press Publishing Co. v. Walling*, n3 stated that preliminary questions of coverage in the investigation of possible violations are to be determined by the agency. n4 Subsequent decisions show that where the Commission believes a matter comes within its authority, it will be given some latitude in investigating whether that belief is correct.

In *SEC v. Wall Street Transcript Corp.*, n5 the SEC was investigating whether a certain publishing company acted as an investment adviser within the meaning of the Investment Advisers Act. While the district court refused to enforce a subpoena addressed to the company on the grounds that the publication clearly was not an "investment adviser" within the meaning of the act, the appeals court reversed, stating that there was at least some doubt as to whether the company was an investment adviser, and that the SEC should be allowed to investigate even though the SEC had "not suggested that it now possesses evidence that the [company] is engaged in practices which would ultimately deny it the benefit of [an exclusion to the statutory definition of investment advisor]." n6

In *SEC v. Brigadoon Scotch Distributing Company*, n7 Brigadoon Scotch Distributing Co. resisted an SEC subpoena on the grounds that the investments being investigated, whiskey warehouse receipts, were not "securities" within the meaning of the federal securities laws. The Second Circuit held that while Brigadoon had raised serious questions as to whether the investments were securities, "it has long been settled that such issues are not to be decided in subpoena enforcement actions." n8 Similarly, the First Circuit, in *SEC v. Howatt*, n9 found that the issue of whether the transactions being investigated were within the Commission's jurisdiction was "murky" and held that the SEC should be permitted to investigate the question: "[Persons opposing an SEC subpoena] may not litigate questions having to do with the application and coverage of the federal securities laws before responding to subpoenas designed to produce the

very information that may be needed to shed light upon those questions." n10

[2] SEC Lacks Reasonable Cause to Conduct an Investigation

Case law indicates that the Commission can authorize an investigation without probable or even reasonable cause to believe that there has been a violation of the federal securities laws. In *Morton Salt*, n11 the Supreme Court stated that even if the agency request is motivated by "nothing more than official curiosity," the subpoena is enforceable because agencies have a legitimate interest in seeing that the law and the public interest are maintained:

Because judicial power is reluctant if not unable to summon evidence until it is shown to be relevant to issues in litigation, it does not follow that an administrative agency charged with seeing that the laws are enforced may not have and exercise powers of original inquiry. It has a power of inquisition, if one chooses to call it that, which is not derived from the judicial function. It is more analogous to the Grand Jury, which does not depend on a case or controversy for power to get evidence but can investigate merely on suspicion that the law is being violated, or even just because it wants assurance that it is not. When investigative and accusatory duties are delegated by statute to an administrative body, it, too, may take steps to inform itself as to whether there is probable violation of the law. n12

The First Circuit stated, in *SEC v. Howatt*, n13 that "[t]he Commission is not required ... to limit its investigations to those against whom 'probable' or even 'reasonable' cause to suspect a violation has been established."

While the D.C. Circuit has implied that the SEC is entitled to engage in "fishing expeditions," n14 that court also held that "[a] government investigation into corporate matters may be of such sweeping nature and so unrelated to the matter properly under inquiry as to exceed the investigatory power." n15

In *Blinder, Robinson & Co. v. SEC*, n16 an injunctive action was filed against the SEC, alleging that it had used a formal order to conduct a broad and sweeping fishing expedition for two years. It was further alleged that this investigation had injured Blinder, Robinson & Co.'s business, and that the grant of such unlimited power by the Commission violated Blinder, Robinson's *Fourth Amendment* rights. The action sought to restrain the SEC from continuing its investigation. The SEC moved to dismiss, arguing that injunctive relief was inappropriate because the opportunity to raise defenses in a subpoena enforcement proceeding constituted an adequate remedy at law. The SEC further argued that the issue was moot insofar as no subpoenas were then outstanding.

The court rejected the Commission's first argument, stating that "[w]here the challenge ... is that the SEC has exceeded its statutory powers, both in the scope of the investigation and the lack of time limitations, such challenges have been judicially recognized." n17 The court also rejected the SEC's second argument, stating that the SEC had not demonstrated that there was a reasonable expectation that the SEC's alleged wrongs would not be repeated. n18

[3] Investigation Conducted in Bad Faith or for Improper Purpose

There is substantial support for the argument that courts should not enforce a subpoena that was issued in bad faith or for an improper purpose. n19 The Second Circuit stated in *Brigadoon Scotch Distribution Company* n20 that courts will not enforce a subpoena "not issued in good faith." For example, the court noted that a subpoena issued for the purpose of harassing or pressuring a witness would not be enforced. n21

In *SEC v. ESM Government Securities*, n22 the company -- ESM Government Securities -- refused to comply with an SEC subpoena. The SEC brought a subpoena enforcement action, and ESM challenged the subpoena, alleging abuse of process. The company contended that the Staff had obtained access to its records under false pretenses. Citing to precedent indicating that agencies should not obtain information under false pretenses and that witnesses should not be penalized for cooperating with the government in good faith, the Fifth Circuit stated that government agencies should

not be permitted to abuse the sense of trust between the government and the people and that "fraud, deceit or trickery is grounds for denying enforcement of an administrative subpoena." n23

Wheeling-Pittsburgh Steel Corp. n24 involved an attempt by the SEC to enforce a subpoena against the president of Wheeling-Pittsburgh Steel Corp. As discussed *above*, n25 the president of the company argued that the subpoena was unenforceable because the investigation had been triggered by a letter to the Commission from a United States Senator who, allegedly acting on behalf of a competitor of Wheeling-Pittsburgh Steel, had urged the SEC to inquire into whether certain statements violated the federal securities laws. The district court declined to enforce the subpoena, stating that the issue being investigated was "patently frivolous" and that the SEC's investigative process had been abused by third parties. n26 On appeal, the Third Circuit, sitting *en banc*, held that enforcement of the subpoena should be denied if it were determined that enforcement would abuse the judicial process or that the SEC was acting in "bad faith" (e.g., the Commission was pursuing the investigation because of political pressure and without an objective determination of the likelihood of a violation). The court then remanded the matter for further discovery and review by the district court for additional evidence. n27

Comment

The SEC is likely to argue that the person challenging the subpoena bears the burden of establishing that the subpoena was issued in bad faith. n28

Courts have stated that the burden of showing bad faith is a heavy one, and is not met by mere allegations of abuse on the part of the SEC. n29 Courts have further stated that a person opposing enforcement of a subpoena must demonstrate that "the improper purpose is that of the Commission, not merely that of one of its investigators," n30 and that the SEC's decision was the product of improper external influence and not an independent determination based on objective facts. n31

[4] Subpoenas Are Overbroad or Unduly Burdensome

It is difficult to oppose successfully a subpoena enforcement proceeding on the grounds that the subpoena is overly broad. The Tenth Circuit has stated that "[i]n the context of a subpoena issued by the SEC, a determination that 'a subpoena [is] within the scope of the authority granted ... is enough to authorize subpoenas for the production of records which might reveal the existence and extent' of any violation of the securities law." n32 Further illustrating the difficulty in proving such a claim is the statement of the D.C. Circuit in *SEC v. Arthur Young & Co.* n33 that "[i]t can hardly be seriously suggested that a request for documents 'not plainly irrelevant' is unreasonable." n34 In the same opinion, however, the court also noted that the Commission cannot impose unreasonable burdens on witnesses in the course of its investigations. n35

A person resisting a subpoena on the grounds that it is overbroad and excessively burdensome should attempt to obtain a modification or clarification of the subpoena from the Staff, which will often give serious consideration to narrowing a subpoena, deferring portions of a subpoena, or extending a return date in order to allow the subpoena recipient to have more time to respond to the subpoena.

Moreover, a court might be reluctant to limit a subpoena when the recipient has not attempted to negotiate the scope of the subpoena with the Staff. "Before the courts will hold an order seeking information reports to be arbitrarily excessive, they may expect the supplicant to have made reasonable efforts before the Commission itself to obtain reasonable conditions." n36 In addition, the person opposing the subpoena might attempt to persuade the Staff that the subpoena is inappropriate and should be modified or withdrawn. However,

the SEC's rules do not provide a procedure by which a recipient of an administrative subpoena can move to quash it ... The statutory scheme designed by Congress provides that the SEC's administrative

subpoenas are not self-executing ... Therefore, any person who is subpoenaed may refuse to comply for just cause and await the Commission's institution of a subpoena enforcement action. At that time, he has the right to contest the enforcement of the subpoena. n37

Some courts have indicated that in considering the reasonableness of the burden imposed by an SEC subpoena, they should consider the extent to which the subpoenaed person is a disinterested third party in the matter being investigated. For example, the D.C. Circuit, in *SEC v. McGoff*, n38 in denying a claim that a subpoena's burden was unreasonable, suggested that a more compelling case could have been made by a subpoenaed party not involved in the possible misconduct being investigated.

Courts have held that persons responding to excessively burdensome subpoenas are entitled to compensation from the SEC. n39 In *Arthur Young*, the D.C. Circuit ordered that the party responding to an SEC subpoena should be permitted to seek reimbursement from the Commission for its costs of complying with the subpoena to the extent that those costs were unreasonable. n40 The court explained, "[T]he *Fourth Amendment* requires that the subpoena be sufficiently limited in scope, relevant in purpose, and specific in directive so that compliance will not be unreasonably burdensome." n41 Nevertheless, the SEC, rarely, if ever, compensates subpoena recipients for the costs of compliance. n42

Courts have also indicated that a subpoena can be challenged if it is "unnecessarily severe." n43 In *Murphy Director Affiliates, Inc.*, n44 a respondent argued that compliance with the subpoena would cause "undue hardship." Noting that the SEC had "actually been rather circumspect in drafting the present subpoena" and was not requiring the respondent "to move its records from their usual location," the district court held that the respondent had not shown that the burden imposed by the subpoena was unnecessarily severe.

FOOTNOTES:

(n1)Footnote 1. *Morton Salt*, 338 U.S. 632 .

(n2)Footnote 2. *Powell*, 379 U.S. 48 .

(n3)Footnote 3. *Oklahoma Press Pbl'g Co. v. Walling*, 327 U.S. 186 (1946) .

(n4)Footnote 4. 327 U.S. at 214 .

(n5)Footnote 5. *SEC v. Wall St. Transcript Corp.*, 422 F.2d 1371 (2d Cir. 1970) .

(n6)Footnote 6. *Wall St. Transcript*, 422 F.2d at 1380 . See also *SEC v. Murray Dir. Affiliates, Inc.*, 426 F. Supp. 684, 686 (S.D.N.Y. 1976) ("It is for the agency, and not the district court, to determine in the first instance whether violations may fall within the coverage of the securities acts.").

(n7)Footnote 7. *SEC v. Brigadoon Scotch Distrib. Co.*, 480 F.2d 1047 (2d Cir. 1973) , cert. denied, 415 U.S. 915 (1975) .

(n8)Footnote 8. *Brigadoon Scotch Distrib. Co.*, 480 F.2d at 1052 .

(n9)Footnote 9. *SEC v. Howatt*, 525 F.2d 226 (1st Cir. 1975) .

(n10)Footnote 10. *Howatt*, 525 F.2d at 229-230 . See also *SEC v. Savage*, 513 F.2d 188, 189 (7th Cir. 1975) (agreeing with the disposition of both *Brigadoon Distrib.* and *Wall Street Transcript*). *Savage* also involved a preliminary question as to whether the conduct in question involved "securities," and resulted in enforcement of the subpoena.

(n11)Footnote 11. *United States v. Morton Salt Co.*, 338 U.S. 632 (1950) .

(n12)Footnote 12. *Morton Salt*, 338 U.S. at 642 .

(n13)Footnote 13. *Howatt*, 525 F.2d at 229 .

(n14)Footnote 14. *SEC v. Arthur Young & Co.*, 584 F.2d 1018, 1030 (D.C. Cir. 1978) .

(n15)Footnote 15. *Arthur Young & Co.*, at 1023 (quoting *Morton Salt*, 338 U.S. at 652) .

(n16)Footnote 16. *Blinder, Robinson & Co. v. SEC*, 692 F.2d 102 (10th Cir. 1982) .

(n17)Footnote 17. *Blinder, Robinson & Co.*, 692 F.2d 102, 106 (citing cases).

(n18)Footnote 18. *Blinder, Robinson & Co.*, 692 F.2d 102, 106-107 .

(n19)Footnote 19. See, e.g., *SEC v. ESM Gov't Sec., Inc.*, 645 F.2d 310, 317 (5th Cir. 1981) (requiring courts to evaluate government's good faith in deciding whether to enforce subpoena); *SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d 118 (3d Cir. 1981) (*en banc*) (stating that agency bad faith "represents but one ground for denying the enforcement request"); *SEC v. Brigadoon Scotch Distrib. Co.*, 480 F.2d 1047, 1056 (2d Cir. 1973) , *cert. denied*, 415 U.S. 915 (1975) .

(n20)Footnote 20. *Brigadoon Scotch Distrib. Co.*, 480 F.2d 1047 .

(n21)Footnote 21. *Brigadoon Scotch Distrib. Co.*, 480 F.2d 1047, 1056 (citing *Powell*, 379 U.S. at 58) .

(n22)Footnote 22. *SEC v. ESM Gov't Secs., Inc.*, 645 F.2d 310 (5th Cir. 1981) .

(n23)Footnote 23. *ESM Gov't Secs.*, 645 F.2d 310, 317 (citing *United States v. Bank of Moulton*, 614 F.2d 1063, 1066 (5th Cir. 1980)) .

(n24)Footnote 24. *SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d 118 .

(n25)Footnote 25. See discussion of the applicability of tests to SEC subpoena enforcement, § 6.04[3] above .

(n26)Footnote 26. *Wheeling-Pittsburgh Steel*, 648 F.2d 118, 127 .

(n27)Footnote 27. *Wheeling-Pittsburgh Steel*, 648 F.2d 118, 128-129 .

(n28)Footnote 28. See *United States v. LaSalle Nat'l Bank*, 437 U.S. 298, 316 (1978) ; *SEC v. Knopfler*, 658 F.2d 25, 26 (2d Cir. 1981) , *cert. denied*, 455 U.S. 908 (1982) .

(n29)Footnote 29. *LaSalle Nat'l Bank*, 437 U.S. at 316 ; see also *Knopfler*, 658 F.2d at 26 ; *SEC v. Blackfoot Bituminous, Inc.*, 622 F.2d 512, 515 (10th Cir. 1980) (refusing to impose additional burdens on the SEC by requiring it to set forth factual basis for the investigation).

(n30)Footnote 30. *Knopfler*, 658 F.2d at 26 .

(n31)Footnote 31. *Wheeling-Pittsburgh Steel*, 648 F.2d at 128 .

(n32)Footnote 32. *Blackfoot Bituminous*, 622 F.2d at 515 (quoting *SEC v. First Sec. Bank*, 447 F.2d 166, 168-169 (10th Cir. 1971) , *cert. denied*, 404 U.S. 1038 (1972)) .

(n33)Footnote 33. *SEC v. Arthur Young & Co.*, 584 F.2d 1018 (D.C. Cir. 1978) .

(n34)Footnote 34. *SEC v. Arthur Young & Co.*, 584 F.2d at 1029 .

(n35)Footnote 35. *SEC v. Arthur Young & Co.*, 584 F.2d at 1031 .

(n36)Footnote 36. *Blackfoot Bituminous*, 622 F.2d at 515 (quoting *United States v. Morton Salt*, 338 U.S. 632, 653 (1950)) .

(n37)Footnote 37. *Bird v. SEC*, , [1980 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 97,506 at 97,645 n.5* (D.P.R. May 19, 1980) .

(n38)Footnote 38. *SEC v. McGoff*, 647 F.2d 185, 192 (D.C. Cir. 1981) , cert. denied, 452 U.S. 963 (1981) .

(n39)Footnote 39. *SEC v. Arthur Young & Co.*, 584 F.2d 1018, 1033 (D.C. Cir. 1978) .

(n40)Footnote 40. *SEC v. Arthur Young & Co* 584 F.2d at 1034 .

(n41)Footnote 41. *SEC v. Arthur Young & Co* 584 F.2d at 1024 . See also *SEC v. Savage*, 513 F.2d 188, 189 (7th Cir. 1975) (stating that the subpoenaed president of the company "shall be free to ask the district court for appropriate protective restrictions," if particular demands for production or removal of records threaten unwarranted disruption of the company's business).

(n42)Footnote 42. In this age of e-mails and other electronically stored documents the cost of production can be massive. It is not unusual for companies to expend millions of dollars in out-of-pocket costs collecting and copying documents.

(n43)Footnote 43. *SEC v. Murphy Dir. Affiliates, Inc.*, 426 F. Supp. 684, 686 (S.D.N.Y. 1976) (citing *United States v. Powell*, 379 U.S. 48 (1984)) .

(n44)Footnote 44. *SEC v. Murphy Dir. Affiliates, Inc.*, 426 F. Supp. 684, 686 (S.D.N.Y. 1976) .



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CHAPTER 6 SUBPOENAS AND THEIR ENFORCEMENT

1-6 Securities Enforcement: Counseling and Defense § 6.06

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§ 6.06 Liability of the SEC

The SEC has successfully argued that damage claims against it for improperly issuing subpoenas are barred by sovereign immunity. n1 In *Sprecher v. Graber*, n2 the Second Circuit also held that Staff members are protected by absolute immunity "insofar as the acts complained of fell within the scope of judicial or prosecutorial functions," n3 and are immune from common law tort actions, such as defamation, injury to business relationship, and subornation of perjury, insofar as they acted within the outer perimeter of their official duties. n4 The Right to Financial Privacy Act does, however, impose personal liability on Staff members for misconduct. n5

In *Hunter v. SEC*, n6 the target of an SEC investigation was allowed to maintain an action for invasion of privacy against the Staff member conducting the investigation. n7 In that case, the Staff member allegedly relayed confidential information obtained in the course of the investigation to the target's ex-girlfriend for use in her civil suit against the target. The court held that the target had a reasonable expectation that "this information could be acquired and disclosed by government agents only as provided by law." n8

FOOTNOTES:

(n1)Footnote 1. *Sprecher v. Graber*, 716 F.2d 968, 975 (2d Cir. 1983) .

(n2)Footnote 2. *Sprecher v. Graber*, 716 F.2d 968 (2d. Cir. 1983) .

(n3)Footnote 3. *Sprecher v. Graber*, 716 F.2d at 975 (citing *Harlow v. Fitzgerald*, 457 U.S. 800, 807 (1982)) .

(n4)Footnote 4. *Sprecher v. Graber*, at 975 (citing *Harlow v. Fitzgerald*, 457 U.S. 800, 807 (1982)) . See also *Holmes v. Eddy*, 341 F.2d 477, 480-482 (4th Cir. 1965) (*per curiam*) (holding that SEC officials were not liable for injury to a business arising from an investigation).

(n5)Footnote 5. See below at § 6.07 for a discussion of *The Right to Financial Privacy Act*.

(n6)Footnote 6. *Hunter v. SEC*, 879 F. Supp. 494 (E.D. Pa. 1995) .

(n7)Footnote 7. *Hunter v. SEC*, 879 F. Supp. at 500 (stating that the plaintiff has set forth a claim sufficient to

withstand a motion to dismiss).

(n8)Footnote 8. *Hunter v. SEC*, 879 F. Supp. at 500 .



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CHAPTER 6 SUBPOENAS AND THEIR ENFORCEMENT

1-6 Securities Enforcement: Counseling and Defense § 6.07

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§ 6.07 The Right to Financial Privacy Act

In 1976, the Supreme Court held in *United States v. Miller* n1 that a customer of a bank cannot challenge on *Fourth Amendment* grounds the admission into evidence, in a criminal prosecution, of financial records obtained by the government from his bank pursuant to allegedly defective subpoenas, despite the fact that he was given no notice of the subpoenas. n2 Congress, in response to *Miller*, enacted the Right to Financial Privacy Act of 1978 (the "RFPA"). n3 The SEC has been subject to the RFPA since 1980. n4

The RFPA gives customers of banks and similar financial institutions certain rights of which they must be notified, including the right to challenge in court an administrative subpoena for financial records in their possession. The RFPA does not protect an individual from SEC subpoenas directed to him or her or any other person possessing the individual's financial records (e.g., an accountant). The RFPA does provide, however, for the award of compensatory damages and the award of reasonable attorneys' fees if the SEC obtains, or a financial institution discloses, financial records in violation of the statute. Punitive damages are also available if the violation was willful or intentional. n5

[1] Scope of the RFPA

The RFPA, which applies only to "customers" of the financial institution, defines a "customer" as "any person or authorized representative of that person who utilized or is utilizing any service of a financial institution, or for whom a financial institution is acting or has acted as a fiduciary, in relation to an account maintained in the person's name." n6 The act defines "person" as "an individual or a partnership of five or fewer individuals." n7 Read together, these provisions exclude corporations from the definition of customer, and so the RFPA does not protect financial records that are identified with a corporation. n8

The RFPA defines "financial records" to mean "an original of, a copy of, or information known to have been derived from, any record held by a financial institution pertaining to a customer's relationship with the financial institution." n9 Thus, the RFPA covers not only tangible records, but information derived from such records.

The RFPA defines "financial institution" as "any office of a bank, savings bank, card issuer as defined in Section 103 of the Consumer Credit Protection Act n10, industrial loan company, trust company, savings association, building and

loan, or homestead association (including cooperative banks), credit union, or consumer finance institution, located in any State or territory," the District of Columbia, or possession of the United States. n11

In order to understand the term "card issuer," one must refer to four definitions set forth in the Consumer Credit Protection Act ("CCPA"). The CCPA defines "card issuer" to mean "any person who issues a credit card, or the agent of such person with respect to such card." n12 The CCPA defines "credit card" to mean "any card, plate, coupon book or other credit device existing for the purpose of obtaining money, property, labor, or services on credit." n13 The CCPA defines "credit" to mean "the right granted by a creditor to a debtor to defer payment of debt or to incur debt and defer its payment." n14 In general, the CCPA defines "creditor" to refer only to a person who both:

(1) regularly extends, whether in connection with loans, sales of property or services, or otherwise, consumer credit which is payable by agreement in more than four installments or for which the payment of a finance charge is or may be required; and

(2) is the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness or, if there is no such evidence of indebtedness, by agreement. n15

The operation of the RFPFA with respect to persons who are financial institutions by virtue of being card issuers is unclear in several respects. First, the application of the term "card issuer" is often uncertain. Second, the application of the RFPFA arguably is uncertain where a person is a customer of the credit card issuer but does not utilize the credit issuer's credit card. Third, the application of the RFPFA arguably is uncertain where a person is a customer who utilizes the credit card of the card issuer, but the financial records do not relate to the extension of credit or to the credit card.

There are a number of exemptions to the application of the RFPFA to SEC investigations. n16 For example, the Commission may obtain, and financial institutions may disclose, "any financial records or information which is not identified with or identifiable as being derived from the financial records of a particular customer." n17 The SEC often utilizes an exemption that provides that it does not have to provide notice to the customer if it is only seeking the name, address, account number, and type of account of any customer or ascertainable group of customers associated with a financial transaction or class of financial transactions. n18 The SEC sometimes utilizes another exemption that applies when it is seeking financial records in connection with an investigation directed at the financial institution possessing the records. n19

[2] Mechanisms by Which the SEC Can Obtain Financial Records

The RFPFA provides a number of mechanisms by which the SEC can obtain a customer's financial records from a financial institution. Before such an institution can disclose financial records of a customer to the SEC, however, the SEC must first submit to the institution a written certificate of compliance with the RFPFA. n20 The most commonly used mechanisms are described below.

[a] Obtaining Financial Records via SEC Subpoena with Notice to the Customer

The most commonly used mechanism for securing records covered by the RFPFA is by subpoena. The act provides that the SEC may obtain financial records pursuant to a lawful subpoena only if:

- (1) the Commission has reason to believe that the records sought are relevant to a legitimate enforcement inquiry,
- (2) a copy of the subpoena or summons has been served on the customer, and
- (3) the time allowed for the customer to challenge the request has passed without any such

challenge. n21

Notice to the customer must set forth, with reasonable specificity, the nature of the law enforcement inquiry. In addition, the following statement must accompany any notice sent to the customer:

Records or information concerning your transactions held by the financial institution named in the attached subpoena or summons are being sought by this (agency or department) in accordance with the Right to Financial Privacy Act of 1978 [12 U.S.C.S. § 3401 *et seq.*] for the following purpose: If you desire that such records or information not be made available, you must:

1. Fill out the accompanying motion paper and sworn statement or write one of your own, stating that you are the customer whose records are being requested by the Government and either giving the reasons you believe that the records are not relevant to the legitimate law enforcement inquiry stated in this notice or any other legal basis for objecting to the release of the records.

2. File the motion and statement by mailing or delivering them to the clerk of any one of the following United States district courts: _____.

3. Serve the Government authority requesting the records by mailing or delivering a copy of your motion and statement to _____.

4. Be prepared to come to court and present your position in further detail.

5. You do not need to have a lawyer, although you may wish to employ one to represent you and protect your rights.

If you do not follow the above procedures, upon the expiration of ten days from the date of service or fourteen days from the date of mailing of this notice, the records or information requested therein will be made available. These records may be transferred to other Government authorities for legitimate law enforcement inquiries, in which event you will be notified after the transfer. n22

In practice, the SEC typically sends to the customer a notification package consisting of 10 to 20 pages and containing the following documents:

- a notification letter informing the customer of rights provided by the RFPA;
- a copy of the subpoena (including transmittal letter and attachment) issued to the financial institution;
- a form for challenging the subpoena;
- a certificate of service;
- a form encaptioned "Customer's Sworn Statement for Filing a Challenge;"
- instructions for completing the motion and sworn statement; and
- a supplement containing copies of the regulations and statutes that authorize the inquiry.

If the customer does not file a sworn statement and motion to quash in the appropriate court within the required time frame, the SEC may obtain the financial records from the financial institution upon providing a written certification that

it has complied with the applicable provisions of the RFPA. n23

If the customer wants to challenge the subpoena pursuant to the RFPA, he or she must file a sworn statement and motion to quash in the appropriate court within the specified time frame. The sworn statement must state that:

- the movant is a customer of the financial institution from which the pertinent financial records have been sought, and
- the applicant's reasons for believing that the financial records sought are not relevant to the legitimate law enforcement inquiry stated by the SEC in the notice or that there has not been substantial compliance with the act. n24

If the court finds that the customer has satisfied these requirements, it shall order the SEC to file a sworn response. The customer, however, has the initial burden of presenting a *prima facie* case that government access would be improper. n25 To satisfy this burden, the movant must show a factual basis for the conclusion that the records are not relevant. n26

The SEC can overcome such an assertion, by showing that it seeks documents reasonably believed to be relevant to its investigation. n27 If after these submissions the court is unable to determine whether the applicant is the customer to whom the financial records sought by the government authority pertain or that there is a demonstrable reason to believe that the law enforcement inquiry is legitimate and that the records sought are relevant to the inquiry, it may conduct such additional proceedings as it deems appropriate. n28

Comment

While the RFPA provides that all such proceedings shall be completed and the motion decided within seven calendar days of the SEC's response, it is not unusual for the process to take substantially longer.

Under the RFPA, the court shall grant the motion and quash the subpoena if it finds that the movant is the customer to whom the financial records pertain and that there is either no demonstrable reason to believe that the law enforcement inquiry is legitimate, no reasonable belief that the records sought are relevant to that inquiry, or there has not been substantial compliance with the provisions of the act. n29 The customer cannot appeal an adverse determination until the government has either completed its investigation or the legal proceedings based on the records have concluded. n30

[b] Obtaining Financial Records via SEC Subpoena Without Notice to the Customer

There are two mechanisms by which the SEC can compel a financial institution to produce a customer's financial records without providing prior notice to the customer. First, the RFPA provides that customer notice may be delayed by an *ex parte* order of a court upon certain findings:

- the investigation is within the lawful jurisdiction of the Commission;
- there is reason to believe that the records being sought are relevant to a legitimate law enforcement inquiry; and
- there is reason to believe that notice will result in any one of several enumerated adverse consequences.

These consequences include:

- endangering the life or physical safety of any person;
- possible flight from prosecution;
- destruction or tampering of evidence;
- intimidation of potential witnesses; and
- other serious jeopardy or undue delay to an investigation or official proceeding. n31

Second, the Exchange Act has been amended to provide that, notwithstanding the RFP, the SEC may obtain the financial records of customers from financial institutions pursuant to an *ex parte* court order upon a showing that the SEC has reason to believe that:

- (A) delay in obtaining access to such financial records, or the required notice, will result in --
 - (i) flight from prosecution;
 - (ii) destruction of or tampering with evidence;
 - (iii) transfer of assets or records outside the territorial limits of the United States;
 - (iv) improper conversion of investor assets; or
 - (v) impeding the ability of the Commission to identify or trace the source or disposition of funds involved in any securities transaction;
- (B) such financial records are necessary to identify or trace the record or beneficial ownership interest in any security;
- (C) the acts, practices or course of conduct under investigation involve --
 - (i) the dissemination of materially false or misleading information concerning any security, issuer, or market, or the failure to make disclosures required under the securities laws, which remain uncorrected; or
 - (ii) a financial loss to investors or other persons protected under the securities laws which remains substantially uncompensated; or
- (D) the acts, practices or course of conduct under investigation --
 - (i) involve significant financial speculation in securities; or
 - (ii) endanger the stability of any financial or investment intermediary. n32

FOOTNOTES:

(n1)Footnote 1. *United States v. Miller*, 425 U.S. 435, 443 (1976) .

(n2)Footnote 2. *United States v. Miller*, 425 U.S. at 445-446 .

(n3)Footnote 3. *Right to Financial Privacy Act*, 12 U.S.C.S. §§ 3401-3422.

(n4)Footnote 4. Exchange Act § 21(h)(1), 15 U.S.C.S. § 78u(h)(1).

(n5)Footnote 5. *12 U.S.C.S. § 3417(a).*

(n6)Footnote 6. *12 U.S.C.S. § 3401(5).*

(n7)Footnote 7. *12 U.S.C.S. § 3401(4).*

(n8)Footnote 8. *See Pittsburgh Nat'l Bank v. United States, 771 F.2d 73, 76 (3d Cir. 1985)* (holding that a corporation is not a "customer" for purposes of the RFPA); *Spa Flying Serv., Inc. v United States, 724 F.2d 95, 96 (8th Cir. 1984)* (same); *Exchange Point LLC v. SEC, 100 F. Supp. 2d 172 (S.D.N.Y. 1999)* (LLC not a "customer").

(n9)Footnote 9. *12 U.S.C.S. § 3401(2).*

(n10)Footnote 10. *15 U.S.C.S. § 1602(n).*

(n11)Footnote 11. *12 U.S.C.S. § 3401(1).*

(n12)Footnote 12. *15 U.S.C.S. § 1602(n).*

(n13)Footnote 13. *15 U.S.C.S. § 1602(k).*

(n14)Footnote 14. *15 U.S.C.S. § 1602(e).*

(n15)Footnote 15. *15 U.S.C.S. § 1602(f).*

(n16)Footnote 16. The RFPA does not apply to subpoenas issued in civil litigation, even if the SEC is a party to the litigation.

(n17)Footnote 17. *12 U.S.C.S. § 3413(a).*

(n18)Footnote 18. *12 U.S.C.S. § 3413(g).*

(n19)Footnote 19. *12 U.S.C.S. § 3413(h).*

(n20)Footnote 20. *12 U.S.C.S. § 3403(b).*

(n21)Footnote 21. *12 U.S.C.S. § 3405.*

(n22)Footnote 22. *12 U.S.C.S. § 3405.*

(n23)Footnote 23. *12 U.S.C.S. §§ 3403(b), 3411.*

(n24)Footnote 24. *12 U.S.C.S. § 3410(a).*

(n25)Footnote 25. *Hancock v. Marshall, 86 F.R.D. 209, 211 (D.D.C. 1980) .*

(n26)Footnote 26. *Hancock v. Marshall, 86 F.R.D. at 211 .*

(n27)Footnote 27. *See Panaro v. SEC, , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,368 at 96,895 (E.D.N.Y. 1987) .* In that case, the Commission responded voluntarily to the customer's assertions of irrelevancy, even though the court found them insufficient.

(n28)Footnote 28. *12 U.S.C.S. § 3410(b), (c).*

(n29)Footnote 29. *12 U.S.C.S. § 3410(c).*

(n30)Footnote 30. *12 U.S.C.S. § 3410(d)*.

(n31)Footnote 31. *12 U.S.C.S. § 3409(a)*.

(n32)Footnote 32. Exchange Act § 21(h)(2), *15 U.S.C.S. § 78u(h)(2)*. *See also, Enforcement Manual* at § 4.5, p. 104.



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CHAPTER 7 DISCLOSURE ISSUES

1-7 Securities Enforcement: Counseling and Defense 7.syn

AUTHOR: Kenneth B. Winer

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CHAPTER 7 DISCLOSURE ISSUES

1-7 Securities Enforcement: Counseling and Defense § 7.01

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§ 7.01 Introduction

When a public company learns that it is the focus of an SEC investigation, the company must assess whether to publicly disclose the existence of the investigation. The SEC's rules provide that "[u]nless otherwise ordered by the Commission, all formal investigative proceedings shall be non-public." n1 Pursuant to this rule, it is the practice of the SEC not to inform anyone, including individuals and entities with potential exposure, of the existence or progress of the investigation, n2 except to the extent necessary to obtain information. The SEC has identified two reasons why it conducts investigations confidentially:

First, we can conduct investigations more effectively if they are not announced publicly. For instance, important documents and evidence can be destroyed quickly if people hear of an investigation. Second, investigations are kept confidential to protect the reputations of companies and individuals if we find no wrongdoing or decide we cannot bring a successful action against them. As a result, the SEC will not typically confirm or deny the existence of an investigation n3

The SEC rules do not, however, relieve a public company of its disclosure responsibilities for making materially accurate and complete disclosure to the investing public. Companies are not usually required to disclose the existence of an SEC probe, and many companies receiving requests to produce information to the Division of Enforcement Staff do not disclose the existence of the probe. Sometimes, however, the federal securities laws require disclosure of the investigation. Even if a company determines that disclosure of the investigation is not required, disclosure might be appropriate for business or other reasons. If the company initially makes a decision not to disclose the existence of an investigation or related conduct, it should periodically revisit this decision in order to access whether nondisclosure is still appropriate.

In addition to assessing whether to disclose the existence of the SEC investigation, the company should consider whether it has identified uncharged conduct that either requires disclosure or that indicates that previously issued disclosures were materially false or misleading when made and should be corrected. Even if the existence of the SEC investigation is not itself material, the underlying facts might require disclosure. For example, if the facts that trigger the SEC investigation also cause the company to conclude that its recently issued financial statements are materially misleading, the company must take corrective action to ensure that the investing public does not rely on the financial

statements.

This chapter (1) provides guidance regarding the factors to be considered in deciding whether to disclose the existence of an SEC investigation and (2) sets forth factors to be considered in assessing whether disclosure is mandatory. It also discusses some of the factors that companies consider in deciding whether to disclose voluntarily the existence of the SEC investigation, even though the federal securities laws do not require disclosure. This chapter also provides an overview of the cases and other authorities relevant to whether the company should disclose the facts underlying the investigation (e.g., the company has received a report that a company employee gave \$100,000 to a foreign government official in return for the official causing his government to enter into a contract with the company). Finally, this chapter discusses some of the factors to be considered in structuring the disclosure.

FOOTNOTES:

(n1)Footnote 1. Rule 5, SEC Rules Relating to Investigations, *17 C.F.R. § 203.5*.

(n2)Footnote 2. *SEC v. Jerry T. O'Brien, Inc.*, *467 U.S. 735, 743 (1984)* .

(n3)Footnote 3. www.sec.gov/answers/investg.htm.



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CHAPTER 7 DISCLOSURE ISSUES

1-7 Securities Enforcement: Counseling and Defense § 7.02

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§ 7.02 Duty to Disclose Existence of an Inquiry

There is no *per se* rule that disclosure of an SEC investigation is mandatory. n1 In assessing whether disclosure of the SEC investigation is mandatory, an issuer should assess two issues:

- whether the existence of the investigation is material;
- whether there is a duty to disclose, assuming the investigation is material.

This analysis involves assessments of whether the information is material. Disclosure will not be mandatory if the information is immaterial. Even if the information is material, the company should consider a number of factors in assessing whether there is a duty to disclose the existence of the investigation immediately.

[1] Assessment of Materiality

The existence of an SEC investigation often is not material to investors. In light of the detailed regulations governing the disclosure of legal proceedings, the absence of any express SEC requirement that issuers disclose the existence of SEC investigations is a strong indication that the existence of a probe is not *per se* material. As set forth below, while SEC rules expressly call for disclosure of a number of other litigation matters, they do not expressly call for disclosure of government investigations. Courts have observed that while the SEC guidelines are not conclusive, "the Commission's expert view of the types of involvement in legal proceedings that are most likely to be matters of concern to shareholders ... is an important source in deciding materiality." n2 Accordingly, the SEC guidelines arguably create a rebuttable presumption that the existence of an SEC investigation is not material.

The United States Supreme Court has held that omitted information is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available." n3 The company should assess both the "quantitative materiality" and the "qualitative materiality" of the information. n4 Some commentators suggest that information should be considered material if the company expects that its disclosure would affect the price of a company security. n5 An American Bar Association task force identified a number of factors to be considered in assessing whether the existence of an SEC

inquiry is material. The task force opined that the mere existence of an investigation is not *per se* material and that because naming a subject matter of an investigation does not indicate that the Staff has determined to proceed in an action against any particular subject, and, because the SEC maintains that (unlike Department of Justice prosecutors) it has no targets, in the absence of other significant information, disclosure would not appear to be required. The task force advised that in assessing materiality, a company should take into account:

- the nature of the investigation in question;
- whether the investigation is formal or informal;
- whether the investigation is in its incipient stages or more advanced;
- the likelihood of enforcement proceedings;
- the nature of remedies that may be sought by the Staff; and
- the likely consequences of such proceedings. n6

In assessing the potential materiality of the prospect of an SEC enforcement action, the issuer should consider the likelihood and the likely impact of such an action. n7 For example, an enforcement action likely to result in a brokerage firm's being barred from the securities industry is more likely to be considered material than an action seeking a cease-and-desist order. Given, among other things, the difficulty of assessing the probability and likely impact of an enforcement action, this set of criteria is often extremely difficult to apply. In addition, the company should consider the impact that the institution of an SEC enforcement action would have on securities class actions, derivative actions or other pending or potential litigation.

The mere fact that the SEC initiated the inquiry should not be viewed as a determination by the Commission that any wrongdoing has occurred. Courts have stated that the SEC is empowered to conduct an inquiry even when it has no reason to believe that the law has been violated. n8 Moreover, SEC correspondence routinely state that the Commission's actions should not be viewed as an indication that it has found wrongdoing.

The company should also consider the cost of responding to the investigation and the extent (if any) to which the cost of the investigation is covered by insurance. These costs are likely to include professional fees, the time and effort of management, and the cost of gathering and photocopying documents. At the outset of an SEC investigation, it is difficult to predict the likely costs of the investigation. Absent insurance, these costs often are more likely to be material to the results of a small company than to a large company.

The company should also consider the likely impact of the investigation on the company's operations and ability to raise capital. The investigation might disrupt the company's relationships with customers, vendors, or creditors. A reluctance to disclose the existence of the investigation might prompt the company to refrain from filing a registration statement or otherwise raising money from investors. The existence of the investigation might affect the ability of the company to recruit or retain key personnel.

In a no-action letter dated February 4, 1976, the Division of Corporation Finance took the position that American Telephone and Telegraph Co. was not required to disclose that two of its subsidiaries were being investigated by the SEC for possible use of corporate funds for political contributions and for failing to properly account for such amounts. n9 In response to the demand of an AT&T shareholder that the company include in its proxy materials a shareholder resolution stating that "management failed to disclose" the existence of the SEC investigation in the prior year's proxy statement, the Commission issued the no-action letter stating that the shareholder resolution would itself be misleading without a further statement that management was not required to disclose the existence of the investigation.

Comment

As a practical matter, while it is often difficult for a company to assess the materiality of information regarding an SEC investigation, a trier of fact is likely to assess materiality with the benefit of hindsight.

[2] Assessing Duty to Disclose

In general, the failure to disclose material information is not actionable unless there is a duty to disclose such information. n10 Neither the federal securities laws nor SEC rules specifically call for disclosure of an SEC investigation. In general, the federal securities laws do not impose a system of continuous disclosure. As the Seventh Circuit has stated, "firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose." n11 In this section, we consider factors that could trigger a duty to disclose.

[a] Filing of a Report with the SEC

The company should disclose the existence of the SEC investigation if the company is filing with the SEC a proxy statement or quarterly or annual report and disclosure of the investigation is required by the rules or instructions governing the report. Regulation S-K sets forth the disclosure requirements for registration statements, periodic financial filings, and proxy materials. There are a number of provisions of Regulation S-K n12 that arguably are relevant to this analysis, including Items 103, 303, and 401(k). A company should consult closely with disclosure counsel in assessing whether Regulation S-K calls for disclosure of an SEC investigation.

[i] Item 103

Item 103 of Regulation S-K requires the disclosure in both annual and quarterly reports of certain "legal proceedings." The item provides:

Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authority n13

By its terms, this item does not require disclosure of SEC investigations. This item requires disclosure only of proceedings that are pending and as "to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject." SEC probes do not have parties. Accordingly, it would appear that Item 103 does not require disclosure of SEC investigations. Moreover, Instruction 5B to the item refers to proceedings in which the "governmental authority is a party," but does not refer to investigations being conducted by the government.

In addition, instructions for other SEC forms state that a "proceeding" does not include government investigations. The SEC's Form BD (which is required to be filed and periodically amended by persons registered as securities broker-dealers and which requires identification of any proceeding that could result in the applicant being found to have made a false statement, to have violated the federal securities laws or to have participated in another activity with similar results) defines "proceeding" to include:

a formal administrative or civil action initiated by a governmental agency, self regulatory organization or foreign financial regulatory authority, a felony criminal indictment or information (or equivalent formal charge). Does not include other civil litigation, investigations or arrests or similar charges effected in the absence of a formal criminal indictment or information (or equivalent formal charge). n14

The last sentence of Item 103 might, however, require the company to disclose an anticipated SEC enforcement action. Neither the SEC regulations nor the instructions to Regulation S-K define "proceedings known to be contemplated by governmental authorities" for the purpose of the regulation or provide guidance as to when a corporation is deemed to know that a proceeding is contemplated by governmental authorities. In the 1978 release extending this requirement to quarterly reports, the SEC noted that a number of commentators had objected to the proposed extension on the ground that it would increase the cost of error "because companies would be required to determine [the government's intentions] on a more or less continuous basis," and stated that this rule requires disclosure of "only material proceedings 'known' by the registrant to be contemplated." n15 The SEC stated that "legal proceedings known to be contemplated by government agencies ... should be disclosed where management reasonably believes that such government action will have a material effect upon the company and its business." n16 It is not clear when a company that is the subject of an SEC investigation knows that a proceeding is contemplated by government authorities. In many instances, Item 103 will require disclosure of an anticipated proceeding (if not of the pending investigation) if the Staff notifies the company that the Commission has authorized an enforcement proceeding. In addition, Item 103 might require a company to disclose an SEC investigation if the company has received a Wells Call. n17

In *In re Occidental Petroleum Corp.*, n18 the SEC: (1) addressed a Commission regulation that requires companies to disclose administrative or judicial proceedings that relate to the protection of the environment and are pending or known to be contemplated by governmental authorities, and (2) indicated that Occidental Petroleum Corp. had violated that requirement by not disclosing contemplated proceedings in its quarterly report. The violation concerned the period during which the United States Attorney had notified Occidental that a criminal proceeding was likely, even though the efforts of Occidental to dissuade the United States Attorney from bringing the action did prove successful n19 after the close of the reporting period.

[ii] Item 303

SEC rules require management discussion and analysis ("MD&A") disclosures in the company's annual and quarterly reports and in any regulation statement filed with the Commission pursuant to the Exchange Act. Item 303 of Regulation S-K provides the primary guidance for preparation of the MD&A.

Item 303(a)(1) requires that the MD&A include a discussion of the company's liquidity and capital resources identifying "any known ... uncertainties that will result or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way." Instruction 5 of Item 303(a) defines liquidity as "the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's need for cash." An investigation could affect a company's liquidity by impairing the company's ability to sell securities to the public, by triggering a restatement that results in a breach of the covenants associated with the company's debt or line of credit, or by leading to the imposition of substantial monetary penalties.

Item 303(a)(3) requires that registration statements and annual reports on Form 10-K describe "any unusual or infrequent events or transactions ... that materially affected the amount of reported income from continuing operations [and] any other significant component of revenues or expenses that, in the registrant's judgment, should be described in order to understand the registrant's results of operations" and "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations..." n20 This item could require disclosure of the SEC investigation if, for example, the expenses associated with the investigation are necessary to understand the company's financial results. Similarly, this item could require disclosure if the company reasonably expects that the investigation will have a material impact on the company's financial results.

[iii] Rule 408 and Rule 12b-20

Even if no specific SEC rule or regulation otherwise calls for disclosure, disclosure might be necessary to avoid making another statement misleading. Rule 408 under the Securities Act requires that "in addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."²¹ Similarly, Rule 12b-20 would require the company to disclose the investigation in the filing if disclosure of the investigation is "necessary to make the required statements, in the light of the circumstances under which they were made, not misleading."²²

In *United States v. Yeaman*,²³ the Third Circuit affirmed the conviction of Yeaman, who was an officer and director of two public companies that failed to disclose in their Annual Reports on Form 10-K that Yeaman was the subject of an SEC investigation. The Court of Appeals noted that the 10-K made no reference to the investigation and affirmatively asserted the following:

Other than described above, neither the Registrant nor any of its officers or directors, to their best knowledge, is a party to any material legal proceeding or litigation which would impact the operations of the Registrant, and such persons know of no material legal proceedings, judgments entered, legal actions or litigation contemplated, or threatened which would impair operation of the Registrant in the future.
n²⁴

The District Court found that disclosure of the SEC investigation was necessary to make not misleading the disavowal of knowledge of threatened proceedings that would impair the operations of the corporation. On appeal, Yeaman argued that he did not know at the time that the 10-K reports were filed that the SEC planned to commence litigation and that the investigation did not result in an enforcement proceeding until almost two years later. The Government argued that Yeaman must have been aware of the scope and gravity of the investigation prior to the filings and, given his knowledge of his activities, must have known of the probability that the proceeding would implicate the two public companies. The Court of Appeals affirmed.

Comment

Many courts treat the issue of whether a public statement is misleading as a mixed question of law and fact that should be reserved for the jury unless no reasonable investor could conclude that the statement was misleading.

[iv] Item 401

SEC rules call for disclosure in periodic reports and registration statements of certain information bearing on the ability or integrity of an officer or director.²⁵ The rules do not expressly call for disclosure of SEC investigations relating to officers or directors. Courts have, however, found disclosures to be materially misleading for failure to disclose information that the rules do not expressly require to be disclosed. For example, even though Item 401(f) only calls for disclosure of events that occurred in the five years before the filing, courts have found material to be misleading for failure to disclose fund conversions that were nineteen years old,²⁶ and an SEC bar order that was fifteen years old.²⁷ Indeed, companies sometimes disclose litigation matters relating to an officer's ability or competence, even if the disclosure is not expressly required by Item 401(f).

[v] Item 5.05 of Form 8-K

SEC regulations generally require registrants to file a Form 8-K within four business days of certain events. Item 5.05 of Form 8-K provides that, absent certain other disclosures, if a registrant grants an express or implicit waiver from a provision of the registrant's code of ethics that applies to the CEO, the principal financial officer, the principal accounting officer or controller, or a person performing similar functions, then the registrant must file a form 8-K briefly describing the nature of the waiver, the person to whom the waiver was granted, and the date of the waiver if the

waiver relates to one or more of the following elements of the code of ethics:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
- compliance with applicable governmental laws, rules, and regulations;
- the prompt internal reporting of violations of the code to an appropriate person or person identified in the code; and
- accountability for adherence to the code.

Instruction 2(ii) of Item 5.05 defines "implicit waiver" as "the registrant's failure to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer." Thus, if, in connection with an SEC investigation or otherwise, a registrant determines that an executive officer has violated the company's code of ethics and decides not to take action against the officer, then the company may have to file a Form 8-K pursuant to Item 5.05.

[vi] Sarbanes-Oxley Certification Requirements

The Sarbanes Oxley Act of 2002 requires that the chief executive officer and chief financial officer of each public company certify that each annual and quarterly report fairly presents, in all material respects, the financial condition and results of the company. Sarbanes-Oxley Section 302 amended the Exchange Act to require that the SEC issue rules imposing certification requirements on each company's principal executive officer(s) and principal financial officer(s). The resulting rules require that each principal executive officer and principal financial officer of a company certify in each quarterly and annual report filed or submitted by the company that, *inter alia*:

- Based on his or her knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- Based on his or her knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- The certifying officer (along with registrant's other certifying officer) are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls

and procedures, as of the end of the period covered by this report based on such evaluation; and

- disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

- The certifying officer and the registrant's other certifying officer have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

- all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

- any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting. n28

Section 906 amended the criminal code to require that each periodic report that is filed by the company with the SEC and that contains financial statements be accompanied by a written statement of the chief executive officer and chief financial officer (or their equivalent) certifying that the report fully complies with the requirements of Exchange Act Sections 13(a) or 15(d) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the company. n29 Accordingly, in connection with the filing of annual and quarterly reports, and of other filings that incorporate the annual and quarterly reports (e.g., proxy statements), the company should consider whether disclosure of information relating to the SEC investigation is necessary to make the certifications accurate.

[vii] Proxy Rules

The proxy rules do not expressly require that a company disclose when nominees are the subject of an SEC investigation. Certain proxy rules, nevertheless, may call for the disclosure of certain SEC investigations. For example, Rule 14a-9 provides in part:

No solicitation subject to this regulation shall be made by means of any proxy statement ... containing any statement which, at the time and in the light of the circumstances under which it was made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading. n30

In some circumstances, this rule could require the disclosure of an investigation.

[viii] GAAP

In evaluating whether a disclosure is misleading, consideration should be given to generally accepted accounting principles ("GAAP"). Statement of Financial Accounting Standard ("SFAS") No. 5, Accounting for Contingencies, requires the recognition of certain loss contingencies and the disclosure of certain loss contingencies. SFAS No. 5 defines "contingency" as an existing condition or set of circumstances involving varying degrees of uncertainty that may, through one or more related future events, result in the acquisition or loss of an asset or the occurrence or

avoidance of a liability. SFAS No. 5, para. 38 provides:

"With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. [For example,] an investigation of an enterprise by a government agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress and the probability of their assertion and the possibility of loss should be considered in each case." n31

Under SFAS No. 5, Accounting for Contingencies, a loss contingency must be accrued as a charge to income if:

- it is probable as of the date of the financial statements that a liability has been incurred, based on information available before the actual issuance date of the financial statements; and
- the amount of the loss can be reasonably estimated, unless the amount is not material.

If one or both of the two conditions for accrual of a loss contingency are not met, and it is either probable or reasonably possible that a loss will be incurred, then the issuer of the financial statements should disclose the contingency, if the contingency is material. n32

[b] Making a Disclosure to the Investing Public

A company should disclose the existence of the SEC investigation if omission of that information will render materially false or misleading another statement being made by the company that is reasonably calculated to reach investors. *Rule 10b-5* provides, in part, that it shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange "to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Thus, disclosure of an SEC investigation could be required if omission of information regarding the investigation would make another disclosure misleading. n33

[c] Selling Company Stock

The company should disclose the existence of the SEC investigation if either the company or its officers are selling the company's stock to the investing public and the investigation is material. n34 If the company or its officers sell stock, without disclosing a material SEC investigation, the sales can constitute a violation of the antifraud provisions of the federal securities laws and might trigger liability for the issuer and its officers and directors under §§ 11 and 12 of the Securities Act of 1933. n35 In addition, sales of securities by other individuals pursuant to the registration statements can trigger disclosure obligations.

[d] Updating Previous Disclosures

There may also be a duty to disclose the existence of the investigation if its existence renders materially misleading another statement previously made by the company on which the investing public is still reasonably relying. The law on duty to update is unsettled. Some courts have held that companies have a duty to update a statement only if the update is necessary to correct a statement that was materially false or misleading when made. n36 Other courts require a company to update a statement that was accurate when the company made it but has since become factually misleading because of subsequent events. n37

[e] Making Selective Disclosures

There might effectively be a duty to disclose the existence of the investigation if the company would otherwise be

selectively disclosing the existence of the probe to persons who might then trade in the securities of the company or tip other individuals. This situation can arise when the company decides it needs to inform more than a small number of senior personnel about the investigation. A decision to inform various employees, suppliers, customers, or others warrants serious consideration of an appropriate public announcement. Companies asked to make representations in contracts or in response to a request for proposals may be forced to disclose the existence of the investigation to persons outside the company. While transmittal to third persons for the purpose of assisting the company in investigating the facts and defending the investigation should not be treated as unlawful tipping in violation of the insider trading laws, the SEC has been extremely aggressive in arguing that the purpose of selective disclosure was to provide a benefit to the corporate executive making the disclosure. n38 In addition, the NYSE and the AMEX each requires that the companies not selectively disclose material information. n39

[f] Nasdaq and NYSE Rules Regarding Timely Disclosure of Material Information

Both Nasdaq and the NYSE have rules calling for timely disclosure of material information. The Nasdaq Marketplace rules provide that to qualify for inclusion in Nasdaq, an issuer, "[e]xcept in unusual circumstances ... shall make prompt disclosure to the public ... of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions" n40 The NYSE rules for listed companies provide, "A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the NYSE. A listed company should also act promptly to dispel unfounded rumors which result in unusual market activity." n41 Thus, failure to disclose material information could jeopardize a company's continued listing on Nasdaq or the NYSE.

Comment

As a practical matter, if the information is material and the company knows enough to draft a press release, the company will often have difficulty deferring disclosure of the information.

FOOTNOTES:

(n1)Footnote 1. Harvey L. Pitt et al., *Director Duties to Uncover and Respond to Management Misconduct*, Insights, June 1997, at 6. ("The federal securities laws do not compel the disclosure of government investigations.")

(n2)Footnote 2. *In re Browning-Ferris Indus. Shareholder Derivative Litig.*, 830 F. Supp. 361, 366 (S.D. Tex. 1993) (citing *GAF Corp. v. Heyman*, 724 F.2d 727, 739 (2d Cir. 1983) ; *General Elec. v. Cathcart*, 980 F.2d 927, 937 (3d Cir. 1992)) . See also *United States v. Matthews*, 787 F.2d 38, 48 (2d Cir. 1986) .

(n3)Footnote 3. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988) (quoting *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)) .

(n4)Footnote 4. See SEC Staff Accounting Bulletin ("SAB") No. 99, Materiality (August 15, 1999).

(n5)Footnote 5. See Alan J. Berkeley, *Some FAQs and Answers About Corporate Disclosure*, Securities Law for Nonsecurities Lawyers (June 2000).

(n6)Footnote 6. ABA Committee on Federal Regulation of Securities, *Report of the Task Force on SEC Settlements*, 47 Bus. Law. 1087, 1187-1188 (1992) (footnotes omitted).

(n7)Footnote 7. In assessing the materiality of a contingent event, the company should balance "the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." *Basic, Inc.*, 485 U.S. 238 .

(n8)Footnote 8. See *United States v. Morton Salt Co.*, 338 U.S. 632, 652 (1950) (an agency may conduct an

investigation motivated by "nothing more than official curiosity"); *SEC v. Howatt*, 525 F.2d 226, 229 (1st Cir. 1975) ("The Commission is not required ... to limit its investigations to those against whom 'probable' or even 'reasonable' cause to suspect a violation has been established").

(n9)Footnote 9. American Tel. & Tel. Co., SEC No-Action Letter, 1976 SEC No-Act. LEXIS 357 (Feb. 4, 1976).

(n10)Footnote 10. *Chiarella v. United States*, 445 U.S. 222, 235 (1980) .

(n11)Footnote 11. *Gallagher v. Abbott Laboratories*, 269 F.3d 806, 808 (7th Cir. 2001) .

(n12)Footnote 12. 17 C.F.R. §§ 229.101 et seq.

(n13)Footnote 13. 17 C.F.R. § 229.103.

(n14)Footnote 14. Form BD at 3, www.sec.gov about/forms/formbd.pdf.

(n15)Footnote 15. Statement of the Commission Regarding Disclosure Obligations of Companies Affected by the Government's Defense Contract Procurement Inquiry and Related Issues, Exchange Act Release No. 33-6791 (August 1, 1988).

(n16)Footnote 16. Statement of the Commission Regarding Disclosure Obligations of Companies Affected by the Government's Defense Contract Procurement Inquiry and Related Issues, Exchange Act Release No. 33-6791 (August 1, 1988).

(n17)Footnote 17. FINRA rules governing disclosure by member broker-dealer firms and persons associated with such firms of SEC investigations provide a useful analogy. Those rules required disclosure of SEC investigations only "after the 'Wells' call has been given." See Chapter 28, below.

(n18)Footnote 18. *In re Occidental Petroleum Corp.*, 1980 SEC LEXIS 1158, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,622 (July 2, 1980).

(n19)Footnote 19. *In re Occidental Petroleum Corp.*, 1980 SEC LEXIS 1158, *7-11, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,622 at 83,349 .

(n20)Footnote 20. Item 303(a)(3), 17 C.F.R. § 229.303(a)(3).

(n21)Footnote 21. 17 C.F.R. § 230.408.

(n22)Footnote 22. 17 C.F.R. § 240.12b-20.

(n23)Footnote 23. *United States v. Yeaman*, 194 F.3d 442 (3d Cir. 1999) .

(n24)Footnote 24. *Yeaman*, 194 F.3d at 451 .

(n25)Footnote 25. See Item 401(f) of Regulation S-K; 17 C.F.R. § 229.401(f).

(n26)Footnote 26. See *SEC v. Scott*, 565 F. Supp. 1513 (S.D.N.Y. 1983) .

(n27)Footnote 27. See *Bertoglio v. Texas Int'l Co.*, 488 F. Supp. 630 (D. Del. 1980) .

(n28)Footnote 28. Exchange Act Rules 13a-14 and 15d-14; 17 C.F.R. §§ 240.13a-14 and 240.15d-14.

(n29)Footnote 29. 18 U.S.C.S. § 1350.

(n30)Footnote 30. *17 C.F.R. § 240.14a-9.*

(n31)Footnote 31. SFAS No. 5, para. 38.

(n32)Footnote 32. *18 U.S.C.S. § 1350 .*

(n33)Footnote 33. Correspondingly, if a company desires not to disclose the existence of an SEC investigation even though that information is arguably material, the company should attempt to draft disclosures so that information regarding the investigation is not necessary to prevent the disclosure from being misleading. For example, in *In re Par Pharmaceutical, Inc. Securities Litigation*, 733 F. Supp. 668 (S.D.N.Y. 1990) , the court denied defendants' motion to dismiss on the ground that a reasonable jury could conclude that disclosure of the company's bribes of FDA officials was necessary because the company issued statements extolling its ability to obtain FDA approvals.

(n34)Footnote 34. *See Roeder v. Alpha Industries, Inc.*, 814 F.2d 22, 26 (1st Cir. 1987) (a company should disclose material uncharged misconduct if a corporate insider is selling the company's stock while in possession of information regarding the conduct).

(n35)Footnote 35. *15 U.S.C.S. §§ 77k and 77l (2003).*

(n36)Footnote 36. *See, e.g., Gallagher v. Abbott Laboratories*, 269 F.3d 806, 810 (7th Cir. 2001) .

(n37)Footnote 37. *See Jeffrey A. Brill, The Status of the Duty to Update*, 7 Cornell J.L. & Pub. Pol'y 605 (Winter 1998).

(n38)Footnote 38. Under the federal securities laws, the provision of material, nonpublic information by a corporate insider to an outsider is not a violation of the federal anti-fraud provisions unless the insider is providing the information in order to benefit the insider.

(n39)Footnote 39. *See NYSE Manual 02(A)* (reprinted in 3 *Fed. Sec. L. Rep. (CCH) P 23,516* (Oct. 18, 1989)) ("A company should not give information to one inquirer which it would not give to another, nor should it reveal information it would not willingly give or has not given to the press for publication."); *AMEX Guide § 402* (reprinted in 3 *Fed. Sec. L. Rep (CCH) P 23,124B* (July 18, 1990) (material information should be released simultaneously to various news organizations).

(n40)Footnote 40. NASD Manual Marketplace Rule 4310(c)(16).

(n41)Footnote 41. NYSE Listed Company Manual Rule 202.05.



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CHAPTER 7 DISCLOSURE ISSUES

1-7 Securities Enforcement: Counseling and Defense § 7.03

AUTHOR: Kenneth B. Winer

§ 7.03 Optional Disclosure of an Investigation

Many companies do not disclose the existence of an SEC investigation, at least until the Enforcement Staff informs the company that it is considering an enforcement action. The disclosure of an investigation can cause substantial harm to a company and its shareholders, even if the company did not engage in any misconduct and no enforcement action is ever brought. The announcement of an SEC investigation can result in a dramatic and unwarranted decline in the price of the company's stock. The uncertainty and doubt triggered by the disclosure of the investigation can have an adverse impact not only on the company's stock, but also on its relationships with creditors, customers, suppliers, and potential investors.

Various negative consequences often result from disclosing the existence of an SEC inquiry. Some commentators believe that public disclosure of an SEC investigation may make it more difficult for the Commission to close an investigation even if the investigation has little substantive merit. n1 In addition, an announcement disclosing that the SEC is investigating whether the company's financial disclosures are materially false or misleading can:

- adversely impact the company's relationships with its customers, suppliers, lenders, and licensing authorities or primary regulators;
- sow confusion and concern among the company's employees, analysts, shareholders, and potential investors;
- trigger press coverage that can be harmful to the company; and
- trigger commencement of a shareholder class action by one or more of the attorneys who specialize in bringing such actions.

A company might voluntarily disclose the existence of an SEC investigation because of risk management concerns. Even if the likelihood of a material enforcement action is low, the company might conclude that voluntary disclosure is appropriate because if the investigation does result in a material enforcement action, the company might have difficulty persuading a fact finder that at the time that the company decided not to disclose the existence of the investigation, the

likelihood of a material enforcement action was low.

Insofar as the company's decision not to disclose the existence of the investigation is based on the conclusion that the investigation is not material, such a decision can expose the company to substantial litigation. In general, courts have taken the position that the determination of whether information is material "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact." n2 Accordingly, courts often will not dismiss a complaint on the grounds that information was not material, unless the information is "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." n3 While dismissal would often be appropriate even under this stringent standard, it is not unlikely that a person sued for failure to disclose the existence of an SEC inquiry would have to withstand the burden of substantial discovery and trial.

Furthermore, as a practical matter, a company might decide that disclosure of the investigation is appropriate in light of the risk that the activity associated with an investigation is likely to generate rumors. The company might decide that members of the media, analysts and/or investors are likely to ask whether there is an SEC investigation and the company does not want to respond with a "No comment." The company might decide that a forthright disclosure is better than silence from the perspective of media and/or public relations. The company might also opt for voluntary disclosure so that it can control the manner and timing of the disclosure (e.g., the company might disclose the investigation on a busy news day).

Comment

If the company does not disclose the existence of the investigation, news of the investigation might become public at a time outside of the company's control. The company should make preparations so that it can respond quickly and effectively if the existence of the investigation becomes public through rumors, press reports, or otherwise.

FOOTNOTES:

(n1)Footnote 1. Harvey L. Pitt et al, *Director Duties to Uncover and Respond to Management Misconduct*, Insights, June 1997, at 6.

(n2)Footnote 2. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) .

(n3)Footnote 3. *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985) . See also *EP MedSystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 871 (3d Cir. 1999) .



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CHAPTER 7 DISCLOSURE ISSUES

1-7 Securities Enforcement: Counseling and Defense § 7.04

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§ 7.04 Disclosure of Facts Relating to an SEC Investigation

In addition to assessing whether to disclose the existence of an SEC investigation, the company should assess whether to disclose additional information regarding the conduct being investigated. This assessment is complicated by the fact that the information available to management regarding the conduct underlying the investigation is constantly evolving and frequently conflicting.

In *Ballan v. Wilfred American Educational Corporation*,ⁿ¹ a shareholder brought an action against Wilfred American, a public company that operated vocational schools, alleging that while Wilfred American had disclosed that it was being investigated by the Departments of Education and Justice in connection with the administration of financial aid programs of some schools it operated, the company failed to disclose additional facts indicating the seriousness of the investigation. The court denied a motion to dismiss, holding that because Wilfred American allegedly issued reports suggesting that its prosperity would continue, it was "obliged to reveal any 'facts' suggesting otherwise so as to make the matters disclosed not materially misleading."ⁿ²As an example, the court noted that the plaintiff

may be able to show that it was materially misleading for defendants not to have stated that a significant number of Wilfred's sales representatives, contrary to Education Department regulations, received a commission on each student they enrolled in a Wilfred school.ⁿ³

The court stated, however, that Wilfred American was not obligated to predict the "likely" outcome of the investigations.ⁿ⁴

The law is unsettled as to the extent to which the federal securities laws require disclosure of uncharged wrongdoing. In *United States v. Matthews*,ⁿ⁵ the Second Circuit held "that at least so long as uncharged criminal conduct is not required to be disclosed by any rule lawfully promulgated by the SEC, nondisclosure of such conduct cannot be the basis of a criminal prosecution," even if the person did engage in such conduct.ⁿ⁶The Second Circuit explained:

Although we have held in a number of civil cases that Schedule 14A [the SEC rules dealing specifically with proxy statements] sets only minimum disclosure standards and that compliance with this Schedule does not guarantee that a proxy statement contains no false or misleading statements, a discussion of criminal liability should begin at least with the rules and regulations that the Commission

has enacted. Schedule 14A provides us "with the Commission's expert view of the types of involvement in legal proceedings that are most likely to be matters of concern to shareholders in a proxy contest." We take cognizance of this "expert view" as disclosed in the Commission's Rules, knowing that it was arrived at in general compliance with the provisions of the Administrative Procedure Act and only after every feasible effort has been made to secure the views of persons to be affected. n7

Thus, *Matthews* suggests that a company need not disclose unlawful conduct unless there is a regulation that, directly or indirectly, calls for disclosure of such conduct. n8

In *Gaines v. Haughton*, n9 the Ninth Circuit addressed whether the omission of certain information regarding the misconduct of nominees was actionable under § 14(a). The Court "dr[e]w a sharp distinction, however, between allegations of director misconduct involving breach of trust or self-dealing -- the non-disclosure of which is presumptively material -- and allegations of simple breach of fiduciary duty/waste of corporate assets -- the disclosure of which is never material for § 14(a) purposes... Absent credible allegations of self-dealing by the directors or dishonesty or deceit which inures to the direct, personal benefit of the directors we hold that director misconduct of the type traditionally regulated by state corporate law need not be disclosed in proxy solicitations for director elections. This type of mismanagement, unadorned by self-dealing, is simply not material or otherwise within the ambit of the federal securities laws." n10

In *United States v. Crop Growers Corporation*, n11 an independent counsel prosecuted a company for failing to disclose that it had violated the federal election laws and had illegally maintained false books and records. Defendants cited to *Matthews* for the proposition that there was "no duty to disclose uncharged criminal conduct." n12 The independent counsel argued that even if *Matthews* applied to the individual defendants, it did not apply to the corporate defendants because corporations do not have a *Fifth Amendment* right against self-incrimination. The District Court held that the due process concerns articulated in *Matthews* did apply. n13

In *In re Teledyne Defense Contracting Derivative Litigation*, n14 shareholders brought a derivative action seeking, *inter alia*, invalidation of the corporation's elections for the board of directors on the ground that the proxy materials had failed to disclose "the extent and nature of the nominees' participation, aiding and abetting and/or willful acquiescence in, [*inter alia*] the continuing cover-up of fraudulent and illegal Government contract activities." n15 The plaintiffs argued that the nominees benefited by retaining their position and sustaining the inflated value of the company's stock, which they owned, and the court held that these facts did not bring the nominees outside the protection of *Gaines*. The Court held, "Directors and officers simply need not confess guilt to involvement in criminal conduct and breaches of fiduciary duties of care when such charges have not yet been brought, let alone proven." n16

A number of courts have found a duty to disclose uncharged criminal conduct in at least some circumstances. n17 In *Roeder*, a shareholder brought a class action alleging that the company and its officers were liable for not publicly disclosing until an indictment was imminent that the company had paid a bribe to obtain subcontracts. Defendants moved to dismiss arguing that they should not be required to accuse themselves of illegal policies. In addressing the defendants' argument that the information was immaterial as a matter of law, the court stated:

Information about bribery is relevant to important questions about the competency of management. Management's willingness to engage in practices that probably or obviously are illegal, and its decision to put the corporation at risk by so doing, may be critically important factors to investors. Investors may prefer to steer away from an enterprise that circumvents fair competitive bidding and opens itself to accusations of misconduct. Furthermore, regardless of financial motives, investors may not want to associate themselves with such an enterprise.

... [I]nformation does not become material simply because some may regard it as antisocial or illegal... .

Management cannot be expected to disclose information that some may find distasteful but that does not alter "the 'total mix' of information made available" to the investor. Corporate bribery, however, involves more than matters of taste. Illegal payments that are so small as to be relatively insignificant to the corporation's bottom line can still have vast economic implications. Even small illegal payments can seriously endanger a corporation's business n18

Accordingly, the court responded that while information does not "become material simply because some may regard it as antisocial or illegal, ... information does not become any less material because someone may be indicted if it is discovered by the authorities." n19 The court distinguished *Matthews* on the ground that it involved a criminal prosecution and that in *Matthews* the defendant was acquitted of being involved in the conspiracy that he was charged with failing to disclose. n20 The court then held that there was no duty to disclose the uncharged criminal conduct because even though it was material, the complaint did not allege any insider trading, any SEC rule requiring disclosure or any disclosure that was inaccurate, incomplete, or misleading. n21

In *SEC v. Fehn*, n22 the SEC brought an injunctive action against H. Thomas Fehn, an attorney who had represented a company and its promoter in an SEC investigation and then had edited a periodic filing that the SEC alleged was materially misleading. The SEC argued, and the court found, that in the course of defending the company and its promoter in an SEC investigation, Fehn learned that the company and the promoter had violated the Securities Act in connection with the company's IPO by failing to disclose actions that the Food & Drug Administration had taken against the company. Fehn advised the promoter that disclosure of the apparent violations was unnecessary and could impair the promoter's ability to assert the *Fifth Amendment* right against self-incrimination. The periodic filing disclosed the FDA action but failed to disclose the apparent violations of the Securities Act and mischaracterized the relationship between the promoter and the company. The District Court enjoined Fehn for aiding and abetting violations of 10b-5 in connection with the periodic filing. On appeal, Fehn invoked *Matthews* and argued that requiring the promoter to disclose the violations would have violated the promoter's *Fifth Amendment* right against self-incrimination. The Court disagreed, noting that the disclosure requirements do not target a highly selective group suspected of criminal activities and that although disclosure might have revealed past criminal violations in this case, the disclosure requirements did not, in general, mandate revelation of "inherently illegal activity." n23

Par Pharmaceutical was a class action in which it was alleged that Par Pharmaceutical failed to disclose that it had paid bribes to FDA employees for the purpose of securing expedited approval of Par products and to delay approval of competing products. The court denied a motion to dismiss on the ground that a jury could reasonably conclude that it was misleading for the company to have extolled its ability to obtain FDA approvals without disclosing that its success resulted from the payment of bribes. n24 The court further held that the "company was not obligated to speculate as to the myriad consequences, ranging from minor setbacks to complete ruin, that might have befallen the company if the bribery scheme was discovered, disclosed or terminated." n25

Ballan involved a claim against a vocational school corporation that had violated regulations promulgated by the United States Department of Education governing financial aid programs. Approximately 95% of the company's students received government sponsored financial aid, which could be terminated if the institution was found to have violated the regulations. The court held that *Matthews* addressed whether corporate management should be compelled to direct conclusory accusations at itself or characterize its behavior in a pejorative manner, but that the company was required to disclose specific facts that an informed investor would consider as potentially endangering the company's future financial performance noting "[t]he fact that a defendant's act may be a crime does not justify its concealment." n26

Comment

In light of the conflicting case law, the impact of the financial scandals of 2001-04, and the Sarbanes-Oxley Act of 2001, it is difficult to derive much comfort from *Matthews* and its progeny.

FOOTNOTES:

(n1)Footnote 1. *720 F. Supp. 241 (E.D.N.Y. 1989)* .

(n2)Footnote 2. *Ballan, 720 F. Supp. 241, 250 (E.D.N.Y. 1989)* .

(n3)Footnote 3. *720 F. Supp. 241, 250* .

(n4)Footnote 4. *720 F. Supp. 241, 248* . *See also In re Par Pharmaceutical, Inc. Securities Litig., 733 F. Supp. 668, 678 (S.D.N.Y. 1990)* ("A company [is] not obligated to speculate as to the myriad of consequences, ranging from minor setbacks to complete ruin, that might have befallen the company if the bribery scheme was discovered, disclosed or terminated.")

(n5)Footnote 5. *United States v. Matthews, 787 F.2d 38 (2d Cir. 1986)* .

(n6)Footnote 6. *Matthews, 787 F.2d 38, 49* .

(n7)Footnote 7. *787 F.2d 38, 47* (citations omitted).

(n8)Footnote 8. *787 F.2d 38, 46* , quoting *Kass v. Arden-Mayfair, Inc., 431 F. Supp. 1037, 1045 (C.D. Calif. 1977)*

(n9)Footnote 9. *645 F.2d 761 (9th Cir. 1981)* .

(n10)Footnote 10. *645 F.2d 761, 776-779* .

(n11)Footnote 11. *954 F. Supp. 335 (D.D.C. 1997)*

(n12)Footnote 12. *954 F. Supp. 335, 345* .

(n13)Footnote 13. *954 F. Supp. 335, 346* .

(n14)Footnote 14. *849 F. Supp. 1369 (C.D. Calif. 1993)* .

(n15)Footnote 15. *849 F. Supp. 1369, 1379* .

(n16)Footnote 16. *849 F. Supp. 1369, 1382* .

(n17)Footnote 17. *See, e.g., Roeder v. Alpha Industries, Inc., 814 F.2d 22, 25-26 (1st Cir. 1987)* ; *SEC v. Fehn, 97 F.3d 1276 (9th Cir. 1996)* ; *In re Par Pharmaceutical, Inc. Securities Litig., 733 F. Supp. 668 (S.D.N.Y. 1990)* ; *Ballan v. Wilfred American Educational Corp., 720 F. Supp. 241 (E.D.N.Y. 1989)* .

(n18)Footnote 18. *Roeder, 814 F.2d 22, 25-26* .

(n19)Footnote 19. *814 F.2d 22, 25* .

(n20)Footnote 20. *814 F.2d 22, 26* .

(n21)Footnote 21. *814 F.2d 22, 26-27* .

(n22)Footnote 22. *97 F.3d 1276 (9th Cir. 1996)* .

(n23)Footnote 23. *97 F.3d 1276, 1292* .

(n24)Footnote 24. *Par Pharmaceutical, 733 F. Supp. 668, 677* .

(n25)Footnote 25. *733 F. Supp.* 668, 678 .

(n26)Footnote 26. *Ballan*, *720 F. Supp.* 241, 249 .



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CHAPTER 7 DISCLOSURE ISSUES

1-7 Securities Enforcement: Counseling and Defense § 7.05

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§ 7.05 Disclosure to Audit Committee and Auditors

Effective August 29, 2002, the SEC adopted regulations implementing § 302 of Sarbanes-Oxley. The SEC regulations require an issuer's principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, each to certify in each quarterly and annual report, filed or submitted by the issuer under Section 13(a) or 15(d) of the Exchange Act, that:

- he or she and the other certifying officers have disclosed, based on their most recent evaluation, to the issuer's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):
 - all significant deficiencies in the design or operation of internal controls (a term relating to internal controls regarding financial reporting) which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
 - any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
- he or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

The SEC could bring a cease and desist proceeding against a CEO or CFO who signed a certification that he knew or should have known was materially false. In addition, the SEC could bring a fraud action in federal court against a CEO or CFO who signed a certification that he knew or was reckless in not knowing was materially false or misleading.

Comment

When an issuer provides notice to an auditor consistent with the disclosures required by § 302 of Sarbanes-Oxley, the auditor will consider its responsibilities under § 10A of the Exchange Act, with respect to the annual audit and quarterly review reports already outstanding, and with respect to any annual audit or quarterly review in progress. These considerations may result in the auditor taking a number of steps, including withdrawing an annual audit report, delaying issuance of a quarterly review or annual audit report, or insisting on information regarding the conduct at issue and any related internal investigations.

Moreover, in connection with § 302, the SEC adopted regulations imposing direct obligations. The SEC required issuers to perform quarterly evaluations of the effectiveness of the company's internal controls over financial reporting:

Every issuer that files reports under section 15(d) of the Act, other than an Asset-Backed Issuer (as defined in Rule 15d-14(g)), a small business investment company registered on Form N-5 (§§ 239.24 and 274.5 of this chapter), or a unit investment trust as defined by Section 4(2) of the Investment Company Act of 1940, must maintain disclosure controls and procedures (as defined in Rule 15d-14(c)).

Within the 90-day period prior to the filing date of each report requiring certification under Rule 13a-14 and Rule 30a-2, an evaluation must be carried out under the supervision and with the participation of the issuer's management, including the issuer's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, of the effectiveness of the design and operation of the issuer's disclosure controls and procedures. n1

In addition, the SEC required issuers to include the following disclosure in their periodic reports:

(a) Evaluation of disclosure controls and procedures. Disclose the conclusions of the registrant's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, about the effectiveness of the registrant's disclosure controls and procedures (as defined in §§ 240.13a-14(c) and 240.15d-14(c)) based on their evaluation of these controls and procedures as of a date within 90 days of the filing date of the quarterly or annual report that includes the disclosure required by this paragraph.

(b) Changes in internal controls. Disclose whether or not there were significant changes in the registrant's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. n2

FOOTNOTES:

(n1)Footnote 1. *17 C.F.R. §§ 240.13a-15; 240.15d-15.*

(n2)Footnote 2. *17 C.F.R. § 229.307.*



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CHAPTER 7 DISCLOSURE ISSUES

1-7 Securities Enforcement: Counseling and Defense § 7.06

AUTHOR: Kenneth B. Winer

§ 7.06 Guidance Regarding Disclosure to Investing Public

In general, disclosures to the investing public should tell the truth, tell it clearly, and include all material facts necessary not to make the disclosure, in the light of the circumstances in which it was made, misleading. This precept applies to disclosures regarding SEC investigations.

As two commentators recently noted, "With every media inquiry, the litigator may see risk where the public relations consultant sees opportunity." n1 Defense counsel should recognize that there are a number of reasons why a company might want to be more forthcoming:

- The company's investors and media might be clamoring for more information. If the company does not provide the information, they might assume the worst.
- The press might be making inquiries. If the company does not provide meaningful input to the press, the resulting story is likely to portray the company more negatively.
- Some media consultants advise that the sooner the company provides facts that satisfy the media, the sooner the media will lose interest in the story. n2
- Accepting responsibility for any wrong the company has done is an important step to a company's maintaining its credibility and retaining or restoring public trust in the company.

The company should consider drafting the disclosure so as to reduce the risk that future events will prompt the company to amend its disclosure. For example, company management will often want to stress that the SEC investigation is only an informal inquiry. If, however, the initial disclosure stresses this point, and the SEC converts the informal inquiry into a formal investigation, then the company might need to consider amending its disclosure. While the issuance of a formal order might not be a significant event in the course of an investigation, an announcement that an informal inquiry has been converted into a formal investigation is likely to attract unfavorable attention from the media, analysts, and investors.

Company management will often want to include in the initial disclosure a statement strongly denying that there has been any misstatement or other misconduct. In 1994, the SEC warned that a statement by a company denying wrongdoing and stating that the company is unaware of any wrongdoing on the part of its officers or employees would be considered fraudulent if the company knows or is reckless in not knowing that its senior officers have engaged in wrongful conduct. n3 The Commission stated that the release was materially false and misleading in that the company knew that one of its officers and directors had engaged in a series of trades between the company and accounts of his family members, and had concealed the trades from the company. The SEC noted that the release also failed to disclose that two members of management had asserted their *Fifth Amendment* right against self-incrimination and had refused to testify before the SEC regarding the foregoing matters. More recently, the risks associated with disclosures were highlighted by private comments that Martha Stewart made in connection with securities in her company, Martha Stewart Living Omnimedia, regarding her sale of stock in Imclone Systems.

Company management often wants to disclose the apparent scope of the SEC investigation for fear that investors and others might otherwise assume that the investigation is far more serious than appears to be the case. For example, if the investigation appears to be limited to whether revenue from one transaction that was recognized in one quarter should have been recognized in a subsequent quarter, the company might want to disclose the limited scope of investigation in order to reassure the investing public of the marginal materiality of the disclosure issue. The danger is that the apparent scope of the investigation is likely to evolve over time, requiring the company to alter its disclosure. Each alteration in the company's disclosure is likely to trigger a new burst of unfavorable publicity.

The company should also consider that the disclosure in its SEC filing or press release will set the parameters of the disclosures that can be made to analysts, the media and others. Accordingly, the perceived need for responding to analysts' likely inquiries should be evaluated in determining the content of the disclosure. At the same time, the disclosure will also be reviewed by the plaintiffs' securities bar. This kind of scrutiny makes it imperative that counsel ensure that the impact of the investigation is neither overstated nor understated.

The disclosure of the existence of an SEC probe sometimes triggers a substantial number of questions from the investing public, analysts, and the press. Accordingly, if the existence of the probe is disclosed, individuals dealing with these constituencies should be carefully prepared regarding the appropriate responses to likely questions. Often, it is best if the company designates one officer to act as the company's sole spokesperson with respect to the SEC investigation. By limiting the number of officers permitted to talk about the SEC investigation, the company promotes consistency in its disclosures and reduces the incentive of the media to contact numerous company employees seeking a new angle on the story.

The company and its advisors should attempt to identify questions likely to be posed and developed answers that are accurate, address the primary concerns of the company's key constituencies and limit the company's legal exposure. Typical questions include:

- When did the questionable conduct occur?
- What was the nature of the questionable conduct?
- Who engaged in the questionable conduct?
- Why wasn't the conduct prevent or detected earlier?
- What disciplinary and other actions has the company taken to address the conduct?
- What is the impact of the conduct on the company?

Companies often respond to an SEC investigation by setting up a working group to manage the impact of the investigation and the company response to the investigation. A company may want its public relations consultant to participate in meetings of the working group in order to (1) learn about the evidence being uncovered, developments in the litigation and the company's litigation strategy and (2) provide input into the development of the company's litigation strategy. It is possible, however, that inclusion of a media consultant could waive the protection of the attorney-client privilege and the work product doctrine. n4

Regardless of whether the existence of the SEC probe is publicly disclosed, appropriate company personnel should be notified of its existence. If the probe is not publicly disclosed, steps must be taken to ensure that the officers and employees responsible for interacting with analysts and the financial press do not inadvertently deny the existence of the inquiry. If a company spokesperson denies the existence of an investigation, it is likely that the company will consider it prudent to correct the denial, even though disclosure of the existence of the inquiry was not considered material. In *In re Carnation Co.*, n5 the SEC found that a company had violated *Rule 10b-5* under the Securities Exchange Act of 1934 because its spokesperson made a false statement regarding the pending sale of the company. The Commission asserted that the company had a duty to ensure that its spokesperson was aware of material corporate developments. Arguably, statements regarding an ongoing investigation would create a similar duty to inform the spokesperson.

FOOTNOTES:

(n1)Footnote 1. Mark Herrmann and Kim Kumiega, *On Trial in the Courts of Law and Public Opinion: The Tension Between Legal and Public Relations Advice*, 28 *Litigation* 29 (Summer 2002).

(n2)Footnote 2. See Sandi Sonnenfeld, *Media Policy -- What Media Policy?* Harvard Business Review 18, 28 (July-Aug. 1994).

(n3)Footnote 3. *In re The Cooper Companies*, Release No. 34-35082, 1994 SEC LEXIS 3975 (Dec. 12, 1994) .

(n4)Footnote 4. Compare *FTC v. GlaxoSmithKline*, 294 F.3d 141, 148 (D.C.Cir. 2002) (quoting *In re Copper Market Antitrust Litigation*, 200 F.R.D. 213, 219 (S.D.N.Y. 2001) (holding that the privilege protected documents that the company had shared with its public relations and government affairs consultants) with *Calvin Klein Trademark Trust v. Wachner*, 198 F.R.D. 53 (S.D.N.Y. 2000) .

(n5)Footnote 5. *In re Carnation Co.*, 1985 SEC LEXIS 1150, [1984-85 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P* 83,801 at 87,596-87,597 (July 8, 1985).



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CHAPTER 8 INTERNAL INVESTIGATIONS AND FACT-GATHERING BY DEFENSE COUNSEL

1-8 Securities Enforcement: Counseling and Defense 8.syn

AUTHOR: Kenneth B. Winer

§ 8.syn Synopsis to Chapter 8: INTERNAL INVESTIGATIONS AND FACT-GATHERING BY DEFENSE COUNSEL

§ 8.01 Introduction

§ 8.02 Reasons for Counsel's Effort

§ 8.03 Staffing the Effort

§ 8.04 Conduct During the Effort

[1] Disclosure to Staff of Results of Internal Investigations

[2] Development of the Action Plan

[3] Searching for Company Documents

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Kenneth B. Winer



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CHAPTER 8 INTERNAL INVESTIGATIONS AND FACT-GATHERING BY DEFENSE COUNSEL

1-8 Securities Enforcement: Counseling and Defense § 8.01

AUTHOR: Kenneth B. Winer

§ 8.01 Introduction

In defending a company in an SEC investigation, defense counsel should take steps to gather information relevant to the investigation. Unless there is corresponding litigation, such as a securities class action or a derivative action, defense counsel does not have access to compulsory process in developing information to defend an SEC investigation. In addition, company counsel may attend SEC testimony only if such counsel represents the individual witness and has no right to obtain copies of documents that other entities and individuals produce to the SEC. For the purpose of this chapter, we use the term "internal investigation" to include the steps that a company's defense counsel takes to obtain information relevant to the SEC investigation.

Information gathering can also be crucial if defense counsel represents an individual, rather than an entity. Accordingly, defense counsel to a potential target of an investigation should seriously consider taking steps to learn about the facts and circumstances relevant to the SEC investigation. These steps are discussed in more detail in Chapter 10.

In this chapter, we discuss the internal investigations conducted by counsel retained to defend a company (or other entity) in an SEC investigation. In particular, we discuss the reasons for defense counsel's internal investigation, the staffing of the internal investigation, and the conduct of the internal investigation.

It should be noted that companies often institute internal investigations separate from the fact gathering activities of defense counsel. The audit committee or management of a public company might institute an internal investigation in response to, as examples, a Section 10A report from its auditor, a Part 205 report from an attorney who represents the company before the SEC, or a whistleblower complaint. In some circumstances, it may be appropriate for the in-house counsel and internal audit personnel to conduct the internal investigation. On the other hand, it might be preferable for outside counsel to conduct the internal investigation if the conduct of the company's senior management, the law department or the internal audit department is at issue, or if the allegations are sufficiently serious, or if the law department and the internal audit department lack sufficient expertise and resources. In many instances, the company may decide to engage in a dialogue with the SEC Staff regarding the composition of the internal investigation team, the planned scope of the internal investigation, the steps that the internal investigation team plans to take, the information identified by the internal investigation and the findings of the internal investigation. The dialogue might increase the SEC Staff's comfort with the course of the internal investigation and might influence the composition of the internal

investigation or the approach being taken by the team. There are similarities between the fact gathering efforts of defense counsel and the internal investigations described in this paragraph. This chapter, however, is focused on the fact gathering efforts of defense counsel.



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CHAPTER 8 INTERNAL INVESTIGATIONS AND FACT-GATHERING BY DEFENSE COUNSEL

1-8 Securities Enforcement: Counseling and Defense § 8.02

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§ 8.02 Reasons for Counsel's Effort

In most instances, the primary purpose of defense counsel's fact-gathering is to assist defense counsel and the company in responding to the SEC investigation. For example, the fact-gathering assists in the preparation of witnesses so that they can testify effectively. The Enforcement Staff often has unrealistic expectations regarding the ability of witnesses to recall details of events that, while significant from the perspective of the Enforcement Staff, were not perceived as especially significant when they occurred. Accordingly, refreshing the witness's recollections of relevant events often enhances the credibility of a witness's testimony. In addition, witnesses will often initially be unable to recall exculpatory information or information that places apparently incriminating information in an exculpatory context. As a result of their internal investigation, defense counsel often can assist a witness in testifying in a manner that accurately places the witness in a more favorable light.

Defense counsel can also use the results of the fact-gathering in discussions with the Staff. For example, defense counsel might use the fact-gathering results to prepare a presentation to the Staff on select issues in the case (e.g., an issuer's disclosure controls and procedures, the remedial measures taken by the company, or the supervisory measures implanted by a broker-dealer). Similarly, in producing to the Staff a company document that, on its face, might appear highly incriminating, defense counsel might communicate to the Staff information that places the document in an exculpatory context.

Fact-gathering also assists defense counsel in advising the company's senior management and board of directors regarding the strategic options available to the company to resolve the SEC investigation. The information developed in such an investigation might expedite a favorable resolution of the investigation by enabling the company to persuade Enforcement Staff that its concerns are unfounded. For example, the Staff might be persuaded to discontinue or curtail an investigation into whether revenue was prematurely recognized if presented with evidence demonstrating persuasively that the issuer in fact delivered the product during the period in which the revenue was recognized. In addition, by assessing the company's potential exposure in the SEC investigation, the internal investigation can assist the company in evaluating whether and on what terms to initiate settlement discussions.

Defense counsel's fact-gathering also assists the company's senior management and board of directors by informing other decisions relating to the SEC investigation. Fact-gathering assists the assessment of whether the company's

disclosures are appropriate and whether the company should correct, clarify or enhance its disclosures. The board of directors and management frequently will want to know if the company or any company personnel have engaged in improper conduct. Indeed, the SEC has criticized a board of directors for failing to take adequate measures when confronted by evidence of fraudulent conduct by management. n1 Defense counsel's fact-gathering can assist the assessment of company personnel.

The fact-gathering can also help the company's senior officers and directors identify aspects of the company's internal controls that warrant improvement. In addition to providing the company with greater assurance of adherence to management's directions, the strengthening of internal controls can aid in the effective defense of the company. Anticipating the need for enhancements that the SEC might otherwise seek to obtain in an enforcement proceeding through a court or administrative order can reduce the perceived need for hasty or extensive intervention by the SEC.

In addition to retaining counsel to represent the company in an SEC investigation, a company can also retain counsel to investigate the relevant facts and report counsel's findings to management, the board of directors, a committee of independent directors, or a government entity. Although typically defense counsel performed many of these functions, it is increasingly common for companies, especially large companies, to retain a separate law firm to perform the function.

By retaining counsel to conduct an internal investigation, and taking appropriate remedial action based on the results may persuade the SEC that management will not tolerate wrongful behavior by rogue employees. The Staff sometimes defers its active investigation pending completion of an internal investigation. The willingness of the Staff to defer its active investigation turns on a number of factors, including:

- the identify of the attorneys conducting the investigation and the extent to which the attorneys are viewed as independent of management;
- the extent to which the company lets the Staff monitor, and have input into, the internal investigation; and
- the extent to which the Staff is comfortable that it will learn the results of the internal investigation on a timely basis. n2

An effective investigation by independent counsel can help defense counsel to persuade the Staff to conduct "a far more limited investigation" than it otherwise would have. n3 Demonstrating that management acted responsibly can assist defense counsel to persuade the SEC to accept settlement terms more favorable to the company than what might otherwise have been available.

An internal investigation by independent counsel can also benefit the company if it ends up litigating against the SEC by assisting the company in arguing against the imposition of civil penalties. In an FTC enforcement action, when a district court considered the civil penalty to be imposed on Phelps Dodge in connection with certain alleged violations of an FTC cease-and-desist order, one factor that the district court identified as indicating the company's bad faith was the failure of the company to investigate indications of misconduct. n4

In the wake of Enron, federal prosecutors have demonstrated an unprecedented interest in cases that involve accounting and financial disclosure. The federal sentencing guidelines for corporations call for an increase in criminal fines to be imposed on corporations in connection with criminal violations of federal law if senior corporate personnel "participated in, condoned, or [were] willfully ignorant of the offense" or if tolerance of the offense by substantial authority personnel was pervasive throughout the corporation. n5 Conversely, the federal sentencing guidelines for corporations call for a reduction in the criminal fine to be imposed on a corporation, under certain circumstances, if the criminal offense occurred despite "an effective program to prevent and detect violations of law." n6 The guidelines

provide for a presumption that the program was not effective if senior management participated in, condoned, or was willfully ignorant of the offensive conduct. n7 The internal investigation and associated remedial action can therefore assist the company in avoiding criminal prosecution or resolving the prosecution on terms more favorable than might otherwise have been available.

An internal investigation by independent counsel might also assist the company's directors in satisfying their duty of care. Delaware case law indicates that directors might be personally liable for fines, penalties and losses incurred by a company as a result of unlawful conduct by the company if the directors have not "assur[ed] themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance... ." n8 In a leading case, the Chancellor of Delaware stated that, under Delaware law, a director "has a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards." n9

When auditors develop concerns regarding the company's internal controls or the integrity of the company's management, the auditors might decline to issue an audit report or complete a quarterly review until independent counsel has completed an internal investigation under the direction of a committee of independent directors and has reported the results of that internal investigation to the auditor. Similarly, auditors might require that the company conduct an internal investigation in response to an auditor report pursuant to § 10A of the Exchange Act.

Certain SEC Staff members have taken the position that directors should not approach internal investigations passively or with a "bureaucratic or process-oriented mindset" because the company's interests may not always be served by an investigation if it is not structured correctly:

In the enforcement context, in particular, we have come to see investigations in which companies did not provide sufficient authority or resources to the lawyers and other professionals conducting an investigation. In other cases, companies have unduly circumscribed the scope of their inquiry. Sometimes the lawyers do not have the ability to ask questions of all relevant persons; sometimes accountants are asked to offer opinions based on limited factual presentations. The injury to a company from a poorly structured or executed investigation can be substantial; when regulators or enforcement authorities ultimately develop the full story, the company's credibility is injured, its attempt to claim credit for cooperation will be jeopardized, and the surprise to shareholders and others can further damage the company's reputation.

Thus, I would urge directors, when authorizing an independent investigation, to assure that their consent to any investigation is fully "informed": Have they have duly considered who will conduct the investigation? Have the investigating professionals been given adequate resources and tools to conduct the investigation adequately? Has the scope of the investigation been properly defined? n10

Accordingly, when authorizing an internal investigation, board members should assure themselves that the scope and conduct of the investigation are adequate.

Internal investigations by independent counsel can also have a positive effect on the company's public image. The fact that the company retained counsel to investigate the facts and took prompt remedial action based on the results of the internal investigation can assist the company in promoting an image of integrity. In addition, disclosure of the information obtained through counsel's investigation may tend to ease concerns of investors, creditors, and persons transacting business with the company. Such disclosure, however, may prompt the SEC or a private plaintiff to assert that the disclosure waived any privilege relating to the investigation. n11 Accordingly, the realistic benefits of such

disclosure should be carefully considered before counsel recommends such action.

FOOTNOTES:

(n1)Footnote 1. Report of Investigation in *The Matter of the Cooper Companies, Inc. As It Relates to the Conduct of Cooper's Board of Directors*, Exchange Act Release No. 35,082, 1994 SEC LEXIS 3975 (Dec. 12, 1994) .

(n2)Footnote 2. "Enforcement Staff Has Strong Interest in Monitoring Internal Probes, Official Says," Securities Law Daily (BNA May 11, 2007).

(n3)Footnote 3. "Enforcement Staff Has Strong Interest in Monitoring Internal Probes, Official Says," Securities Law Daily (BNA May 11, 2007) (quoting Assistant Director Yuri B. Zelinsky).

(n4)Footnote 4. *See United States v. Phelps Dodge Industries, Inc.*, 589 F. Supp. 1340, 1364 (S.D.N.Y. 1984) .

(n5)Footnote 5. *Guidelines Manual* § 8C2.5, 18 U.S.C.S. Appx. § 8C2.5. And although the Supreme Court, in *United States v. Booker*, 125 S. Ct. 738 (2005) , held that the guidelines are not mandatory, courts must still consult the guidelines at sentencing and prosecutors will still look to the guidelines in making their charging decisions.

(n6)Footnote 6. *Guidelines Manual* § 8C4.11, 18 U.S.C.S. Appx. § 8C4.11.

(n7)Footnote 7. *Guidelines Manual* § 8C2.5(f), 18 U.S.C.S. Appx. § 8C2.5(f).

(n8)Footnote 8. *In re Caremark Int'l., Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) .

(n9)Footnote 9. *Caremark*, 698 A.2d at 970 .

(n10)Footnote 10. Giovanni P. Prezioso, General Counsel, United States Securities and Exchange Commission, Remarks before the Vanderbilt Director's College (Nashville, TN, September 23, 2004), available online at www.sec.gov/news/speech/spch092304gpp.htm.

(n11)Footnote 11. *See* Chapter 12 (discussing the concepts of privilege and waiver, including the self-evaluative privilege). Given the multiple purposes that can be served by an internal investigation, it is desirable that the engagement letter reflect that the primary purposes of the internal probe is to provide legal advice and other legal services.



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CHAPTER 8 INTERNAL INVESTIGATIONS AND FACT-GATHERING BY DEFENSE COUNSEL

1-8 Securities Enforcement: Counseling and Defense § 8.03

AUTHOR: Kenneth B. Winer

§ 8.03 Staffing the Effort

It usually is appropriate for defense counsel to work closely with a company employee who acts as a guide regarding the structure and operations of the company and as a liaison between counsel and company personnel. This employee is often a member of either the legal department or internal audit department of the company. The employee selected for this task should have no apparent potential exposure and should be knowledgeable regarding the relevant organization and operations of the company.

In conducting the internal investigation, counsel may need the assistance of individuals with accounting, engineering or other areas of substantive expertise. Experts assisting counsel in conducting the internal investigation should be retained by counsel and the engagement letter should be drafted to protect the attorney-client and work product privileges applicable to the investigation. For example, the engagement letter should contain confidentiality provisions governing the information received by, and the work product of, those experts.

The company may employ people who have the necessary expertise and who (because they are already on the company's payroll and are already familiar with the company's business) can provide the expert assistance at a lower cost than an outside expert. Use of company staff can be appropriate "as long as there is no question of the staff being tainted." n1 Care should nevertheless be exercised before turning to company personnel to provide the expertise. Reliance on company personnel might impair the perceived independence of an internal investigation being conducted by independent counsel. In addition, reliance on company personnel may impair privileges that otherwise would apply to the work of an expert acting under the direction of counsel. In one case involving a grand jury subpoena, n2 company counsel had asked six company employees, who were responsible for monitoring the costs associated with certain contracts, to perform an analysis of those costs in anticipation of litigation. A grand jury sought testimony regarding this analysis. The company resisted the discovery, arguing that the employee's analysis was protected by work-product immunity and that the employees should be asked to testify without reference to the prior analysis conducted for the defense. The court rejected the company's argument holding that the employees could be compelled to testify regarding the analysis performed because that "factual information is not protected ... just because the information was developed in anticipation of litigation." n3 In addition, care should be exercised not to staff the internal investigation with company personnel who are potential witnesses.

Comment

If company personnel are assigned to assist defense counsel in the investigation, defense counsel should instruct the personnel to keep confidential any documents that they generate while assisting defense counsel and to mark all such documents as confidential, privileged, and prepared for the purpose of assisting counsel. n4

If counsel retains a private investigator to assist the investigation, counsel should take steps to ensure that the investigator does not engage in conduct likely to be viewed as improper by either law enforcement agencies or triers of fact. For example, investigators should be instructed that they should not engage in misrepresentations in order to obtain desired information or in any other conduct that would be improper for counsel.

FOOTNOTES:

(n1)Footnote 1. J. Lumb, "Conference Panelists Review Internal Investigation Procedures," SEC Today (BNA Dec. 14 2007) (comment of Mark Schonfeld, Director of the SEC's Northeast Regional Office).

(n2)Footnote 2. *In re Six Grand Jury Witnesses*, 979 F.2d 939 (2d Cir. 1992) .

(n3)Footnote 3. *In re Six Grand Jury Witnesses*, 979 F.2d at 945 .

(n4)Footnote 4. To the extent that such documents are created on computers, it is important that the computerized version of such documents also bear such legends.



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CHAPTER 8 INTERNAL INVESTIGATIONS AND FACT-GATHERING BY DEFENSE COUNSEL

1-8 Securities Enforcement: Counseling and Defense § 8.04

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§ 8.04 Conduct During the Effort

[1] Disclosure to Staff of Results of Internal Investigations

As mentioned below, one of the reasons why companies that are the subject of SEC investigations often decide to conduct an internal investigation and to report to the Staff regarding the results of that internal investigation is to encourage the Staff to defer the production of documents and testimony. As set forth below, the Staff tends to consider a number of factors in deciding whether to defer these steps.

The Staff is more likely to defer the production of documents and the taking of testimony pending the completion of an internal investigation if the company permits the Staff to monitor, and have input into, the progress of the internal investigation. Staff members often ask about the scope of the internal investigation and suggest expansions in the scope. In addition, Staff members often ask to review the internal investigation work plan and often suggest modifications in the plan, such as additional witnesses to be interviewed and additional terms to be used in electronic searches of electronically stored data. n1 In addition, the Staff often requests updates regarding the progress of the internal investigation and significant evidence gathered in connection with the internal investigation.

In addition, the Staff is more likely to defer the production of documents and the taking of testimony if the Staff is comfortable with the competence and independent mental state of the individuals conducting the internal investigation. Where there is a substantial question regarding the conduct of the company's senior management, the Staff is likely to be uncomfortable if the internal investigation is conducted or directed by company employees or the company's regular outside counsel. Similarly, the Staff is likely to be concerned if the individuals conducting the internal investigation lack experience in conducting internal investigations.

The Staff is more likely to agree to a short deferral than to a long deferral. The Staff is also more likely to agree to a deferral if the Staff is comfortable that the company has taken effective steps to preserve relevant documents.

Of course, the Staff's willingness to defer the production of documents and the taking of testimony is also influenced by the extent to which the relevant Staff members are consumed by other matters. The Staff is more likely to agree to a deferral if the relevant Staff members are extremely busy on other important matters.

The Staff often is reluctant to defer substantially the taking of testimony unless the Staff is comfortable that the company will report to the Staff the results of the internal investigation. n1.1 Although the Staff often prefers to receive a written report of the internal investigation, it will often accept oral briefings accompanied by a presentation of, and explanation of, the key evidence gathered in the internal investigation.

[2] Development of the Action Plan

The company, in conjunction with independent counsel, should decide on the scope of an internal investigation. For example, if it appears that the SEC investigation was triggered by a press report questioning whether the company prematurely recognized revenue on two large contracts by the company's European subsidiary in the second quarter of the previous fiscal year, the scope of the internal investigation will probably include the facts and circumstances related to the recognition of revenue on those two contracts. Counsel and the company will have to consider whether the scope should be expanded to include other topics, including: (1) other contracts on which the European subsidiary recognized revenue in that quarter; (2) other contracts on which the European subsidiary recognized revenue in other selected periods; (3) selected other contracts on which the company recognized revenue; (4) the company's disclosure controls and procedures; (5) the conduct of company personnel; and (6) the quality of the company's narrative disclosures. In making this determination, counsel and the company should consider the various purposes to be served by the internal investigation.

Determining the scope of the investigation involves a delicate balancing of the factors discussed in connection with the decision of whether to undertake an internal investigation. Consideration should be given to: (1) the expected scope of the SEC investigation; (2) the need to uncover evidence that might assist the company in responding effectively to the SEC investigation; (3) the need for the company to determine the extent to which remedial action is appropriate, including determining whether and how company personnel should be disciplined; (4) the extent to which company records were falsified, the extent to which the company's disclosure controls and procedures should be enhanced, and the extent to which other remedial action should be taken (e.g., if the company prematurely recognized revenue, consideration should be given to whether a restatement is required); (5) if it is anticipated that the results of the internal investigation might be disclosed to the SEC, the need to satisfy the SEC that the scope of the internal investigation was adequate; (6) the expense and disruption caused by the internal investigation; (7) the need for speed; and (8) the need to maintain the confidentiality of the internal investigation.

At the outset of an internal investigation, the company should issue to counsel a charter setting forth the mandate pursuant to which the internal investigation is being conducted. The company and counsel should discuss the scope of the internal investigation. In many instances, counsel should obtain a committee resolution, a letter or memorandum authorizing counsel to conduct a confidential internal investigation, defining the scope of the investigation, authorizing counsel to inform company personnel that they are instructed to cooperate in the investigation, and (if applicable) specifying that the investigation is in anticipation of litigation and for the purpose of the company's obtaining legal advice. This process forces the company to focus on the scope of the internal investigation and will assist the company in successfully seeking the protection of the attorney-client privilege and the work-product doctrine in the event that discovery is sought in United States courts for documents generated in connection with the internal investigation. n2

Comment

The company and counsel should reevaluate the scope of the investigation as information is gathered and analyzed. While an investigation of limited scope might appear appropriate initially, the investigation might uncover information that warrants a substantial expansion of the scope of the investigation. On the other hand, if information is obtained that casts a new light on the initial indications of possible wrongdoing, it might be appropriate to curtail the initial scope of the investigation. This is especially true because, in light of the pending SEC investigation, counsel needs to conduct the internal investigation

quickly. In addition, the company's senior management and board of directors might have an urgent need for the results of the investigation so that they can make informed decisions regarding the extent to which remedial action is warranted.

Once the scope of the investigation has been defined, counsel should develop an action plan. Counsel should identify the categories of documents to be gathered and the individuals responsible for gathering the documents. Counsel should also identify the witnesses to be interviewed and the topics to be covered during the interviews. Counsel should address the order of the interviews and the extent to which potential interviews can be conducted by telephone or other means. In connection with both the search for documents and the conduct of interviews, counsel should consider the extent to which they will require the assistance of experts (e.g., accountants).

One important issue that often arises in developing an action plan is the extent to which counsel should contact third party witnesses. In many instances, third parties are likely to possess information significant to the investigation. For example, in an investigation involving revenue recognition, customer personnel might have significant information regarding when sales contracts were executed and whether the sales contracts were accompanied by any side agreements. On the other hand, contacting third parties might endanger the confidentiality of the investigation or jeopardize the company's relationship with the third party. In many instances, an approach can be developed that will enable counsel to obtain the required information while minimizing the associated risks.

An action plan often evolves during the investigation as documents are gathered and reviewed and witnesses are interviewed. This evolution can result from a number of factors including: redefinition of the scope of the investigation; the identification of new avenues of investigation; the receipt of additional SEC subpoenas; or a conclusion that one of the issues initially identified has been resolved and that some of the avenues of investigation initially identified are no longer warranted.

In planning an internal investigation, consideration should be given to the possibility that the company will not be able to file a compliant quarterly or annual report until the internal investigation has been completed and the results of the internal investigation have been reported to the company and, perhaps, the auditors and the SEC Staff. The board and top management might hesitate to authorize, or sign the filing until these steps have been accomplished. In addition, the auditor might decline to complete its review or audit until these steps have been completed. Given the significant consequences that can result from a failure to file timely, it is important to keep this potential milestone in mind.

In planning the internal investigation, counsel should be mindful of certain critical dates: the date on which the upcoming periodic report is initially due, the date on which applicable extensions expire, the date by which a periodic filing must be filed to avoid the breach of a loan covenant, the date by which a filing must be filed to avoid delisting by the NYSE, NASDAQ or other exchanges. In setting the timetable for the action plan, counsel should work back from that critical date, allowing sufficient time for the auditor to evaluate, and respond to, the results of the internal investigation. Although it is appropriate for counsel to be mindful of the critical dates in planning and conducting the internal investigation, counsel should not inappropriately limit the scope or thoroughness of the internal investigation to meet the company's timetable.

[3] Searching for Company Documents

For defense counsel's fact-gathering and independent counsel's internal investigation, the search for and review of company documents can be crucial. For independent counsel, documents can provide important evidence. Documents frequently reflect information that is not available through the recollection of live witnesses, but that might have a significant impact on the outcome of the SEC investigation. For example, the correspondence between the company and its auditor might demonstrate that the company disclosed all relevant facts regarding a transaction to the auditor and that the auditor concurred in the company's accounting for that transaction. Similarly, company documents might contain information, no longer recalled by management, corroborating the reasonableness of management's judgment. In

addition, documents can be useful in questioning witnesses. If a government investigation is already underway and the internal investigation team plans to use key words to search for documents, consideration should be given to sharing the list of search terms with the Government.

For defense counsel, documents are also important because they can assist defense counsel in forecasting the likely direction and outcome of the SEC investigation and in preparing witnesses for testimony. The Enforcement Staff tends to place great weight on the documents and to make extensive use of documents in questioning witnesses. Corporate documents can refresh the recollections of a witness so that the witness can fairly and effectively testify regarding exculpatory information. Similarly, careful consideration of a document by the witness in advance of testimony often enables the witness to recall more fully the context in which the document was created and received. Counsel should take steps to ensure that the company preserves, and the company's IT department does not inadvertently destroy, documents relevant to the matter being investigated. If a government investigation is already underway, consideration should be given to discussing with the Government the steps being taken and the steps not being taken with respect to back-up tapes and to the electronically stored information.

Often the search for documents in connection with defense counsel's fact-gathering and independent counsel's internal investigation is combined with the search for documents responsive to the initial SEC subpoena(s). The process of securing, searching for, and organizing relevant documents is discussed in Chapter 9.

[4] Interviewing Company Personnel

Interviews of company personnel often constitute another important part of defense counsel's fact-gathering and independent counsel's internal investigation. Along with the review of company documents, interviews of company personnel are usually a primary source of information. In addition, these interviews offer the defense counsel an opportunity to assess the credibility of the witnesses and to begin the process of preparing them to testify if the SEC subpoenas their testimony.

Before interviewing personnel, counsel should review the relevant documents, prepare an outline of topics to be covered with the witness, and select the documents that should be shown to the witness during the interview. If the witness authored the document, the witness might be able to explain what a document was intended to convey or why the document was drafted. Other witnesses might be able to place important documents into context or provide information regarding steps taken in response to the documents or regarding meetings and other events described in the document. By showing a document to a witness, counsel might refresh a witness's recollection or persuade a witness to provide accurate information that the witness might otherwise not have provided.

Comment

Counsel should exercise caution before showing a witness documents that the witness has not previously seen. Showing such a document to a witness can result in confusion if months or years later the Staff questions the witness about whether the witness has ever seen the document. Counsel should also exercise caution before showing a privileged document to a witness. There is a risk that doing so could result in a court later holding that the privilege has been waived. *Rule 612, Federal Rules of Evidence.*

Counsel sometimes use questionnaires to identify potential witnesses. In general, the use of questionnaires should be limited to soliciting objective information to screen for individuals who need not be interviewed. The questionnaire should indicate that the defense counsel is not representing any individual company personnel in connection with the matter. Before defense counsel circulates a questionnaire, defense counsel should ensure that the questionnaires are clearly labeled as created pursuant to an attorney-client relationship between the company and defense counsel.

At the beginning of each interview, defense counsel should explain to the witness that: (1) the company, not the witness,

is counsel's client; n4 (2) they seek information to assist in providing legal advice and services to the company; (3) the company's ability to successfully assert privileges under United States law with respect to this investigation requires that the witness keep the substance of the interview confidential from anyone other than counsel; and (4) the company, not the witness, controls the privileges associated with the investigation and has the sole right to determine whether to waive any privileges associated with this internal investigation and may decide to disclose information to the SEC or other government agencies. Counsel should also explain that (1) senior management has authorized the counsel to state that company employees should cooperate in the investigation; (2) counsel are attempting to determine the truth relating to certain issues; and (3) the witness should not destroy or discard any documents relevant to the investigation. If the company is considering disclosing, or has committed to disclose to the SEC information obtained in the interview, then counsel should consider so advising the witness. A witness commits obstruction of justice when deceiving company counsel during an interview while knowing, after company counsel informed the witness, that the company may choose to disclose to other third parties--including government agencies--any witness-proffered information. n5

Comment

Defense counsel should consider including these statements in a memorandum that is provided to the witness either in advance of the interview or at the beginning of the interview.

In a number of instances, employees interviewed by company counsel have subsequently asserted that their communications with company counsel are protected by a privilege controlled by the employee and that the company therefore is not free to disclose the contents of those communications. Courts have developed a number of tests for evaluating these assertions. A recent opinion by Judge Lewis Kaplan contains a useful summary of those standards. n6

The company's defense counsel should think carefully before telling a company employee that company counsel could also represent the employee. In 2005, the Fourth Circuit addressed the instructions given to company employees who were being interviewed by company counsel. n7 At each of three interviews, company counsel advised the employee that counsel represented the company--not the employee--that the privilege belongs to the company, and that the company decides whether to waive the privilege. Counsel also made statements such that although they represented the company, they "can represent [the employee] until such time as a conflict appears, [but] ... the attorney client privilege belongs to [the company] and [the company] can decide whether to keep it or waive it." n8

When a grand jury issued a subpoena calling for documents relating to the interviews, the company agreed to waive the attorney-client privilege and produce the documents. The three employees moved to quash, asserting that each had an attorney-client relationship with the company counsel who had conducted the interviews. The District Court denied the motion to quash. The Fourth Circuit panel unanimously affirmed, rejecting the employees' argument that company counsel's statement that they could represent the employees "manifested an agreement by the investigating attorneys to represent them." n9 The Fourth Circuit cautioned that:

our opinion should not be read as an implicit acceptance of the watered-down "Upjohn warnings" the investigating attorneys gave the appellants. It is a potential legal and ethical mine field. Had the investigating attorneys, in fact, entered into an attorney-client relationship with appellants, as their statements to the appellants professed they could, they would not have been free to waive the appellants' privilege when a conflict arose. It should have seemed obvious that they could not have jettisoned one client in favor of another. Rather, they would have had to withdraw from all representation and to maintain all confidences. Indeed, the court would be hard pressed to identify how investigating counsel could robustly investigate and report to management or the board of directors of a publicly-traded corporation with the necessary candor if counsel were constrained by ethical obligations to individual employees. However, because we agree with the district court that the appellants never entered into an attorney-client relationship with the investigating attorneys, they averted these troubling issues. n10

Some company employees may request that their own counsel attend any interview by company counsel. Company counsel usually can agree to this request as long as accommodating this request does not result in excessive delays.

In advance of the interview, consideration should be given to whether to specifically advise the witness that the witness has a right to have personal counsel present at the interview. Counsel should consult with the company as to whether the witness should also be advised that the company will indemnify the witness for reasonable fees and expenses associated with the participation of personal counsel in the interview. Companies consider a number of factors in assessing whether to pay these fees and expenses. These factors include the applicable corporate indemnification statutes, the corporate charter and bylaws, the witness's employment contract, as well as the benefits that the company may derive by providing separate counsel. These benefits include the possibility that separate counsel may give the employee the confidence necessary to speak candidly to counsel and the risk that a failure to pay these fees and expenses may undermine corporate morale.

Comment

This part of the interview is very delicate. Counsel should be sensitive to the danger that these communications will unduly alarm the witness and thereby impede the ability of the company to gather the necessary information.

In most circumstances, at least two members of counsel's team should be present for each witness interview. One member of the team can take the lead in asking questions and the second member can focus on taking notes. Moreover, the second member can later serve, if necessary, to corroborate the recollections of the first member regarding the statements of the witness and to confirm that the first member conducted the interview appropriately.

Independent counsel typically takes detailed notes of and prepares memoranda of employee interviews. Careful thought should be given as to whether the company's defense counsel should take notes of employee interviews and if memoranda should be prepared. In deciding whether to prepare a record of interviews, consideration should be given to the possibility that the company may later waive attorney-client and other applicable privileges or the memoranda might otherwise be deemed not protected by privilege. n11 On the other hand, management and the audit committee might want the additional comfort that comes from having the interviews documented. Moreover, the SEC and other law enforcement agencies are likely to view with skepticism any internal investigation in which interviews were not documented.

The notes of the interview should be marked as "Confidential," and should state (if true) that they reflect the attorney's mental impressions and are not a substantially verbatim record of the interview. The notes should clearly reflect, in detail, that the investigators made the appropriate statements to the witness at the outset of the interview.

Comment

There are several reasons why a court might determine that internal investigation materials are not protected by the attorney-client privilege or work product immunity. A court might determine that the primary purpose of the investigation was not to obtain legal advice or services or to prepare for litigation. A court might conclude that the privilege was waived by the assertion of a reliance on counsel defense. A court might determine that because of disclosures made to the SEC, auditors or the public, the privilege was waived. Alternatively, a court might conclude that the company did not have the requisite intent to keep the materials confidential.

In taking interview notes and drafting the interview memoranda, the investigator should be conscious of the possibility that the memoranda will ultimately be disclosed to the SEC or another law enforcement agency. Care should be taken to make the interviews accurate and complete. Consideration should be given as to whether witness statements should be

quoted verbatim or paraphrased. Given the likelihood that privileges will be waived or otherwise found not to apply, attorneys should hesitate to incorporate mental impressions into the notes or interview memoranda.

In taking notes and preparing interview memoranda, counsel should make a record of both the exculpatory and incriminating evidence elicited. It can undermine the credibility of an internal investigation if it appears that counsel engaged in selective note-taking. Many companies provide copies of interview memoranda to the Staff, and Staff members often examine the memoranda carefully, not only to learn the information obtained from the witness, but also to assess the scope, thoroughness and vigor of the questioning. In addition, failure to record incriminating statements can deprive the company of a documented basis for some of its decisions.

The employee may ask for a copy of counsel's interview notes or interview memorandum. Having the employee review the memorandum might enhance the accuracy and utility of the memorandum. Counsel should, nevertheless, hesitate to agree to this request. A witness who reviews an interview memorandum might be found to have adopted the memorandum as the witness's own statement, which could make the memorandum discoverable. Counsel often decline to make interview notes or memoranda available to a witness, largely because of time constraints and privilege concerns.

Counsel should also hesitate before tape recording a witness interview or having a court reporter transcribe the interview. Courts are less likely to treat such a record of the interview as protected by the attorney-client and/or work product privileges than a memorandum that has been prepared by counsel and that contains the mental impressions of counsel. n12 In addition, witnesses are often less candid if the interview is being recorded. Furthermore, there is a significant risk that a witness will misstate certain facts during the initial interview either because the witness has not yet reviewed relevant documents and taken other steps to refresh his/her recollection or because the witness might be tempted to distort the truth intentionally.

Company employees, other than the witness and inside counsel, should be discouraged from attending the interviews. The presence of senior officers at interviews could possibly chill the candor of the witness and may also be interpreted as evidence that the interview had a business purpose. Additionally, there is a significant risk that the senior officer will be required to testify regarding knowledge obtained as a result of his or her presence during such interviews and that the Enforcement Staff will suspect that his or her presence was part of an effort to conform the witness's recollection with the version of the facts advocated by the executive.

If the witness is represented by personal counsel, counsel should exercise caution before agreeing that the interview will be subject to an undefined "joint defense privilege" or other limitations on the ability of the company to use the information obtained in the interview. n13 The danger posed by an undefined joint defense agreement is illustrated by two interviews of the then-chief financial officer of Empire Blue Cross and Blue Shield. At the interviews, Empire was represented by both inside counsel and outside counsel and the CFO was represented by his personal attorney. After learning that Empire was the subject of a grand jury investigation, Empire's counsel later provided its notes of the interviews to the prosecutors and the prosecutors indicted the CFO. There was a factual dispute as to whether the first interview had been expressly subject to a joint defense agreement. In assessing this factual dispute, the district court noted that if the interview was covered by an express joint defense agreement, then the disclosure of the notes taken by Empire's counsel was a breach of that agreement and constituted "unprofessional conduct." n14 After finding that the second interview may have been protected by the joint defense privilege, the district court stated that it would have to consider what remedy would be appropriate. n15

Comment

Company counsel should make it a practice to document the extent, if any, to which a company is agreeing to limits on its ability to use information obtained in an interview.

This case also illustrates the importance of documenting the extent, if any, to which the company is agreeing to limits on its ability to use information obtained in an interview. After noting that neither the CFO nor his counsel were able to locate their notes to corroborate their testimony that the first interview was expressly subject to a joint defense agreement and that the notes of Empire's counsel did not refer to a joint defense agreement, the district court found that the CFO had not met his burden of showing that the first interview was expressly covered by the joint defense privilege. n16

During the interview, counsel should ask questions designed to learn all the information that the witnesses can recall regarding the relevant events and the circumstances surrounding the events. Thus, counsel usually should refrain from initially relying on leading questions. Rather, counsel should ask open-ended questions, listen attentively to the witness and encourage the witness to tell the story in the witness's own words.

Comment

Company counsel will sometimes need to interview a witness more than once. After conducting the interview, counsel might become aware of statements by other witnesses or of documents that generate new questions to pose to the witness. Insights gained from communications with the SEC might give defense counsel new appreciation for the implications of statements made in earlier interviews. As a result of information gathered during the internal investigation, the scope of the investigation might broaden to include topics that were outside the scope of the investigation when the witness was previously interviewed.

Company counsel may request that the witness contact counsel if the witness recalls any additional information or discovers any additional documents pertaining to the subject of the investigation. To the extent possible, defense counsel should avoid telling one witness what another witness has told counsel or otherwise refrain from educating the witness, although it will often be necessary to refresh the witness' recollection regarding facts of which the witness once had knowledge.

Counsel's interview of a witness who is a former employee of the company may be protected by attorney-client privilege if the interview relates to information obtained when the witness was an employee of the company. While the law is not completely settled, a number of courts have held that the attorney-client privilege can apply to communications between a former employee of a company and counsel to a company, at least if the former employee had been employed by the company while the relevant conduct occurred. n17

Documents frequently reflect information that witnesses do not recall, but that might have a significant impact on the outcome of the SEC investigation. For example, the correspondence between the company and its auditor might demonstrate that the company disclosed all relevant facts regarding a transaction to the auditor and that the auditor concurred with the company's accounting for that transaction. Similarly, company documents might contain information, no longer recalled by management, corroborating the reasonableness of management's judgment. Corporate documents can refresh the recollections of a witness so that the witness can fairly and effectively testify regarding exculpatory information. Similarly, careful consideration of a document by the witness in advance of testimony often enables the witness to recall more fully the context in which the document was created and received.

[5] Information and Materials from Sources Outside the Company

Company counsel should also consider conducting a search of publicly available information. For example, in connection with SEC investigations into securities trades, it is often important for counsel to obtain trading information from the listing exchange or from the NASDAQ and relevant news stories or analyst reports from computer databases.

In many instances, individuals or entities outside the company are also important sources of information. Company

counsel should carefully consider contacting these persons (or their counsel) in order to learn the information in their possession and any information or documents that these individuals or entities provided to the SEC Staff. Before making these contacts, however, company counsel should consider whether they are likely to be protected by a joint defense privilege and whether steps should be taken to bolster the assertion of the joint defense privilege. n18 Even in the absence of any joint defense agreement, debriefing these persons may be warranted in light of the importance of the information they possess to an effective defense of the company.

Comment

Company counsel should be mindful in interviewing third parties, however, that the fact and substance of the interview will likely be disclosed to the SEC and perhaps others.

Company counsel should consider whether persons other than the client are likely to have relevant documents. To the extent that the relevant documents are exculpatory or have been obtained by the SEC, counsel should consider attempting to obtain copies of such documents, regardless of whether they have been subpoenaed by the Staff. During the investigation, the SEC will not disclose those documents to company counsel except to the extent the Staff introduces the documents as exhibits in testimony. On the other hand, to the extent that such documents are incriminating and have not been obtained by the SEC, defense counsel should consider merely inspecting the documents.

In one action to enforce a grand jury subpoena, n19 counsel for a company and its sole shareholder obtained copies of certain telephone records from the telephone company. Apparently, the telephone company destroyed the records before they could be subpoenaed by the government. The government instead subpoenaed the records from counsel. In ordering the production of these records, the Second Circuit noted that while documents created by a defendant's attorneys or their agents in connection with a case are not discoverable under the Federal Rules of Criminal Procedure, these records had been created by a third party (the telephone company) and were discoverable.

FOOTNOTES:

(n1)Footnote 1. Note however, the discussion of private entity investigations in the *Enforcement Manual* at § 3.1.4, pp. 44-45 ("Do not take any investigative step principally for the benefit of the private entity's investigation or suggest investigative steps to the private entity.").

(n2)Footnote 1.1. See Chapter 12, *below*, regarding the attorney-client privilege, the attorney-work product privilege and the impact of disclosure to the Government on the protection that these privileges provide to materials generated in an internal investigation.

(n3)Footnote 2. If the principal purpose of the investigation is to prepare for anticipated litigation, the ability of the company to successfully assert the work product privilege can be undermined if the company makes statements or creates documents that create a contrary impression. See *In re Kidder Peabody Sec. Litig.*, 168 F.R.D. 459, 462-467 (S.D.N.Y. 1996) (holding that the work product privilege did not protect memorandum summarizing interviews taken during investigation because investigation would have been conducted for business purposes even if litigation had not been anticipated).

(n4)Footnote 3. See R. Hanson, D. Lee, M. Morrow "Consequences of Untimely Periodic Reports under the Exchange Act," 21 Insights No. 3 at 8 (Aspen Publishers, March 2007).

(n5)Footnote 4. D.C. Bar Ethics Opinion No. 269, Obligation of Lawyer for Corporation to Clarify Role in Internal Corporate Investigation (January 15, 1997) (where a possible conflict between a corporation and a corporate employee is apparent and there is any ambiguity regarding the lawyer's role, the lawyer should advise the employee of the lawyer's position as counsel to the corporation.). See also *United States v. Int'l Bhd. of Teamsters*, 119 F.3d 210, 217 (2d Cir. 1997).

(n6)Footnote 5. Second Superseding Indictment, *United States v. Singleton*, Criminal No. H-04-514-SS (S.D. Tex.); Press Release, "Former Computer Associates Executives Indicted on Securities Fraud, Obstruction Charges; Former General Counsel Pleads Guilty; Company Enters Into Cooperation Agreement," (U.S.D.O.J. Sept. 22, 2004) available at www.usdoj.gov/usad/nye/pr/2004oct06a.htm.

(n7)Footnote 6. *United States v. Stein*, 463 F.Supp.2d 459, 462-466 (S.D.N.Y. 2006) .

(n8)Footnote 7. *In re Grand Jury Subpoena*, 415 F.3d 333 (4th Cir. 2005) .

(n9)Footnote 8. *In re Grand Jury Subpoena*, 415 F.3d at 336 .

(n10)Footnote 9. *In re Grand Jury Subpoena*, 415 F.3d at 340 .

(n11)Footnote 10. *In re Grand Jury Subpoena*, 415 F.3d at 340 .

(n12)Footnote 11. Materials prepared in connection with an investigation might not be deemed protected by attorney-client or work product privilege if: (1) the primary purpose of the investigation is a business purpose; (2) the materials were prepared in the expectation that they would be provided to third parties; or (3) the results of the internal investigation were shared with the company's auditor or another third party.

(n13)Footnote 12. *See Fed. R. Cr. P. 26.2* (Federal Rule of Criminal Procedure requiring production of contemporaneously recorded statements after a witness has testified on direct examination at trial.).

(n14)Footnote 13. *See United States v. Weissman*, 1996 U.S. Dist. LEXIS 19066 (S.D.N.Y. April 3, 1996) . *See also In re Grand Jury Subpoena*, 415 F.3d 333, 341 (4th Cir. 2005) .

(n15)Footnote 14. *Weissman*, 1996 U.S. Dist. LEXIS 19066 at *43 .

(n16)Footnote 15. *Weissman*, 1996 U.S. Dist. LEXIS 19066 at *92 .

(n17)Footnote 16. *Weissman*, 1996 U.S. Dist. LEXIS 19066 at *43 .

(n18)Footnote 17. *In re Allen*, 106 F.3d 582, 605 (4th Cir. 1997) ; *In re Coordinated Pretrial Proceedings in Petroleum Prod. Antitrust Litig.*, 658 F.2d 1355, 1361 n.7 (9th Cir. 1981) .

(n19)Footnote 18. *See Chapter 12* (discussing the elements and assertion of the joint defense privilege); *see also In re Grand Jury Subpoena Duces Tecum Dated Nov. 16, 1974*, 406 F. Supp. 381, 389-393 (S.D.N.Y. 1975) (describing the requirements of the joint defense privilege).

(n20)Footnote 19. *In re Grand Jury Subpoenas Dated Oct. 22, 1991*, 959 F.2d 1158, 1166 (2d Cir. 1992) .



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CHAPTER 9 PRODUCTION OF DOCUMENTS

1-9 Securities Enforcement: Counseling and Defense 9.syn

AUTHOR: Kenneth B. Winer

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CHAPTER 9 PRODUCTION OF DOCUMENTS

1-9 Securities Enforcement: Counseling and Defense § 9.01

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§ 9.01 Introduction

Documents often play a central role in an SEC investigation. From the perspective of the Staff, documentary evidence is often central to reconstructing the events under investigation. Moreover the Staff tends to rely heavily on exhibits when questioning witnesses.

From the perspective of the recipient of a document request, the preservation, collection, review and production of relevant documents can be costly. Documents may contain representations that are materially misleading and form the basis of a possible enforcement action. The Staff often views documents as key evidence regarding the conduct and state of mind of potential defendants and often relies heavily on documents in questioning witnesses. The issuer's records can fail to accurately and fairly reflect transactions in the assets of the issuer. A broker-dealer or other regulated entity may fail to keep and maintain records required by the federal securities laws. Destruction of relevant documents can result in felony charges. Failure to produce responsive documents in a timely manner can heighten the suspicions of the Staff and result in the imposition of sanctions, especially for registered broker-dealers.

The Staff can request that a person voluntarily produce documents and information or, in formal investigations, issue subpoenas demanding the production of documents. In addition, the Staff can utilize the SEC's examination power to obtain documents and information from regulated entities, such as securities broker-dealers. n1

Once the Commission has issued a Formal Order of investigation, any member of the Staff who is designated on the Formal Order as an officer of the Commission can issue a subpoena *duces tecum*, calling for the production of documents. Typically, the subpoena will call for the production of original documents, and the transmittal letter from the Staff will state that the witness may instead produce copies at his or her expense.

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, Securities Exchange Act § 17(b), *15 U.S.C.S. § 78q(b)*; Investment Company Act § 31(b), *15 U.S.C.S. § 80a-30(b)*.



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CHAPTER 9 PRODUCTION OF DOCUMENTS

1-9 Securities Enforcement: Counseling and Defense § 9.02

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§ 9.02 Preservation of Documents

As soon as the company learns that it is the subject of an investigation by the SEC or other law enforcement agency (or even that it is likely to become such a subject), the company should take affirmative steps to preserve documents relevant to the investigation. Prompt preservation of documents is important for several reasons. First, it is a federal crime to destroy, or encourage others to destroy, documents with the intent of obstructing an SEC investigation. n1 As the prosecutions of Arthur Andersen, Frank Quattrone, and Martha Stewart illustrate, federal prosecutors are eager to bring charges in matters involving destruction of relevant documents. The Sarbanes-Oxley Act requires accountants to "maintain all audit or review work papers [in connection with the audit of an issuer of securities to which Section 10A(a) of the Exchange Act applies] for a period of five years from the end of the fiscal period in which the audit or review was conducted." n2 The Act also forbids the alteration or destruction of documents relating to a government proceeding. n3

Second, the SEC is likely to react adversely to companies that are involved in the destruction of documents, which will likely both prolong the investigation and result in the SEC seeking more severe sanctions against the company. For example, in September 2003, the SEC imposed a \$10 million monetary penalty on a company charged with aiding and abetting a public company in issuing materially false financial statements. The charging document criticized the respondent for failing to conduct an adequate search for responsive documents. The respondent produced documents initially pursuant to requests for voluntary production and subsequently pursuant to subpoenas. The respondent then supplied a certification that the production was complete. Subsequently, the Staff made further inquiries which led to the production of a large quantity of additional documents many of which--in the view of the Staff--should have been produced before the certification. The Commission charged that the respondent failed to search in certain offices reasonably likely to contain responsive documents and to search adequately the respondent's computer drives. n4 In the release announcing the settlement, the SEC Staff stated that the magnitude of the penalty was partially due to the respondent's inadequate search for and production of documents. n5

In March 2004, the SEC charged Banc of America Securities LLC under the recordkeeping and access requirements of Sections 17(a) and 17(b) of the Exchange Act and Rule 17a-4(j) for document production failures during an SEC investigation. n6 In this settled ceased-and-desist proceeding the SEC imposed a \$10 million penalty. Although the cease-and-desist proceeding was brought under recordkeeping and access requirements applicable only to registered

broker-dealers, the proceeding further signaled the intent of the SEC to impose monetary penalties on defendants that are perceived to have engaged in discovery abuses during the SEC investigation.

The Enforcement Staff now maintains a "cooperation log" in connection with each investigation. The Staff members are instructed to record in this log each perceived discovery abuse (including untimely or incomplete document productions), as well as each instance of perceived cooperation.

Third, the destruction of relevant documents can impair the ability of a company to defend both the SEC investigation and private litigation. The documents destroyed may result in exculpatory information becoming unavailable to the company. In addition, a trier of fact may interpret the company's destruction of documents as evidence that the company did engage in wrongful conduct. Indeed, there is substantial precedent indicating that, at least in some circumstances, a court may instruct a jury that it can infer that the destroyed documents would have contained damaging evidence.ⁿ⁷ Moreover, destruction of documents was a factor cited in the cease-and desist order imposing the \$10 million penalty on Banc of America Securities.ⁿ⁸

Upon learning of an SEC investigation (or the likelihood of an SEC investigation) counsel should consider preparing a memorandum or e-mail to be sent out by the company's general counsel to employees having possession, custody, or control of possibly responsive documents informing these individuals of the investigation and the need to preserve all documents related to the subject matter of the investigation. The company should exercise care in drafting this document so that it properly emphasizes the importance of preserving the documents and clearly sets forth the scope of the documents that must be preserved. In drafting the document, counsel should realize that the document may later be reviewed by the SEC, another law enforcement agency, or a trier of fact. If the company has received a subpoena or document request from the government, it may be appropriate to include the specifications in the subpoena or document request as well as a broader and clearer description of the documents to be preserved so that there can be no question that the company took steps to preserve all documents responsive to the specifications. In any event, it is advisable to limit an employee's discretion in deciding which documents relate to the subject matter of the investigation. The e-mail or memorandum should specify that it extends to computerized documents and, where appropriate, to tape recordings.

The company should also exercise care in identifying the personnel to whom the company should send the e-mail or memorandum. A team that includes both inside counsel and outside counsel should work to identify the appropriate recipients of the e-mail or memorandum. Although the company may legitimately fear that a broad circulation of the document preservation e-mail or memorandum will be disruptive and generate damaging rumors, an overly narrow list of recipients could lead to the destruction of relevant documents.

In many instances, it may be appropriate to take additional steps to ensure that paper documents are being preserved. Many non-lawyers tend not to be as thorough in identifying and preserving relevant documents as the SEC Staff expects. In addition, the Staff is likely to be skeptical of document preservation measures implemented by employees whose integrity is in doubt. Furthermore, if the preservation effort was imperfect, the Staff may be more likely to suspect bad faith if the preservation efforts were implemented by employees whose conduct is being investigated. Accordingly, counsel should consider sending someone whose integrity is not in question to secure documents located in key locations or accessible by individuals whose integrity is in question.

The company should also address routine document destruction activities such as the overwriting or deletion of electronic data and the scheduled destruction of documents maintained in document storage facilities by suspending all document retention procedures that might result in the inadvertent destruction of relevant documents. To ensure that the company has identified all inconsistent document retention policies, it is sometimes useful to review the company's written document retention policies and to discuss with knowledgeable company personnel those document retention policies that have not been reduced to writing. In appropriate circumstances, consideration should be given to imaging the hard drives of key personnel in order to protect against those personnel inadvertently deleting or altering significant evidence. To ensure that backup tapes and other electronically stored information is preserved, it often is appropriate for

company counsel to consult with members of the company's IT department, including both senior members of the IT department and the technicians with more on-the-ground knowledge of how the company maintains, stores, and deletes electronic documents. In addition, there are a number of consulting firms that specialize in assisting companies in preserving, collecting, processing and producing documents in connection with government investigations and with litigation. Counsel may find it useful to involve a consulting firm that specializes in the preservation, collection, production and organization of electronic documents. These consulting firms come with varying degrees of relevant experience. In selecting such a consulting firm, counsel should ask about the firm's experience with the company's specific technology (e.g., Lotus Notes, Unix) and in dealing with the relevant law enforcement agencies. It may also be appropriate to ask for references who will comment on the skills, experience and diligence of the specific senior personnel with whom the consulting firm plans to staff the engagement.

Comment

Preserving back-up tapes and other electronically stored information indefinitely can be costly and disruptive. Defense counsel can discuss with the SEC Staff the extent to which normal procedures should be modified so that information on back-up tapes and other electronically stored information is preserved.

FOOTNOTES:

(n1)Footnote 1. *See 18 U.S.C.S. § 1503. See also United States v. Fineman, 434 F. Supp. 197 (E.D. Pa. 1977)* (ruling that defendant's knowledge that a grand jury investigation was pending at the time he intentionally caused destruction of documents was sufficient basis to convict on obstruction of justice charge).

(n2)Footnote 2. *See 18 U.S.C.S. § 1520.*

(n3)Footnote 3. *See 18 U.S.C.S. §§ 1512, 1515, and 1519.*

(n4)Footnote 4. *In re Am. Int'l Group, Inc., Exchange Act Release No. 34-48477, 2003 SEC LEXIS 2163* (Sept. 11, 2003) .

(n5)Footnote 5. "AIG Agrees To Pay \$10 Million Civil Penalty," SEC News Release 2003-111, 2003 SEC NEWS LEXIS 2100 (Sept. 11, 2003).

(n6)Footnote 6. Press Release 2004-9, "SEC Brings Enforcement Against Bank of America Securities for Repeated Document Production Failures During a Pending Investigation," SEC News Release 2004-29, 2004 SEC NEWS LEXIS 519 (Mar. 10, 2004).

(n7)Footnote 7. *See, e.g., Shaffer v. RWP Group, 169 F.R.D. 19 (E.D.N.Y. 1996)* (holding that an adverse inference charge was appropriate where party recklessly destroyed relevant evidence); *Farrell v. Connetti Trailer Sales, Inc., 727 A.2d 183 (R.I. 1999)* .

(n8)Footnote 8. *In re Banc of Am. Sec. LLP, Exchange Act Release No. 34-49386, 2004 SEC LEXIS 548* (Mar. 10, 2004) .



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CHAPTER 9 PRODUCTION OF DOCUMENTS

1-9 Securities Enforcement: Counseling and Defense § 9.03

AUTHOR: Kenneth B. Winer

§ 9.03 Negotiating with the Staff Regarding the Subpoena

In part, because the Staff is unfamiliar with how the company operates and compiles and maintains information, SEC document subpoenas and requests for documents often are ambiguous and burdensome. While working with the company to ensure that the company will preserve all relevant documents, company counsel should also assess the extent to which the request is ambiguous or unduly burdensome. Although senior management and the board of directors of a company that has received an SEC subpoena or other request for documents may be tempted to commit immediately to full production and a firm timetable, it usually is in the company's best interest not to make specific commitments until counsel has completed this assessment. The SEC Staff is likely to be more receptive to requests to extend the production timetable or narrow the scope of the initial production before the company has committed to full production on a specific timetable rather than after the company has made such a commitment.

If, as is often the case, the SEC subpoena or document request appears unduly burdensome, defense counsel should do the work necessary to develop detailed information supporting the company's position that the subpoena is unduly burdensome before contacting the Staff to complain that the scope of the subpoena is overbroad. In addition, counsel should develop specific suggestions for narrowing the scope and should then meet with the Staff. The Staff will often agree to narrow a subpoena or at least defer production as to portions of the subpoena. For example, in connection with a subpoena that expressly or implicitly calls for the production of e-mails, the Staff may agree to limit the initial production to e-mails to or from certain identified key personnel that contain certain agreed-upon key-word search terms and that are stored on the company's existing e-mail servers (as opposed to difficult to access back-up tapes). Similarly, in connection with a subpoena or other request calling for all documents relating to a certain topic, the Staff may agree to exclude from the search documents stored in certain departments that are peripheral to the investigation's focus. All modifications to, and clarifications of, subpoenas and requests for voluntary production should be reflected in written correspondence between counsel and the Staff.

The initial meeting(s) with the Staff regarding document production often provides counsel with a vehicle for attempting to explore the Staff's view of the investigation and the Staff's perception of the client. Given that counsel has often not yet mastered the facts by the time of this meeting, counsel must hesitate to provide information to the Staff at this early stage of the investigation. The meeting, nevertheless, may provide an opportunity for counsel to begin attempting to influence the Staff's view of, and approach to, the matter.

The Staff often subpoenas documents with a return date two to four weeks in the future. The Staff will usually agree to extend the return date on a subpoena if counsel and the company can explain why such an extension is appropriate. In general, the Staff is reluctant to extend the return date indefinitely. In some instances, counsel should suggest a rolling production in which the company produces the documents in waves, rather than not producing any documents until all responsive documents have been identified and prepared for production.

In general, it is preferable to produce documents for inspection at a location other than the company's offices (e.g., the law firm's offices). The presence of SEC Staff on company premises can be disruptive. In addition, if the company makes the documents available for inspection by the Staff at the company's premises, there is danger that the Staff will talk to company personnel or overhear conversations among company personnel.

It is rarely, if ever, appropriate to ignore any SEC subpoena. Lack of timely responsiveness to a subpoena may detract from the company's credibility and working relationship with the Staff and result in the Commission seeking substantially higher penalties in connection with any settlement. Given the fluid nature of the Staff's investigative activities, the company's ability to work well with the Staff can significantly reduce the burden of responding to its requests. Moreover, failure to comply with a Commission subpoena "without just cause" is punishable as a misdemeanor. n1 Extensions should be reflected in written correspondence so as to avoid a misunderstanding that the recipient has failed to comply in a timely fashion.

FOOTNOTES:

(n1)Footnote 1. Exchange Act § 21(c), *15 U.S.C.S. § 78u(c)*.



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CHAPTER 9 PRODUCTION OF DOCUMENTS

1-9 Securities Enforcement: Counseling and Defense § 9.04

AUTHOR: Kenneth B. Winer

§ 9.04 Searching for Documents

The appropriate division of responsibilities between counsel and client in searching for and producing documents varies depending on a number of factors, including whether the client has a legal department, whether the company has the resources necessary to conduct the search, the expected difficulty of the search, and the amount of time available. At a minimum, it is usually appropriate for outside counsel to participate in designing the search and in testing whether the personnel conducting the search have an appropriate understanding of the scope of the subpoena. Similarly, at a minimum, it is usually appropriate for client personnel to participate in identifying locations reasonably likely to contain responsive documents and in introducing counsel to those personnel reasonably likely to have possession of responsive materials.

Care should be taken to ensure that the search for documents is thorough. Even if the company conducted a reasonable, good-faith search at the outset, if significant responsive documents surface late in the investigation, the Staff might infer that the documents were deliberately withheld in order to obstruct the probe. Accordingly, a systematic effort should be made to identify all locations reasonably likely to contain documents responsive to the subpoena or document request and the types of potentially relevant documents generated by the company and its personnel. Each of these locations should then be searched for responsive documents by persons who understand the request and the importance of exercising care in locating and identifying documents. As with document preservation, care should be exercised to avoid placing excessive reliance on personnel who appear to have personal exposure in connection with the SEC investigation. Counsel often supervises and tests the thoroughness of the search through follow-up interviews.

Staff members take the position that a subpoena to a company calls not only for the responsive documents in the company's possession, but also those in its custody or control. Consideration should therefore be given to whether production should be requested from the company's officers, directors, employees, and agents reasonably likely to have possession of responsive documents.

Companies should make a diligent, good faith effort to identify responsive documents. Although the Staff knows that document searches conducted reasonably and in good faith are likely to be imperfect, the Staff tends to evaluate the adequacy of a search for documents with the benefit of hindsight. Accordingly, if the company fails to include the files of a certain individual or location in its initial search and then later discovers the documents, the Staff is likely to take a

dim view regarding the quality of the search.

It is common to use search terms to gather potentially responsive electronic documents. Defense counsel often seek input from the SEC Staff regarding the list of search terms. The SEC Staff will rarely bless the list of search terms but may suggest additional search terms. Defense counsel can add the suggested search terms, sometimes after negotiating with the Staff whether suggested search terms are necessary and appropriate. In addition, if a suggested search term results in an excessive number of hits, defense counsel can discuss with the SEC Staff whether the suggested term is appropriate.

Counsel involved in the search should maintain a contemporaneous record of the locations searched, the date each location was searched, who searched each location, the criteria employed in the search, and the document(s) obtained from each location. To the extent that the search involves interviews, a record should be made of the individuals who conducted each interview, the questions they posed, and the responses they elicited. Although it is sometimes appropriate to rely on company employees to search their files for responsive documents, it is often best to place limited reliance on employees who have potential exposure in the SEC investigation. Counsel should consider asking company employees who search files to confirm in writing that they employed the specified search criteria and provided to counsel all responsive documents. A contemporaneous record is important for several reasons. The record can assist in making subsequent searches more efficient. When it later turns out (as it inevitably does) that one or more responsive documents were not identified, the record can help establish that the company conducted a diligent search in good faith.

In addition, in certain recent cases, the SEC has required settling defendants to certify to the completeness of the production as a condition of presenting the settlement to the Commission for approval. A form of the certification used in certain recent cases is set forth in Appendix A. The Staff has shown willingness to modify the form certification to conform with particular issues. The contemporaneous record can assist during settlement by providing the basis on which a company can reasonably sign the required document production certification.

If the company or its counsel discovers a responsive, nonprivileged document after completion of the document production, the document should be produced promptly and steps should be taken to determine whether the failure to identify and/or produce the document reflects a flaw in the search or production process. While tardy production of a responsive document can cause difficulties, these difficulties can be seriously compounded by a failure to produce the document promptly once it is discovered.

The search for documents should not necessarily be limited to documents responsive to the subpoena. Defense counsel should extend the search to cover additional documents that might contain exculpatory information or that help to explain the relevant events. It is also important to search for relevant, but nonresponsive, documents that contain incriminating information. Even if a document is clearly not responsive to the current subpoena, the Staff might issue subsequent, broader subpoenas. In addition, nonresponsive documents can help counsel understand the case, advise the company, and prepare witnesses for testimony. Furthermore, some members of the Enforcement Staff believe that a truly cooperative company will voluntarily produce significant documents even if the documents clearly are not responsive to any SEC subpoena or request for documents.

If the company maintains certain relevant documents outside the United States, company counsel should consider whether privacy laws protect the information in the documents. For example, pursuant to The Data Protection Directive 95/46 EC, many European countries have adopted laws prohibiting the transfer to the United States of personally identifiable information ("PII") collected from data located in or processed on equipment located in that country except in limited circumstances. A company producing such protected information to the SEC could be subject to civil and criminal liability in the foreign country if the company does not provide the required notice. The SEC Staff is familiar with these data privacy laws and recognize them as a valid ground for not producing any responsive documents. The Staff further believes, however, that in many circumstances, a company can comply with those laws and provide the responsive documents to the Staff at least in redacted form. If a company decides that data privacy laws restrict its

ability to comply with a subpoena, counsel should discuss this with the Staff.

If the documents are located in the United States and are not responsive to an SEC subpoena, before voluntarily producing documents, counsel should consider whether privacy laws protect the subpoenaed documents. Both federal and state law should be considered.

If requested documents contain trade secrets, counsel should consider taking steps to protect the trade secrets. While the law on the subject is unclear, in the case where documents contain trade secrets the Staff may agree to a solution that serves the needs of the Staff while protecting the legitimate interests of the company. For example, counsel might offer to make the documents available for inspection while declining to produce copies.



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CHAPTER 9 PRODUCTION OF DOCUMENTS

1-9 Securities Enforcement: Counseling and Defense § 9.05

AUTHOR: Kenneth B. Winer

§ 9.05 Review of Documents

Documents should be reviewed in order to (1) determine if they are responsive; (2) determine if they are protected by privilege; (3) locating additional responsive documents, and (4) assess whether they are significant for understanding the relevant facts, identifying potential witnesses, or preparing a witness for testimony. As a general rule, it is usually good practice to interpret the responsiveness entries broadly and to produce the documents if they are not privileged and are arguably responsive. The review for the first two purposes necessarily occurs before the documents are produced. While it usually is more efficient if the review for the other purposes can occur simultaneously with the review for the first two purposes, time pressures will sometimes require that there be two separate reviews. An intermediate option is to conduct a thorough review for privilege and a quick review for significance prior to production and a more detailed review after production.

In investigations involving a substantial number of documents, counsel should seriously consider developing a computer database of documents. A computer database can greatly facilitate the identification and retrieval of documents and allows multiple counsel in different locations simultaneously to work with documents and document information. Counsel should consider including a number of objective fields in the database including: (1) type of document; (2) author of document; (3) recipients of document; (3) the source of the information (e.g., the files of John Doe); (5) the title, if any, of the document; (6) the identity of the other persons referred to in the document; (7) the date of the document; (8) whether the document relates to various previously identified topics; (9) the date of the event(s) to which the document refers; (10) whether and when the document was produced to the Staff; (11) the privilege(s), if any, applicable to the document; and (12) entities to which the document has been produced. In addition, it often is appropriate to include a number of subjective fields (e.g., whether the document is a key document) and a brief summary of the document's contents and/or significance. Counsel should leave a field for whether the SEC has marked the document as an exhibit and the exhibit number(s), if any, that the Staff assigned to the exhibit.

In designing the fields, counsel should consider how they intend to use the database (e.g., the construction of a chronology, the preparation of a white paper setting forth the Staff's concerns and the responses to those concerns, the compilation of witness preparation binders to be used in advance of testimony, or the preparation of a Wells Submission and related presentations). For example, it often is useful to develop a field that includes the testimony, if any, of witnesses regarding the document and attorney notes regarding the document.

Counsel should also consider combining the computer database with images of at least a subset of the documents. While paper documents will have to be scanned to develop a computer database with images, computerized documents (such as Word documents and e-mails) can be loaded directly into the database. The cost of scanning documents is now comparable to ordinary photocopying. Once a database of digital document images is created, however, the cost of producing paper or electronic copies is typically less than ordinary copying. This is an important consideration where the defense team may include multiple law firms or if separate counsel of individual employees may require access to a subset of documents.

When the computer database is linked to images of documents, it becomes a powerful tool for organizing and retrieving documents by different criteria. By enhancing counsel's ability to understand the case and to identify documents useful in preparing a witness for testimony, the database can increase counsel's ability to mount an effective defense of the investigation. In addition, while the development of such a database can be costly, in the long run, it can result in significant savings by eliminating costly manual searches.



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CHAPTER 9 PRODUCTION OF DOCUMENTS

1-9 Securities Enforcement: Counseling and Defense § 9.06

AUTHOR: Kenneth B. Winer

§ 9.06 Production of Documents

In general, recipients of an SEC subpoena should produce to the Staff all responsive nonprivileged documents identified during the search unless the Staff has agreed that certain responsive documents need not be produced or the recipient is asserting a legal argument against production (e.g., *Fifth Amendment* right against self-incrimination or a foreign blocking statute). Failure to produce responsive, non-privileged documents can have serious consequences.

In general, the Staff prefers that documents be produced in electronic format. The SEC's subpoena or document request typically includes the Staff's specific guidelines and instructions for the production of documents to the SEC in electronic format. In addition, the SEC Enforcement Manual describes the Staff's preferred format and specifications for the production of documents in electronic format. n1 If the Staff receives electronic data in a format that it cannot readily search, the Staff might demand that the data be produced again in the preferred format. Accordingly, counsel should consider having its IT specialist talk to one of the SEC's IT specialists, especially if counsel is not thoroughly familiar with the Staff's preferences.

Stamping production numbers on documents produced to the Staff serves a number of other benefits. It assists counsel in determining the sources of documents produced to the Staff and in the preparation of annotated chronologies and whitepapers. While counsel usually can purchase and obtain a transcript of testimony, the Staff usually will not provide copies of the testimony exhibits. By noting the production numbers on the exhibits, counsel can (at least to the extent that the documents were produced by the client(s) or by a person cooperating with counsel) reconstruct the exhibits.

Sometimes, the cost of copying responsive documents is burdensome because of the number of documents or because of the size or condition of such documents. In such circumstances, the Staff may agree to inspect the documents and designate which are of interest to the Staff, rather than requiring the company to produce all responsive documents. The cost and burden savings of this approach should be weighed against the inherent inability to prove to the Staff at a later date that particular documents were made available for inspection, but not copied and produced because the Staff failed to select them. Counsel and the company should consider whether the Staff should be asked to inspect the documents at the company's offices or off-site (e.g., counsel's offices).

The Staff typically specifies the desired format for the production of electronic documents. It often is appropriate to

have a technical person talk to an IT staff member at the SEC to ensure compliance. The Staff sometimes requests production of electronically stored information in native format but this request may be subject to negotiation.

The production of documents can be a lengthy process. It is important to keep the Staff informed regarding the production. Usually, substantial productions are made on a rolling basis.

The Staff sometimes requests that a company describe in detail the specific steps the company has taken to respond to subpoenas and informal requests in the course of a lengthy investigation in which the company is cooperating. Sufficient records regarding the search should be maintained to enable the company to respond to such a request.

Comment

Even if the SEC requests voluntary production of documents, the recipient of an SEC request for documents should not withhold nonprivileged documents that are responsive to the SEC request without notifying the Staff that such documents are being withheld.

Unless the company or individual producing the documents has decided to make a complete waiver of privilege with respect to all responsive documents, responsive documents should be reviewed for privilege before production. In making privilege determinations, defense counsel should consider two indictments that federal grand juries issued in 2005 based on alleged over-assertions of privilege in response to grand jury subpoenas.

In October 2005, former partners of a Big Four accounting firm were charged with conspiracy, tax evasion and obstruction of justice based, in part, on the alleged improper assertion of attorney-client privilege.ⁿ² In December 2005, a well-known Southern California grocery chain, the Ralphs Grocery Company ("Ralphs"), was charged for, among other things, obstructing justice by designating certain company memoranda as protected by the attorney-client privilege and the attorney work product doctrine and not producing the memoranda in a prompt manner to the government in response to a grand jury subpoena.ⁿ³

It is sometimes uncertain whether a particular document is protected by privilege, either because the facts are uncertain or the application of the law of privilege to the facts is uncertain. Because the privilege belongs to the client and the production of privileged documents can destroy the privilege, many counsel tend to err on the side of protecting the privilege. These indictments indicate that this tendency could create criminal exposure for the client and (perhaps) counsel.

If documents are withheld under a claim of privilege, the Staff will require that a privilege log be prepared identifying the documents that have been withheld. Customarily, documents are identified by: (1) date; (2) general subject matter sufficient to understand the relevance of the document but without disclosing the privileged communication; (3) author; (4) all recipients, including cc's; and (5) type of the privilege asserted. The privilege log is usually presented in a spreadsheet format and may be provided at the time of production or, with the agreement of the Staff, at a later date.

The SEC Enforcement Manual instructs the Staff to "carefully review the privilege log to determine whether the privilege has been properly asserted" and to "obtain additional information where entries in the privilege log are incomplete or do not otherwise provide sufficient information to determine whether the privilege has been properly asserted."ⁿ⁴ Many Staff members tend to insist on the provision of privilege logs even if a complete log would have to list hundreds or thousands of documents. Staff members believe that a privilege log can itself contain valuable information. In addition, Staff members believe that in the process of finalizing a privilege log, counsel often determine that certain documents should be produced because they are not privileged. The Staff often will, however, agree not to require that the privilege log include privileged materials prepared by defense counsel in the course of defending the SEC investigation.

Comment

On rare occasions, a company might conclude that it is not cost-effective to search for privileged documents in light of the high cost of the search and the company's perception that waiver of any privilege poses little risk. On these occasions, counsel might ask the Staff to agree that in exchange for obtaining relatively speedy access to documents, it will return any documents that counsel later identified as privileged and not assert that the company has waived any privilege or protection by producing it. The SEC Enforcement Manual indicates that the Staff will reserve the right to retain the identified documents if the Staff determines that it has a sound legally defensible basis for keeping the document that counsel claims to be privileged. n5 It should be noted, however, that such an agreement might not prevent others from asserting that there has been a waiver of a court from determining that a waiver has occurred.

When producing documents to the Staff, affirmative steps must be taken by counsel to preserve the confidentiality of those documents for purposes of the Freedom of Information Act ("FOIA"). n6 Under FOIA, all United States government agencies are required to disclose records upon receiving a written request for them, except if protected from disclosure under one of the nine major exemptions contained in FOIA. n7 While the SEC is conducting the investigation, it will routinely deny FOIA requests for documents that relate to the investigation. The SEC's interest in the confidentiality of the documents often ceases when the investigation is over. This is when the submitter's interest in maintaining the confidentiality of the documents becomes paramount.

In order to receive confidential treatment for the documents submitted, counsel must make a request for confidential treatment at the time of production. n8 If not made, the SEC will assume that all exemptions from disclosure under FOIA have been waived. As a matter of practice, confidential treatment should be requested on everything submitted to the SEC. In making the request for confidential treatment, counsel should take the following steps: (1) use standard boilerplate language at the end of every transmittal letter requesting that the documents be afforded confidential treatment under *17 C.F.R. § 200.83* and FOIA; (2) include the legend "FOIA Confidential Treatment Requested" on the envelope, fax cover sheet, and the letter itself; (3) include the identity of the client and a name, address and phone number of a client contact person or counsel in the request; (4) stamp each page (or segregable portion of each page) of the documents with the identifying number and code, and the legend "Confidential Treatment requested by [name]"; n9 (5) send to the SEC's FOIA office in Alexandria, Virginia, a copy of the letter requesting FOIA confidential treatment; (6) keep counsel's contact information up to date; and (7) send a renewal request, if applicable, as any confidential treatment request will expire in ten years. n10 Taking the above steps should help ensure that documents submitted to the SEC receive confidential treatment.

If it appears likely that the SEC will share the produced documents with state securities enforcement agencies, then counsel should consider stamping the document to address state law FOIA. For example, if the SEC Staff is working with the office of the New York Attorney General, counsel might stamp the documents, "Confidential Treatment Requested Pursuant to U.S. FOIA, NY FOIL and other Applicable Laws and Regulations." Different state agencies afford differing levels of confidentiality to documents produced in securities investigations. For example, at the conclusion of an investigation the New York Attorney General may post on its website the documents relevant to the investigation redacting only personal information such as social security numbers, personal addresses or highly personal messages in e-mails.

Unless electronic images have been made of the documents being produced to the Staff, counsel should retain at least one hard copy set of the documents produced. In such circumstances, it usually is appropriate to retain a second set for archive purposes, given that the working set of the documents is likely to deteriorate over time as the documents are repeatedly pulled and reviewed for different purposes.

When producing documents, counsel should consider addressing with the Staff documents that on first examination might appear to be problematic for the client. It sometimes is useful to defuse these documents at the time of production

by putting them into context or otherwise explaining why a more benign interpretation is appropriate. Alternatively, it sometimes is appropriate to identify a harmful document and explain the remedial action(s) that have been taken in response to the document.

The Staff sometimes asks that a company producing business records also provide a certification, under penalty of perjury, that the records are business records that were:

- Made at or near the time of the occurrence of the matters set forth therein, by, or from information transmitted by, a person with knowledge of those matters;
- Kept in the course of regularly conducted business activity; and
- Made by the regularly conducted business activity as a regular practice.

The purpose of this certification is to qualify for the "business records exception to the hearsay rule." n11

At the conclusion of the document production, the Staff may request a written confirmation that all non-privileged requested materials have been produced and that any documents withheld based upon an assertion of privilege has been noted in the privilege log that the company has provided to the Staff. n12 In addition, if the company later negotiates a settlement with the Staff, the Staff may require that someone sign under penalty of perjury a Certification as to Completeness of Document Production. Accordingly, counsel and the company should design and supervise the search and production of documents in a manner that will enable someone to state under oath that the company or its agents has conducted a reasonable good faith search of all the company's locations that are reasonably likely to contain responsive documents, including general file areas, offices and files of individual officers, directors and employees, storage facilities, email and archive files, and all other original and back-up electronic and computer files and systems, except as expressly agreed by the Staff in writing.

In addition, there are several steps relating to documents that a company might consider taking if the company intends to seek cooperation credit under Seaboard. n13 For example, the company might voluntarily produce problematic documents that are not responsive. Similarly, the Staff might provide to the Staff a compilation of the documents that counsel thinks are important. If the document is in a foreign language, the company might provide a translation, in addition to a copy of the original. If the document is protected by data privacy laws, the company can develop a creative solution that enables the company to get to the Staff the information that the Staff wants while complying with the data privacy law.

FOOTNOTES:

(n1)Footnote 1. Enforcement Manual at 3.2.6.2.3.

(n2)Footnote 2. D. Tween & J. Bailey, *Over-Assertion of Attorney-Client Privilege: Can It Be A Crime?*, Business Crimes 4 (Law Journal Newsletters, Feb. 2006).

(n3)Footnote 3. Indictment, United States v. Ralphs Grocery Co., CR No. 05-CR-1210 ALL (C.D. Calif. 12/15/05) (indictment *available at* www.usdoj.gov/USAAO/cac/pr2005/171.htm).

(n4)Footnote 4. Enforcement Manual 3.2.6.2.5.

(n5)Footnote 5. Enforcement Manual 4.2.1.

(n6)Footnote 6. 5 U.S.C.S. § 552.

(n7)Footnote 7. 5 U.S.C.S. § 552(b)(1)-(9).

(n8)Footnote 8. *17 C.F.R. § 200.83(c)(1)*.

(n9)Footnote 9. *17 C.F.R. § 200.83(c)(2)*.

(n10)Footnote 10. *17 C.F.R. § 200.83(c)(7)*.

(n11)Footnote 11. Enforcement Manual 3.2.6.2.5.

(n12)Footnote 12. Enforcement Manual 3.2.6.2.5.

(n13)Footnote 13. *See* Chapter 17.



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CHAPTER 9 PRODUCTION OF DOCUMENTS

1-9 Securities Enforcement: Counseling and Defense § 9.07

AUTHOR: Kenneth B. Winer

§ 9.07 Provision of Information Compilations to the Staff

Especially at the outset of a probe, the Staff often asks for information on a voluntary basis. For example, especially in insider trading investigations the Staff might ask for a chronology setting forth events, the identity of persons with knowledge of those events, and the dates on which such persons obtained that knowledge.

Great care should be taken when preparing a compilation of information for the Staff. First, the Staff may rely on the compilation in conducting the investigation and determining whether an enforcement act is appropriate. Second, the company and counsel may lose credibility if the Staff determines that the compilation is incomplete or inaccurate. Third, a chronology of events submitted to the SEC might be admitted as evidence in a judicial proceeding. Fourth, deliberately false statements in the chronology would be subject to criminal prosecution under *18 U.S.C.S. § 1001*.



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CHAPTER 10 TESTIMONY

1-10 Securities Enforcement: Counseling and Defense 10.syn

AUTHOR: Kenneth B. Winer

§ 10.syn Synopsis to Chapter 10: TESTIMONY

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Kenneth B. Winer



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CHAPTER 10 TESTIMONY

1-10 Securities Enforcement: Counseling and Defense § 10.01

AUTHOR: Kenneth B. Winer

§ 10.01 Preparing Witnesses for Testimony

If an SEC investigation is not defused in the early stages, the Division of Enforcement Staff will frequently seek to take the testimony of corporate personnel and others under oath. Testimony is one of the most critical events in an SEC investigation. In this chapter, we discuss issues relating to the preparation of a witness for testimony and to the defense of testimony.

[1] Timing of Testimony

Usually the Staff prefers to have completed most of its document collection and review before launching into this stage of the investigation, although its efforts to discover documents will likely continue throughout the entire inquiry. Failure to gather pertinent documents prior to testimony can often lead to the Staff's taking the testimony of one or more witnesses on one or more occasions. In general, counsel should discourage this practice by endeavoring to defer testimony until document production is largely complete. Allowing multiple examinations of a witness creates unnecessary expense, risk of confusion and conflicting testimony. Sometimes, however, the SEC will insist on taking testimony even though the document production is ongoing.

Witnesses sometimes push to schedule testimony early in the course of an investigation. Witnesses sometimes believe that the SEC investigation is based on a simple misunderstanding of the facts that could readily be addressed through early testimony. In addition, they might believe that there are advantages to being the first to present their side of the facts.

There are, however, a number of disadvantages to testifying early in an investigation. If a witness testifies early in an investigation, defense counsel might not have adequate time to investigate the legal and factual issues. In addition, an early testimony date might limit the ability of the witness to prepare adequately for the testimony. As a result, the witness might fail to develop fully the exculpatory evidence or to frame answers as effectively as might otherwise have been possible. Once testimony is given, it cannot be retracted. Accordingly, it rarely is in the interest of a witness to testify before the witness's defense counsel has conducted an adequate investigation and the witness has had an adequate opportunity to prepare for the testimony.

[2] Authority of the SEC to Subpoena Witnesses to Testify

The SEC has the authority to subpoena a person to appear anywhere in the United States: "Attendance of witnesses and the production of [books, papers, correspondence, memoranda and other records] may be required from any place in the United States or any State at any designated place of hearing." n1 Thus, the SEC can subpoena a person to appear in Washington for testimony even if the witness resides, transacts business, or was served hundreds, or even thousands, of miles away.

Witnesses summoned before the SEC are entitled to the same witness fees and mileage reimbursements as witnesses in the courts of the United States. The SEC does not tender witness fees and reasonable travel expenses with the subpoena. Rather, the witness may submit a claim for reimbursement and fees after appearing for testimony. Reimbursement is limited to the cost of coach airfare and to the government *per diem* for meals and lodging. In addition, the witness may receive a witness fee for each day spent in testimony or in traveling to or from the site of the testimony. Accordingly, a witness who travels to testify should retain materials relating to the cost of transportation, lodging and food. The witness should not assume that the reimbursement will cover all reasonable costs. The SEC often sets caps on reimbursement that are significantly below the reasonable costs incurred by the witness. The SEC does not reimburse the witness for either legal fees or the travel expenses incurred by counsel.

The Staff will often subpoena a witness to appear for testimony two or four weeks after the date on which the subpoena was served. Often, this will not provide sufficient time to prepare for the testimony, especially if the production of documents is not yet complete. In such circumstances, counsel should attempt to negotiate a sufficient extension of the return date to permit effective preparation. In general, attempting to negotiate such a limited extension will rarely trigger a subpoena enforcement proceeding. In attempting to negotiate an extension, however, counsel should weigh the need for additional time against the risk that insisting on such additional time will unnecessarily antagonize the Staff. Accordingly, when seeking such extensions, it is important to communicate to the Staff that the requests are motivated by legitimate factors and not by a desire to obstruct or impede the investigation. In some circumstances (e.g., where it is highly likely that the Staff will subpoena the witness and counsel anticipates that substantial meeting time will be required prior to testimony), counsel should begin the process of preparing a witness before the Staff subpoenas the witness or otherwise indicates an intention to question the witness.

The SEC subpoena will often call for the witness to appear for testimony in a conference room at the offices in which the Staff is located (e.g., a subpoena issued by Staff of the Northeast Region is likely to call for the witness to appear at the SEC offices in New York). It is sometimes possible to persuade the Staff to take the testimony in a location that is more convenient for the witness than the location initially designated in the subpoena. However, the Staff will almost always insist on taking testimony either at an SEC office or other federal government office.

[3] Representation of the Witness and Conflicts of Interest

The sequestration rule of the Commission's Rules of Practice protect the confidentiality of the testimony by prohibiting the attendance at the testimony of anyone other than the SEC Staff, the witness and his or her counsel. Each witness has the right to be accompanied by counsel, but only if counsel represents the individual witness. Thus, counsel for the company can attend testimony only if he or she represents the witness personally. The Staff will ask counsel to confirm this fact on the record at the beginning of the testimony. Before company counsel can undertake to represent the witness personally, counsel will have to determine that there is no conflict of interest that would preclude simultaneous representation of this witness and the company. If the company counsel either has represented or expects to represent other individual witnesses in the matter, counsel must also assess whether representation of these witnesses is consistent with the simultaneous representation of this witness. n2

If the Staff believes that an attorney representing multiple witnesses has a conflict of interest, the Staff may discuss the conflict with counsel. In rare instances, the Staff might inform the witnesses of the Staff's concerns. The Staff typically will not, however, exclude an attorney from representing multiple witnesses.

Comment

Counsel should consider obtaining each client's consent to the representation, and must secure consent prior to sharing information received from one client with another.

Where it is expected that the company will pay legal fees incurred in connection with the representation of individual officers, directors and employees, consideration should be given to any requirements regarding the expenditure of company funds for such purposes. In *Messing v. FDI, Inc.*,ⁿ³ for example, the court noted that Delaware law required a resolution of the board of directors and the receipt of an undertaking from the director (whose fees would be paid by the company) regarding his obligation to reimburse the company if no indemnification was available before making any expenditure of corporate funds in connection with the representation of corporate directors. In addition, the payment arrangement should be discussed with the witnesses.

[4] Cold Calls

The Staff will sometimes cold call a witness in order to ask questions. The Staff believes that it can be useful to catch a witness unprepared. For example, the Staff believes that a witness who traded based on inside information is more likely to give an easily refuted explanation than a witness who is subpoenaed for testimony and therefore has an opportunity to construct a more defensible explanation. Typically, there will be two Staff members on the call--one to ask questions and one to take notes. Pursuant to the Privacy Act, the Staff members should at a minimum identify themselves as SEC employees and provide the following information to the witness it is about to question: (1) the principal purpose in requesting information is to determine whether there has been a violation of the federal securities laws; (2) the information provided by the public is routinely used by the SEC and other authorities to conduct investigative, enforcement, licensing and disciplinary proceedings, and to fulfill other statutory responsibilities; (3) the federal securities laws authorize the SEC to conduct investigations and to request information from the witness, but the witness is not required to respond; and (4) there are no direct sanctions and no direct effects upon the witness for refusing to provide information to the Staff.

Learning what statements the witness made to the Staff, and what statements the Staff believes were made, is important. Unfortunately, by the time the witness has retained counsel, the witness usually has only a vague recollection of the cold call interview.

[5] Interviews by the Staff

The Staff will sometimes ask to interview a witness. The SEC Staff is particularly likely to rely on interviews if criminal enforcement authorities have expressed an interest in the matter. SEC Enforcement officials also participate in interviews with the Division of Corporation Finance and the Division of Market Regulation. In addition, the Staff will sometimes interview a witness if the purpose of the witness is to enhance the Staff's understanding of certain documents or procedures. While it is often appropriate for a witness voluntarily to participate, great care should be taken to ensure that the witness is prepared to answer the Staff's questions both accurately and effectively. For the reasons discussed above, counsel should resist producing a witness for an interview before counsel has been able to conduct an adequate investigation and to meet with the witness to prepare the witness to respond effectively to the questions posed at the interview.

Consideration should be given to whether the interview should be transcribed or recorded. Having the interview transcribed or recorded reduces the danger that the Staff will recall the witness's statements inaccurately or out of context. On the other hand, transcribing or recording the interview might facilitate the Staff's ability to use the information obtained in a subsequent enforcement proceeding. In addition, a transcript is much more likely than the Staff's notes to be discoverable in private litigation. The Staff is more likely to agree not to record the interview if the witness is viewed as peripheral, if the prospective defendants have already agreed to settlement terms that the Staff

considers likely to be acceptable to the Commission, or if there is an ongoing criminal investigation and the witness is neither a target nor viewed as a likely target. If the interview is not transcribed, defense counsel should take detailed notes of the interview so that defense counsel has an accurate record of the questions posed and responses provided. In some circumstances, defense counsel should consider noting the extent to which the government officials are taking notes. Although SEC enforcement attorneys typically take detailed notes, in regards to matters in which criminal enforcement authorities have not expressed an interest, investigators often take very limited notes and then create memoranda that are incorrect or incomplete.

Comment

It is important to treat interviews seriously even if they are not being recorded or transcribed. While the Staff's willingness to interview a witness without making a recording or obtaining a transcript might indicate that the Staff does not consider the interview to be central to the inquiry, an imprecise or inaccurate statement during the interview could have serious ramifications.

[6] Fifth Amendment

One of the first issues that must be addressed with respect to each individual witness called to produce documents or testify before the Staff is whether that individual should assert the *Fifth Amendment* right against self-incrimination. It is usually appropriate to address this question before the individual witness provides either documents or testimony to the SEC. n4

Comment

If the assertion of the *Fifth Amendment* privilege appears to be an important consideration in developing the defense strategy for a witness, company counsel would normally either not undertake the witness's representation or bring in separate counsel to advise the witness on the issues of whether to assert the *Fifth Amendment* right.

[7] Pre-Testimony Investigation

As discussed in Chapter 8, defense counsel should thoroughly investigate the legal and factual issues relating to their client. If counsel represents the company as well as the individual witness, counsel will likely have access to numerous witnesses and documents. In addition, it often is appropriate for counsel to attempt to gather information and insights from the Staff and from counsel to other witnesses. Before the witness testifies, defense counsel should attempt to:

- identify the potential violations of the federal securities laws on which the Staff is likely to be focused and assess the Staff's perception of the witness's role in the potential violation;
- assess the evidence, both documents and testimony, relating to the witness's role in the conduct at issue, including any responsibility that the witness might have had to supervise that conduct;
- assess what other witnesses might say about the witness were they to testify;
- identify exculpatory evidence that tends to show that there was no violation and/or that the witness acted reasonably and responsibly;
- identify conflicts between the witness's recollection and the documents, the testimony of other witnesses, and the recollections of other witnesses;
- determine whether the witness is a potential target of the Staff investigation; and

- determine whether the witness has a significant risk of becoming the target of a criminal investigation.

In general, counsel, not the witness, should gather the information from other witnesses. While it might appear more effective to contact other witnesses directly, the Staff is highly likely to ask questions in testimony regarding these contacts. These questions will likely elicit details regarding these communications, including whatever information the witness gathered. In addition, there is a danger that the Staff will view this contact as an effort to coordinate testimony. Accordingly, it usually is better for counsel to the witness to contact counsel for other individuals and entities in the effort to gather information.

[8] Completing Questionnaire

The Staff routinely uses a standard background questionnaire to obtain background information from a witness prior to testimony, including the witness's date and place of birth, social security number, securities, brokerage and bank accounts, employment history, prior testimony and depositions, and information regarding family members. While there are no direct sanctions for not completing the form, the usual practice is to provide the requested information unless the witness plans to assert the *Fifth Amendment* right against self-incrimination. A reasonable good faith effort should be made to obtain the request information. Because the background questionnaire might become public, however, counsel should consider asking for alternative treatment of the social security number. The enforcement manual suggests one method by which the Staff can handle such requests. n4.1

[9] Preparation for Testimony

Adequate preparation for testimony is crucial. Witnesses in SEC investigations are often busy individuals with many demands on their time. They may express reluctance to devote adequate time to preparing for testimony. If the witness is a potential target of the SEC investigation, counsel will have to stress the importance of adequate preparation, the severe adverse consequences that can result from an SEC investigation, and the danger that a failure to prepare adequately could increase the likelihood of those adverse consequences.

It usually is appropriate to schedule two or more sessions with the witness before the witness testifies. The first session(s) should take place well before the expected date of testimony. Counsel should devote the initial session(s) primarily to learning the witness's recollection of the facts and refreshing the witness's recollection of the facts, including the probable location of documents on which the Staff might rely in questioning the witness and the identity of witnesses with knowledge relating to the witness and the facts under investigation.

By learning the witness's recollections of the facts, counsel can better prepare for subsequent sessions by reviewing documents and other material, speaking to other witnesses, and speaking to counsel for other witnesses. These steps will enable counsel to identify instances in which the witness's initial recollection appears to conflict with documentary evidence or the testimony of other witnesses. In addition, the process of talking and thinking about past events and reviewing documents often improves the quality of the witness's recollection. Furthermore, if the witness's counsel also represents other persons in connection with the SEC investigation, it enables counsel to assess and advise the witness regarding potential conflicts of interest.

Witnesses sometimes question whether it is in their interest to refresh their recollection. There are several reasons why it often is in the interests of the witness to have a refreshed recollection before the testimony. First, during testimony, the Staff may show documents or pose questions to the witness that refresh a witness's recollection. Having a witness first recall a significant fact during testimony poses a number of dangers to an unprepared witness. Second, the testimony might be exculpatory or, if incriminating, might assist counsel in better assessing the potential criminal exposure of the witness and in advising the witness whether to assert the *Fifth Amendment* right against

self-incrimination. Third, the Staff tends to have unrealistic expectations regarding the extent to which an individual should recall facts and may view the witness's lack of recollection as reflecting either a lack of candor or as evidencing a failure to devote sufficient attention to the matter.

Comment

In preparing a witness, counsel should hesitate before refreshing the witness's recollection with a document otherwise protected by privilege. Under *Rule 612 of the Federal Rules of Evidence*, use of a document to refresh a witness's recollection may waive privileges that otherwise protect the document. Even though the Federal Rules of Evidence do not apply to an SEC investigation, the Staff is likely to assert that such use of a privileged document constitutes a waiver.

[10] Familiarizing Witness with the Testimony Process

In order to make the witness more comfortable when testifying, counsel should take steps to make the witness more familiar with the testimony process, eliminating as much in the way of surprise as possible. Counsel should consider describing the setting in which the testimony is likely to occur. Counsel should also explain the anatomy and function of an SEC investigation. To the extent possible, counsel should

- describe the physical layout of the conference room in which the testimony will occur;
- explain that a court reporter will be present and transcribe the testimony;
- explain that most of the questions will probably be asked by a Staff attorney and that the Staff attorney is often accompanied by another Staff attorney or the branch chief, and perhaps by the Staff accountant or the analyst assigned to the case, who might also ask questions;
- review with the witness the documents that the Staff attorney may show to the witness in advance of testimony; and
- review with the witness the opening statement that the Staff attorney will make at the beginning of the testimony including questions regarding the witness' address, telephone numbers, educational background, employment background, criminal convictions, securities accounts, receipt of the subpoena and the search for and destruction of relevant documents, and other matters.

Counsel should also conduct a mock question and answer session in which counsel poses questions as if a member of the Enforcement Staff and the witness answers as if giving actual SEC testimony. In addition to other benefits (which are discussed below), this practice can make the witness more comfortable with the process.

[11] Preparing Witness to Answer Questions Effectively

Preparation of a witness for testimony is similar to the preparation of a witness for a deposition; however, unlike in a deposition, a witness in SEC testimony is responding to questions of persons serving in the role akin to that of a prosecutor and judge combined. Given that the vast majority of SEC enforcement actions settle, the investigative testimony is, in a very real sense, equivalent to the trial appearance of a witness.

In private litigation, attorneys often advise deposition witnesses not to help opposing counsel understand the case and to give opposing counsel as little information as possible while still telling the truth. Defense counsel often take a different approach in preparing a witness for SEC testimony. Because the Staff and the Commission will rely heavily on the transcript of the testimony in assessing whether to bring an enforcement action, counsel should seriously consider

advising the witness to volunteer certain facts important to the defense. Accordingly, an important part of the preparation for testimony is the process of gathering and identifying those facts and themes that are important to the defense. Those themes should then guide the witness in framing an effective response to the Staff's questions.

Counsel should educate the witness about the Staff's likely focus in the anticipated testimony, and the issues important to the Staff. It is important for the witness to understand, to the extent possible, the Staff's working theory of the case. This understanding will further assist the witness in framing precise answers to the Staff's questions and identifying additional information that might assist the Staff in determining that the federal securities laws have not been violated, or putting damaging disclosures in an appropriate context.

In addition, counsel should advise the witness of the importance of telling the truth. Counsel should explain that telling the truth is important both because lying during testimony is a crime and because it undermines the witness's credibility. Lying in testimony can implicate several provisions of the criminal code. Section 1001 of Title 18 provides:

Whoever, in any matter within the jurisdiction of [any department or agency] of the Government of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device of material fact; makes any materially false, fictitious or fraudulent statement or representation; or makes or uses any false writing or document knowing the same to contain any materially false, fictitious or fraudulent statement or entry; shall be fined under [Title 18], imprisoned not more than five years, or both. n5

Section 1621 further provides:

Whoever ... having taken an oath before a competent tribunal, officer, or person, in any case in which a law of the United States authorizes an oath to be administered, that he will testify, declare, depose, or certify truly, or that any written testimony, declaration, deposition, or certificate by him subscribed, is true, willfully and contrary to such oath states or subscribes any material matter which he does not believe to be true ... is guilty of perjury and shall, ... be fined under this title or imprisoned not more than five years, or both. n6

Section 1512 makes it a crime to corruptly

obstruct . . . ; influence . . . ; or impede . . . ; any official proceeding or [to] attempt . . . ; to do so. n7

Counsel should explain to the witness that his or her demeanor is important, because the Staff members at the testimony will perform a significant role in forming the decision of the senior Staff and the Commission regarding the nature and extent of any enforcement action that will be authorized by the Commission. The witness should be advised to be respectful, but not obsequious, hostile, or overly familiar. The witness should be advised to avoid attempts at humor, and that all statements made in the presence of the Staff, even "off the record," might have an impact on the outcome of the investigation. Witnesses should be told that in general they should not volunteer information not required by the question posed by the Staff.

Counsel should advise the witness to listen carefully to the question. The witness should evaluate whether he or she understands the question, whether the question incorporates an inaccurate or misleading premise, and whether the question is compound. The witness should pause before answering, taking time to formulate the answer before he or she begins to articulate the response. Many questions have more than one truthful answer. An effective witness provides a truthful answer that advances the positions favorable to the witness. As the witness articulates the answer, the witness should parse the words to ensure that they respond to the question and are accurately communicating the message that the witness intends to communicate.

Counsel should alert the witness to be especially careful when the Staff purports to summarize the prior testimony of the witness. Whether deliberately or inadvertently, the Staff's purported summaries often distort, or introduce inappropriate nuances into, the prior testimony of the witness. The witness should carefully consider each aspect of the purported summary, including whether the purported summary is accurate, whether it omits key facts, and whether it contains misleading characterizations. The witness should not adopt the summary unless completely comfortable with the summary. Often the witness will not be able to recall the prior testimony precisely. In such circumstances, it is appropriate for the witness to state that he or she does not have a precise recollection of the prior testimony.

In general, the witness should be cautioned against engaging in speculation. Out of an eagerness to cooperate with the Staff or a false impression that they should remember more than they do, many witnesses will be tempted to testify as if they recall certain events when, in fact, they are merely speculating that such events might well have occurred. Unless the witness clearly indicates that the testimony is based on surmise or speculation, the testimony can inadvertently mislead the Staff and (if the testimony conflicts with other evidence) create credibility problems for the witness or for others. Even if clearly identified as speculation or surmise, such answers can unnecessarily prolong the testimony. Accordingly, the witness should be cautioned against testifying regarding events based on surmise; rather, the witness should testify regarding events only to the extent that he or she truly recalls them. Counsel should explain that many witnesses have difficulty recalling conversations and documents, and that the witness should not be uncomfortable that the witness's recollection is imperfect or incomplete. Counsel should, however, caution the witness that falsely testifying to not recalling a material fact is perjury.

Comment

In some instances, speculation testimony will be important to place documents or other testimony in context. In such instances, it may be appropriate for the witness to speculate, but only to the extent previously worked out with counsel and only if clearly identified as speculation.

Similarly, a witness may be tempted to respond to questions posed by the Staff even though the witness does not understand the question. This can cause substantial confusion if the interpretation the witness places on the questions differs from the Staff's intention. Accordingly, a witness should ask the Staff to repeat the question if the witness does not understand the question.

In order to protect the attorney-client privilege, it is prudent to alert the witness to identify for counsel questions that call for him or her to testify regarding any meeting at which counsel to the company or to the witness was present or any document that was addressed to or from counsel for the company of the witness. For example, the Staff might ask from whom the witness learned a certain fact and, unbeknownst to counsel, the witness may have first learned that information through a privileged communication from other company counsel. The witness should be instructed to confer with counsel before testifying regarding any communication with either the witness's counsel or the company's counsel.

The Staff often relies heavily on documents when questioning a witness and will frequently endeavor to use documents to refresh a witness' recollection. Counsel should explain to the witness the concept of refreshed recollection and admonish the witness not to testify to recalling a document merely because it shows the witness as an author or recipient of the document or recall an event merely because the event is described or referred to in the document. Counsel should advise the witness that when the Staff shows the witness an exhibit in testimony, the witness should carefully review the document before responding to questions regarding the document.

As the interview date approaches, counsel should attempt to assist the witness in being more comfortable and effective in responding to the Staff's questioning. The witness should be trained to listen carefully to the questions posed, to evaluate the question for ambiguities and for implied premises, and to provide careful and accurate responses. Often this training is best accomplished by mock question and answer sessions in which defense counsel, or a colleague of defense

counsel, questions the witness as if a member of the Enforcement Staff and the witness attempts to respond as if in testimony. Counsel should assess the witness's demeanor and responses and whether the witness was

- listening carefully to the questions;
- responding to questions that the witness did not understand;
- pausing after the question to evaluate the question and to frame a response;
- identifying questions that embodied inaccurate factual assumptions;
- articulating answers that were responsive, concise and accurate;
- framing the answers to advance the witness's themes;
- speculating inappropriately or without clearly labeling the testimony as speculation;
- volunteering information not called for by the question; and
- reviewing a document before responding to questions about the document.

Counsel should also alert the witness of the need to be particularly vigilant during the periods after meals and at the end of the day. Many witnesses have a natural tendency to lose focus during these periods. Many SEC Staff attorneys time their questioning so that they are exploring the most sensitive areas during these periods. Accordingly, witnesses must make a special effort to focus during these periods.

Counsel should tell the witness that if counsel speaks during the testimony, the witness should pay attention to what counsel is saying. Counsel might be identifying an ambiguity or privilege issue or making statements that should otherwise alert the witness to danger.

Counsel should provide guidance as to whether a witness should hesitate before consulting with counsel. There are potential negative consequences that can arise from a witness consulting with counsel during the testimony instead of waiting for a break in the testimony. Often, the Staff will note for the record when the witness consults with counsel. In addition, there is some danger that the Staff will treat an answer as less credible if it follows a consultation between the counsel and the witness. Before consulting with counsel during testimony, the witness should consider whether the witness is uncomfortable answering the question without input from counsel or whether there is a danger of giving damaging testimony that might have been averted if the witness had consulted with counsel. In general, if the answer to either question is affirmative, the witness should promptly consult with counsel. The harm that can be inflicted by ill-advised testimony far outweighs the subtle potential consequences of consulting with counsel.

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C.S. § 78u.*

(n2)Footnote 2. Issues relating to multiple representation are discussed in Chapter 11, *below*.

(n3)Footnote 3. *439 F. Supp. 776 (D.N.J. 1977)* .

(n4)Footnote 4. The *Fifth Amendment* privilege is discussed in Chapter 13, *below*.

(n5)Footnote 4.1. Enforcement Manual 3.3.5.2.1.

(n6)Footnote 5. *18 U.S.C.S. § 1001.*

(n7)Footnote 6. *18 U.S.C.S. § 1621.*

(n8)Footnote 7. *18 U.S.C.S. § 1512(c)(2).*



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CHAPTER 10 TESTIMONY

1-10 Securities Enforcement: Counseling and Defense § 10.02

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§ 10.02 Defending SEC Testimony

[1] Right of the Witness to be Represented by Counsel

The Commission's Rules of Practice provide the following description of the role of a witness's counsel during SEC testimony:

The right to be accompanied, represented and advised by counsel shall mean the right of a person testifying to have an attorney present with him during any formal investigative proceeding and to have this attorney (1) advise such person before, during and after the conclusion of such examination; (2) question such person briefly at the conclusion of the examination to clarify any of the answers such person has given; and (3) make summary notes during such examination solely for the use of such person. n1

It will sometimes be appropriate for an expert to accompany counsel in order to assist in defending the SEC testimony. For example, in an SEC investigation involving complex accounting issues, it might be appropriate for an accounting expert to accompany counsel to assist in the defense of the company's principal accounting officer.

The SEC's Rules of Practice do not expressly state that an expert may accompany counsel at testimony; however, the United States District Court for the District of Columbia has held that an expert may accompany counsel for the purpose of providing assistance. In *SEC v. Whitman*, each of two witnesses refused to testify unless the Staff permitted an accountant to accompany and assist each witness and his counsel during the actual taking of testimony. Refusing to enforce the subpoenas unless the SEC permitted the accountant to accompany and assist the witnesses, the court said that, in light of the Administrative Procedure Act, to the extent the Commission's rules impinged "upon counsel's ability to adequately represent his client who has been called upon to testify, they cannot be upheld." n2

Prior to the witness's testifying, counsel should ascertain if the witness suffers from a medical condition rendering him or her particularly susceptible to fatigue, memory lapses, or other conditions that might impair the ability to testify effectively. If the witness has such a condition, counsel should consider notifying the SEC Staff of that condition at or before the outset of testimony.

[2] Statements by Counsel at the Beginning of Testimony

At the outset of testimony, counsel should request on the record that the transcript and all other records of the testimony be accorded confidential treatment pursuant to *17 C.F.R. § 200.83* and the Freedom of Information Act ("FOIA"). In addition, counsel might consider making one or more of the following statements:

- Before we went on the record, the Staff provided us with the Commission's Supplemental Information Form which, among other things, notifies us of a process within the Commission, informally known as the Wells process, which permits people who have been told that the Staff might recommend that the Commission authorize an enforcement action to submit a statement to the Staff and the Commission. We assume that this notification was provided to us solely for our information and that -- since the witness has not yet testified -- the provision of this notice does not reflect any conclusions of judgments on the part of the Staff prior to the taking of testimony.
- If there comes a time when the Staff reaches a tentative conclusion that it will recommend that the Commission authorize an enforcement action against the witness, we request that we be notified of this tentative conclusion and the nature of the suspected violation in time to prepare and submit a Wells statement.
- We note that the letter transmitting the subpoena to the witness states that this inquiry is confidential and should not be construed as an indication by the Commission or its Staff that any violations of law have occurred or as a reflection upon any persons or entities. We assume that it remains the position of the Staff that the inquiry is confidential and that neither the inquiry nor the subpoena should be construed as an indication by the Commission or its Staff that any violations of law have occurred.
- We note that the Commission's Supplemental Information Form provided to us before the beginning of testimony also discloses a number of "routine uses" of information provided in investigations that have been adopted by the Commission in purported reliance on the Privacy Act of 1974. While we understand that the Staff has no authority to waive or modify the provisions in the form and that the witness is here to testify, we note for the record that we do not consent to the specific routine uses. By way of example, we do not consent to Routine Use No. 19, which would authorize the Commission and its Staff to use information obtained from this testimony to respond to inquiries from the public and the press.
- We request that the Staff notify us if the Staff shares with any other federal or state agency any information obtained through this testimony.
- The witness has not been authorized to waive the attorney-client privilege of any person and does not intend to waive either his or her own privilege or the privilege of any other entity.

Counsel should anticipate that if one objects to the list of routine uses or requests notification of the provision of information to another agency, the Staff is likely to respond that the list of routine uses reflects the position of the Commission and the Staff and that the Staff does not agree to provide notice to the witness regarding the sharing of information.

Comment

If counsel plans to make one or more of these statements, counsel should explain this to the witness and describe the Staff's likely responses. Otherwise, the witness might be distracted by this exchange. In addition, it is often advisable to alert the Staff before going on the record if defense counsel plans to

make such opening remarks.

[3] Representing the Witness During Testimony

The Rules of Practice governing investigations do not authorize counsel to object to the Staff's questions; the Staff frequently notes that the federal rules of procedure and evidence do not govern SEC testimony. It is usually appropriate for counsel to note on the record, usually in a nonadversarial tone, defects in the Staff's questions (e.g., the question is compound or ambiguous, the question assumes the existence of a fact not in evidence). Counsel should be alert for Staff questions that inadvertently distort a witness's testimony or that contain an inaccurate premise. While it is arguably preferable for a witness to handle such questions without the intervention of counsel, it may be necessary for counsel to intervene to protect the integrity of the record.

Comment

Counsel can and should object to questions that call for information protected by the attorney-client privilege and the work-product doctrine and, if necessary, instruct the witness not to answer the question.

Counsel should monitor the condition of the witness. Testifying before the Staff can be extremely tiring. Accordingly, counsel should request a break whenever the witness appears to be tiring. Although the Staff controls the timing of breaks, it will almost always accommodate such a request. If the Staff refuses to accommodate a reasonable request for a break (which is highly unusual), counsel should consider unilaterally taking a break from the testimony if the witness is so fatigued that accurate or effective testimony is jeopardized.

Multiple staff members can pose questions to the witness, with different Staff members taking the lead on different topics or one Staff member asking the initial round of questions on a topic and another Staff member asking follow-up questions. If the multiple-teaming of questioning becomes distracting, defense counsel can gently request that the Staff proceed in a less distracting manner.

After meals and near the end of testimony, counsel should remind the witness of the need to focus on the questions and answers. These reminders can help the witness guard against a natural tendency to relax at these times.

The SEC often relies heavily on documents during testimony. In general, counsel should ensure that the witness does not respond to questions regarding a document until he or she has completed reading it. Where the Staff has focused on only a portion of a long document, it sometimes is appropriate to have the witness respond after reading only a portion of the document. If a witness reads only a portion of a document before responding to a question about a document, either the witness or counsel should state on the record that the witness has not read the entire document.

Occasionally, a witness will inadvertently give an answer that is not completely accurate. For example, he or she might inadvertently neglect to identify one or two persons who were present at a meeting. Counsel should confer with the witness on such occasions.

If it is determined that the witness has testified inaccurately, counsel must determine whether and how to correct the testimony. While prompt clarification, supplementation, or correction of testimony arguably is not a defense to a charge under §§ 1001 or 1621, it is likely to be viewed as strongly negating the element of intent. For example, the court in *Fletcher v. Hook*ⁿ³ affirmed the district court's dismissal for a perjury claim where the false statement was corrected later in the person's testimony.

Even if the witness did not deliberately provide testimony that he or she knew to be false, it might still be appropriate to supplement, clarify, or correct the testimony. First, the inaccurate testimony might inappropriately incriminate the witness or some other person. Second, the Staff might incorrectly determine that the witness deliberately gave false

testimony knowing that it was false, and refer the matter to be prosecuted as a potential perjury claim. In addition, if the SEC concludes that the witness violated the federal securities laws, it is more likely to refer the matter to the Department of Justice ("DOJ") for prosecution, and the DOJ is more likely to prosecute, if the witness has testified inaccurately under oath. Third, the Staff and the Commission have considerable discretion in determining whether to bring enforcement actions, the charges to make in any action and the penalties, if any, to demand. If the Staff believes that a witness deliberately provided false testimony, it might exercise its discretion adversely against that witness. Fourth, when the Staff is assessing the evidence, it often is considering the credibility of the witness. If the Staff believes that the witness gave false and misleading testimony on some issues, it might not credit the witness even as to issues on which he or she testified truthfully and accurately.

There are a number of methods by which the testimony of a witness can be clarified, supplemented, or corrected. Preferably, the witness can work the supplementation into responses to questions posed by the Staff. Alternatively, during the course of the testimony, the Staff will usually permit the witness to make a clarifying statement or counsel will be permitted to ask a clarifying question. In addition, at the conclusion of the testimony the Staff will afford the witness the opportunity to make clarifying statements and defense; counsel has the opportunity to ask clarifying questions.

As set forth above, the Commission's rules authorize the witness's counsel to ask clarifying questions at the conclusion of the testimony, but do not address the right of counsel to ask clarifying questions during the course of the testimony. Many defense counsel believe that it is better to ask clarifying questions during the course of the testimony than to wait until the conclusion of the testimony. It is more efficient and less confusing to ask clarifying questions while the witness's recollection is fresh in the minds of the witness, defense counsel and the Staff. By asking clarifying questions promptly after the portion of testimony at issue, counsel can address any misunderstandings before they become deeply embedded in the Staff's view of the case. Perhaps most importantly, if counsel waits until the end of the testimony there is a greater danger that the Staff members will miss the clarifying testimony when they review the relevant testimony. In general, the Staff will not object to defense counsel asking clarifying questions during the course of the testimony although some will ask that defense counsel defer clarifying questions until the Staff has completed a line a questioning. If counsel waits until the conclusion of the testimony to pose clarifying questions, those questions can, and often do, trigger additional questions from the Staff.

Comment

During the testimony, counsel should maintain a running list of potential clarifying and supplementary questions.

[4] Obtaining a Transcript of the Testimony

SEC rules provide that a witness' testimony should be transcribed:

Transcripts, if any, of formal investigative proceedings shall be recorded solely by the official reporter, or by any other person or means designated by the officer conducting the investigation. A person who has submitted documentary evidence or testimony in a formal investigative proceeding shall be entitled, upon written request, to procure a copy of his documentary evidence or a transcript of his testimony on payment of the appropriate fees: *Provided, however,* That in a nonpublic formal investigative proceeding the Commission may for good cause deny such request. In any event, any witness, upon proper identification, shall have the right to inspect the official transcript of the witness' own testimony. n4

The Staff interprets this rule as prohibiting defense counsel from tape recording the testimony or otherwise preparing a verbatim record of the testimony. Especially given the poor quality of the transcripts and the lack of a contemporaneous

transcript, the Staff's position is problematic. The witness has a right to effective representation before, during and after testimony. A verbatim record can assist an attorney in providing effective representation, especially if the record is accurate and available to defense counsel on a timely basis.

A witness who has provided testimony has a qualified right to obtain a copy of the transcript of the testimony upon payment of a fee to the reporter. n5 Before the Staff will permit counsel to obtain the transcript, counsel's request must be approved by an Assistant Director of the division or equivalent. It is not unusual for there to be delays in the Staff's processing of the request. If counsel needs to obtain the transcript quickly, counsel should raise the issue at the start of the testimony and later check on the Staff's processing of the request.

Comment

In deciding to request a copy of the transcript, counsel should consider not only the expense involved in obtaining the transcript, but also the risk that the witness might be required to produce the transcript in response to a discovery request served in civil litigation. It is rare for the Commission to deny a request for a transcript.

The transcript of the testimony provided by the Staff does not include a copy of the exhibits shown to the witness. Accordingly, during the testimony counsel should either keep a careful record of the documents shown to the witness as exhibits, or ensure that the transcript will contain a sufficiently detailed description of the documents to enable counsel to identify the documents.

Comment

Given the substantial delays often attendant in obtaining the transcript, it is often better for counsel to make a list of the exhibits shown to the witness.

In addition to having a conditional right to purchase the transcripts, the witness and his or her counsel have the right to inspect the transcript. Many Staff members acknowledge that the witness and counsel also have the right after the testimony to inspect exhibits used during the testimony.

FOOTNOTES:

(n1)Footnote 1. SEC Rules of Practice and Conduct, *17 C.F.R. § 203.7 (1995)*.

(n2)Footnote 2. *613 F. Supp. 48, 49 (D.D.C. 1985)* .

(n3)Footnote 3. *446 F.2d 14 (3rd Cir. 1971)* .

(n4)Footnote 4. Rule 6, SEC Rules of Investigation, *17 C.F.R. § 203.6*.

(n5)Footnote 5. Rule 6, SEC Rules of Investigation, *17 C.F.R. § 203.6*. ("[I]n a nonpublic formal investigative proceeding the Commission may for good cause deny such request.").



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CHAPTER 11 REPRESENTING MULTIPLE WITNESSES

1-11 Securities Enforcement: Counseling and Defense 11.syn

AUTHOR: Marc B. Dorfman Kenneth B. Winer

§ 11.syn Synopsis to Chapter 11: REPRESENTING MULTIPLE WITNESSES

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§ 11.04 Disclosure of and Consent to Multiple Representation

Marc B. Dorfman

Kenneth B. Winer



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CHAPTER 11 REPRESENTING MULTIPLE WITNESSES

1-11 Securities Enforcement: Counseling and Defense § 11.01

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§ 11.01 Introduction

The Securities and Exchange Commission (SEC) Staff usually will not permit company counsel to attend the testimony of a company employee unless counsel also represents the employees individually. The value to the company of its counsel's attendance at the testimony of current and former employees should not be underestimated. An oral or written summary, or even a transcript of the testimony, will not reflect the full dynamic between the Staff and the witness. Firsthand participation in preparation of the testimony will permit significantly more informed decisions with respect to defense strategy.

In addition, the company's attorney-client privilege will be better protected, and defense theories will likely be more effectively vetted if company counsel participates in preparation of the testimony.

Moreover, in SEC investigations involving complex facts, multiple representation of individual employees can result in substantial cost savings. The effective defense of such investigations frequently requires that counsel master massive quantities of information. Joint representation provides individuals with the benefit of such a defense without requiring the expense of separate counsel acquiring such mastery. Moreover, it frequently is not feasible for new counsel to master the necessary facts in the limited interval between when a witness receives a subpoena and when the witness must testify. Joint representation provides individual employees with the opportunity for more effective representation than might otherwise be available. n1 For all the foregoing reasons, it is desirable to have the same counsel represent both the company and some or all of the employees who testify.

The United States Supreme Court has held that the *First Amendment* grants defendants freedom of association in their right to counsel, n2 and that "joint representation is not *per se* violative of constitutional guarantees of effective assistance of counsel." n3

FOOTNOTES:

(n1)Footnote 1. *See Glasser v. United States*, 315 U.S. 60, 92 (1942) (Frankfurter, J., dissenting) ("Joint representation is a means of insuring against reciprocal recrimination. A common defense often gives strength against a common attack.").

(n2)Footnote 2. *See NAACP v. Button*, 371 U.S. 415, 427-429 (1963) .

(n3)Footnote 3. *Holloway v. Arkansas*, 435 U.S. 475, 482 (1978) .



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CHAPTER 11 REPRESENTING MULTIPLE WITNESSES

1-11 Securities Enforcement: Counseling and Defense § 11.02

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§ 11.02 Ethical Restrictions on Multiple Representation

Before company counsel can represent an employee individually, counsel must carefully assess whether such multiple representation is consistent with applicable ethical guidelines. Often, multiple representation will require informed consent from each client following full disclosure.

Ethical rules limit the ability of counsel to represent multiple clients in an SEC investigation. In general, a lawyer may simultaneously represent more than one client in the investigation only where the lawyer reasonably believes that the multiple representation will not adversely affect any of the clients, and all of the clients consent after full disclosure regarding the implications of the multiple representation.

The Model Rules of Professional Conduct provide that:

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and (2) each client consents after consultation.

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client ... unless: (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved. n1

The Model Code of Professional Responsibility requires a lawyer to decline multiple representation if the exercise of the lawyer's independent judgment on behalf of a client will be or is likely to be adversely affected by the acceptance of the representation, or if it would be likely to involve him in representing differing interests. An exception to this rule states that a lawyer may represent multiple clients if it is obvious that the lawyer can adequately represent the interest of each client, and if each consents to the representation after full disclosure. Such disclosure relates primarily to the possible effect of the multiple representation on the exercise of the lawyer's independent judgment on behalf of each client. n2

The Model Code further provides that:

[a] lawyer who represents two or more clients shall not make or participate in the making of an aggregate settlement of the claims of or against his clients, unless each client has consented to the settlement after being advised of the existence and nature of all the claims involved in the proposed settlement, of the total amount of the settlement, and of the participation of each person in the settlement.
n3

In 2004, the Association of the Bar of the City of New York Committee on Professional and Judicial Ethics (the "NYC Bar Association") issued a thoughtful formal opinion on the simultaneous representation of a company and one or more company employee(s) in a government investigation. This formal opinion, "Representing Corporations and their Constituents in the Context of Governmental Investigations," Formal Opinion 2004-02, provides useful guidance to attorneys who represent a company in an SEC investigation and are evaluating whether also to represent one or more officer(s), director(s), and/or employee(s) of the company. n4

FOOTNOTES:

(n1)Footnote 1. Model Rules of Professional Conduct Rule 1.7. A number of states that adopted the American Bar Association Model Rules have adopted Model Rule 1.7 with modifications. For example, the District of Columbia Rules of Professional Conduct Rule 1.7 provides:

(b) Except as permitted by paragraph (c) below, a lawyer shall not represent a client with respect to a matter if: (1) ...a position to be taken by that client in that matter is adverse to a position taken or to be taken by another client in the same matter, even though that client is unrepresented or represented by a different lawyer; (2) [s]uch representation will be or is likely to be adversely affected by representation of another client; (3) [r]epresentation of another client will be or is likely to be adversely affected by such representation; or (4) [t]he lawyer's professional judgment on behalf of the client will be or reasonably may be adversely affected by the lawyer's responsibilities to or interests in a third party or the lawyer's own financial, business, property, or personal interests.

(c) A lawyer may represent a client with respect to a matter in the circumstances described in paragraph (b) above if each potentially affected client provides consent to such representation after full disclosure of the existence and nature of the possible conflict and the possible adverse consequences of such representation.

(c) A lawyer may represent a client with respect to a matter in the circumstances described in paragraph (b) above if each potentially affected client provides consent to such representation after full disclosure of the existence and nature of the possible conflict and the possible adverse consequences of such representation.

(n2)Footnote 2. Model Code of Professional Responsibility DR 5-105.

(n3)Footnote 3. Model Code of Professional Responsibility DR 5-106(A).

(n4)Footnote 4. Formal Opinion 2004-02 is available at the website of the NYC Bar Association, at www.abcnyc.org/lawyer_ethics.html.



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CHAPTER 11 REPRESENTING MULTIPLE WITNESSES

1-11 Securities Enforcement: Counseling and Defense § 11.03

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§ 11.03 SEC Sequestration Rule

In general, company counsel will not be able to attend the testimony of company employees unless company counsel also represents the employee. On relatively rare occasions, the Staff will permit company counsel to attend testimony even though counsel does not represent the witness. The Staff is particularly likely to permit company counsel if the presence of company counsel is necessary to preserve the attorney-client privilege.

The SEC Rules of Practice purport to limit the ability of counsel to represent multiple witnesses in an SEC investigation. For example:

Any person compelled to appear, or who appears by request or permission of the Commission, in person at a formal investigative proceeding may be accompanied, represented and advised by counsel... . [p]rovided, however, that all witnesses shall be sequestered, and unless permitted in the discretion of the officer conducting the investigation no witness or the counsel accompanying any such witness shall be permitted to be present during the examination of any other witness called in such proceeding. n1

Comment

In practice the presumption of the rule is reversed, and the SEC very rarely invokes its purported power to sequester counsel.

In *SEC v. Csapo*, n2 the Commission attempted to enforce a subpoena while refusing to permit the witness to be accompanied by counsel who had represented eight other witnesses in the investigation. The Commission relied on two interrelated propositions to support its invocation of the sequestration rule:

- the presumption underlying the rule that multiple representation increases the likelihood that subsequent testimony will be tailored, either consciously or unconsciously, to conform with or explain what has come earlier; and

- the evidence suggests the possibility that some of the individuals represented by counsel might have been pressured to accept such representation in order to present a "common front."

The D.C. Circuit began its analysis by observing that the validity of the SEC sequestration rule must be judged in light of the controlling language of § 6(a) of the Administrative Procedure Act, which provides: "Any person compelled to appear in person before an agency or representative thereof is entitled to be accompanied, represented, and advised by counsel, or if permitted by the agency, by other qualified representative." n3 The court held that "before the SEC may exclude an attorney from its proceedings, it must come forth, as it has not done here, with 'concrete evidence' that his presence would obstruct and impede its investigation." n4

Accordingly, the SEC will, in general, not object to company counsel also representing individual witnesses in testimony.

[1] Factors to Consider

The comment to Model Rule 1.7 states that "an impermissible conflict may exist by reason of substantial discrepancy in the parties' testimony, incompatibility in positions in relation to an opposing party or the fact that there are substantially different possibilities of settlement of the claims or liabilities in question." n5

[a] The Risk of Criminal Prosecution

Multiple representation frequently is inappropriate where there is a significant risk of criminal prosecution. First, counsel might face a serious ethical dilemma in assessing whether one client should decline to testify on the ground of the *Fifth Amendment* right against self incrimination where another client is seeking to cooperate actively with the Commission. Second, counsel would face a serious ethical dilemma in assessing whether to seek governmental immunity or plea bargain to the detriment of the other client. n6 Indeed, the comment to Model Rule 1.7 cautions that "[t]he potential for conflict of interest in representing multiple defendants in a criminal case is so grave that ordinarily a lawyer should decline to represent more than one codefendant." n7

[b] The Appearance of Lack of Integrity

In assessing whether it is appropriate to represent multiple clients in an SEC investigation, counsel should consider a 2002 order in which a divided SEC took the position that, in an administrative proceeding, the serious potential for even the appearance of a lack of integrity in the proceedings, without an actual, identified conflict, is enough to merit disqualification of a lawyer. n8 The Commission disqualified an attorney based on the fact that the attorney represented several witnesses who were likely to be called by the Commission to testify against the attorney's other client. After noting that "[e]ven the appearance of a lack of integrity could undermine the public confidence in the administrative process" and that the witness's testimony could either be consistent or inconsistent with the respondent's theory of the case, the Commission disqualified the attorney explaining:

An attorney has a general duty to act in good faith, a duty that takes its shape from the larger object of preserving the integrity of the entire judicial process. As part of this duty, an attorney before any tribunal must advocate his client's position forcefully in order to advance the integrity of the proceeding. Here, however, [the attorney's] representation of [the respondent] with respect to subject matters that are substantially related to his representation of the witness clients could result in divided loyalties that will prevent him from fulfilling his duty to act in good faith. This serious potential for prejudice to the integrity of the proceeding leads us to conclude, therefore, that [the attorney] may not represent [the respondent] while simultaneously representing any witness who may be called against [the respondent.]

It does not alter our conclusion that an actual conflict has not yet been established. The "likelihood

and dimensions of nascent conflicts of interest are notoriously hard to predict," especially in the case where an attorney represents multiple clients with respect to substantially-related matters. A "few bits of unforeseen testimony or a single previously unknown or unnoticed document may significantly shift the relationship" between multiple clients. We need not wait until an actual conflict taints the "adversarial presentation of evidence" where the nature of the multiple representation presents such a serious potential for conflict.

Thus, the Commission asserted the authority to disqualify an attorney in order to avoid even the appearance of a lack of integrity in the administrative process. While the order relied on the fact that the respondent's attorney simultaneously represented the witness, given the vagueness of the standard employed by the Commission, it is not totally clear that the Commission would have reached a different result if respondent's counsel had ceased to represent the witnesses once the Commission instituted the administrative proceeding.

[c] The Effect on Attorney Client Privilege

In assessing whether it is appropriate to represent both the company and one or more individual employee(s) of the company, counsel should also consider the implications that the simultaneous representation of the company and the employee can have on attorney client privilege. In a 2001 opinion, the Fifth Circuit addressed the question of whether a company can waive the privilege that protects an employee's communications with the employee's lawyer regarding a matter relating to the business affairs of the company where the employee's lawyer also represented the company in the matter. n9 The Court observed that the "individual's allegedly protected communications with Lawyer do not appear to be distinguishable from discussions between the same parties in their capacities as corporate officers and corporate counsel." n10 The Court noted that courts are divided on whether in the context of a criminal investigation, the privilege is effective where two or more clients had jointly consulted with a lawyer and one client is willing to testify regarding the joint consultation. n11 The Court held that the individuals could assert privilege only "to the extent that communications regarding individual acts and liabilities are segregable from discussions about the corporation." n12 Thus, if counsel represents both a company and an individual, it is possible that the company will be able to waive the privilege with respect to communications between the individual and that counsel regarding the company's affairs.

Company counsel often does not decide whether to represent an individual employee until the SEC has served a subpoena on the witness (or otherwise indicated an intention to take the witness's testimony). By that time, company counsel often will have interviewed the individual employee and others regarding the relevant facts and will be in a good position to assess the extent to which there are potential conflicts of interest.

[d] SEC Standards of Professional Conduct

The SEC Standards of Professional Conduct for Attorneys, adopted January 23, 2003, can impact the ability of a company to represent both an issuer and employees of an issuer. n13 An attorney who represents an issuer in connection with an SEC investigation qualifies as an "attorney who appears and practices before the Commission in the representation of an issuer." n14 Two components of these standards are relevant to the ability of an attorney to represent both an issuer and an employee of an issuer. Part 205 provides, in part, that "an attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization." n15 This provision should pose a problem only if it were interpreted to mean that an attorney who simultaneously represents in connection with an SEC investigation an issuer and an employee of an issuer owes his or her professional and ethical duties exclusively to the issuer, and not also to the client employee. Nothing in the proposing release or promulgating release indicates that this interpretation is intended and the language of the section does not dictate this interpretation. Accordingly, a strong argument can be made that despite Part 205, an attorney who represents both an issuer and an employee of an issuer owes his or her ethical and professional duties to both clients.

Part 205, also imposes reporting requirements on attorneys who, in appearing and practicing before the Commission in

the representation of an issuer, become aware of evidence of a material violation. n16 This requirement can pose a barrier to simultaneously representing an issuer and an employee of the issuer, especially if the issuer has not established a qualifying legal compliance committee ("QLCC"), n17 and there was therefore a possibility that the attorney might be required to assess whether the issuer had taken appropriate remedial action with respect to the client of the attorney who was an employee of the issuer. n18

There are, however, steps that the issuer can take that would relieve the attorney of the obligation to report evidence of a material violation. If the issuer's Chief Legal Officer ("CLO") also retained the attorney to investigate evidence of a material violation, then Part 205 does not require the investigating attorney to report the evidence of a material violation if either of the following occurs:

- the issuer's attorney reports the results of such investigation to the issuer's CLO and either:
 - the issuer's attorney and the CLO reasonably believe that no material violation has occurred, is ongoing, or is about to occur; or
 - the CLO reports the results of the attorney's investigation to the issuer's board of directors, the audit committee, the QLCC, or another committee of independent directors; or
 - the attorney was retained by the issuer's CLO to assert, consistent with the attorney's professional obligations, a colorable defense on behalf of the issuer in the SEC investigation or any judicial or administrative proceeding relating to such evidence of a material violation *and* the CLO provides reasonable and timely progress reports to the issuer's board of directors, the audit committee, the QLCC, or another committee of independent directors. n19

Similarly, Part 205 does not impose on an attorney an obligation to report evidence of a material violation if the attorney was retained or directed by the QLCC to: (1) investigate such evidence or (2) assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer in any investigation or judicial or administrative proceeding relating to such evidence of a material violation. n20

Counsel should reassess the propriety of the multiple representation and the adequacy of any disclosure and consent at each phase of the investigation. For example, even if it is appropriate to represent multiple witnesses during testimony, it might not be appropriate to represent multiple witnesses in the Wells phase of the process, during settlement discussions, or during the subsequent litigation. (It is the practice of the Staff to notify a potential defendant/respondent when the Staff has reached a tentative decision to recommend that the Commission authorize an enforcement proceeding against that person. This notice is referred to as a "Wells call." n21)

In some circumstances, it might be appropriate for an individual officer or director to be represented by a second law firm as well as the firm that also represents the company. The second law firm can serve a number of important functions. First, the second firm can help the individual understand and appreciate the first firm's disclosure regarding the potential for differing interests. Second, the second firm can provide the individual with assurance that the advice of the first firm is in the interests of the individual. Third, the second firm can advise the individual on discrete issues regarding which the first firm might have a conflict. For example, a firm representing a company might not be able to advise an individual regarding whether that individual should assert the *Fifth Amendment* right against self-incrimination, but might be able to advise the individual once he or she has decided to testify. Fourth, if the first firm ceases to represent the individual, the second firm is likely to be sufficiently familiar with the matter so that it can quickly be prepared to assume sole responsibility for his or her defense. For example, if the SEC Staff makes Wells calls to both the individual and the company, the second firm can assume responsibility for the Wells submission and

settlement negotiations if the Wells call gives rise to a conflict of interest that precludes the first firm from simultaneously representing the company and the individual.

The practical application of this dual representation can take several forms, depending on the needs of the parties. For example, sometimes the second firm might serve as adviser instead of participant, having no contact with the SEC. In other circumstances, the second firm might actively participate in defending the witness's testimony and in other meetings with the Commission.

FOOTNOTES:

(n1)Footnote 1. Rule 7(b), SEC Rules Relating to Investigation, *17 C.F.R. § 203.7(b)*.

(n2)Footnote 2. *SEC v. Csapo*, 533 F.2d 7 (D.C. Cir. 1976) .

(n3)Footnote 3. *5 U.S.C.S. § 555(b)*.

(n4)Footnote 4. *Csapo*, 533 F.2d at 11 . See also *SEC v. Higashi*, 359 F.2d 550 (9th Cir. 1966) (holding that Administrative Procedure Act precluded SEC from invoking sequestration rule to prevent corporate director from being represented by lawyer who represented corporation).

(n5)Footnote 5. Model Rules of Professional Conduct Rule 1.7 cmt. [7].

(n6)Footnote 6. See *In re Investigation Before February, 1977 Lynchburg Grand Jury*, 563 F.2d 652, 657 (4th Cir. 1977) (holding that professional ethics can prevent lawyer from advising client to testify in exchange for immunity when that involves testimony adverse to another client's interest). See also *In re Investigation Before April 1975 Grand Jury*, 531 F.2d 600, 603 n.4 (D.D.C. 1976) (discussing various circumstances in which conflict can arise in multiple representation).

(n7)Footnote 7. Model Rules of Professional Conduct Rule 1.7 cmt. [7].

(n8)Footnote 8. 3-10007, *In re Clarke T. Blizzard and Rudolph Abel*, SEC Admin. Proceeding File No. 2002 SEC LEXIS 1087 (Apr. 24, 2002). It should be noted, however, that the Commission ultimately dismissed the proceeding rather than risk appellate review of this order. *In re Blizzard and Abel*, SEC Admin. Proceeding File No. 3-10007, 2004 SEC LEXIS 1298 (June 23, 2004), available at <http://www.sec.gov/litigation/opinions/ia-2253.htm>.

(n9)Footnote 9. *In re Grand Jury Subpoena*, 274 F.3d 563 (5th Cir. 2001) .

(n10)Footnote 10. *274 F.3d at 572* .

(n11)Footnote 11. *274 F.3d at 573* .

(n12)Footnote 12. *274 F.3d at 573* .

(n13)Footnote 13. The standards are available on the SEC website at www.sec.gov/rules/final/33-8185.htm and codified at 17 C.F.R. § 205.

(n14)Footnote 14. Section 205.3(a) codified at *17 C.F.R. § 205.3(a)*.

(n15)Footnote 15. Section 205.3(a) codified at *17 C.F.R. § 205.3(a)*.

(n16)Footnote 16. Sections 205.3(b), 205.3(c), 205.5(c) codified as *17 C.F.R. §§ 205.3(b), 205.3(c), 205.(c)*.

(n17)Footnote 17. Section 205.2(k), codified as *17 C.F.R. § 205.2(k)*.

(n18)Footnote 18. Sections 205.3(b)(3), (9), codified as *17 C.F.R. § 205.3(b)(3), (9)*.

(n19)Footnote 19. Section 205.3(b)(6), codified as *17 C.F.R. § 205.3(b)(6)*.

(n20)Footnote 20. Section 205.3(b)(7), codified as *17 C.F.R. § 205.3(b)(7)*.

(n21)Footnote 21. For a further discussion of the Wells process, see Chapter 16 *below*.



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CHAPTER 11 REPRESENTING MULTIPLE WITNESSES

1-11 Securities Enforcement: Counseling and Defense § 11.04

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§ 11.04 Disclosure of and Consent to Multiple Representation

Simultaneous representation of multiple clients in an SEC investigation will usually require disclosure and informed consent. n1 A comment to District of Columbia Rules of Professional Conduct Rule 1.7 includes the following guidance regarding the disclosure that should precede the consent:

Disclosure and consent are not mere formalities. Adequate disclosure requires such disclosure of the parties and their interests and positions as to enable each potential client to make a fully informed decision as to whether to proceed with the contemplated representation. If a lawyer's obligation to one or another client or to others or some other consideration precludes making such full disclosure to all affected parties, that fact alone precludes undertaking the representation at issue. Full disclosure also requires that clients be made aware of the possible extra expense, inconvenience, and other disadvantages that may arise if an actual conflict of position should later arise and the lawyer be required to terminate the representation. n2

Comment

Even where consent has been given, the lawyer must be satisfied that he can simultaneously represent both clients adequately without adverse effects. Accordingly, counsel should agree to represent more than one client in an SEC investigation only after careful consideration of all the factors involved.

Information provided by a client to his or her attorney is confidential and cannot be shared with others absent the client's consent. Accordingly, defense counsel should secure informed consent from each of the clients to use and disclose information obtained from each on behalf of the others. n3

FOOTNOTES:

(n1)Footnote 1. *See Messing v. FDI, Inc.* 439 F. Supp. 776, 784 (D.N.J. 1977) (holding that law firm can simultaneously represent multiple individual defendants in derivative action because individuals are capable of informed consent and can act independently).

(n2)Footnote 2. D.C. Rules of Professional Conduct 1.7 cmt. [19].

(n3)Footnote 3. *See, e.g.*, Model Rules of Professional Conduct Rule 1.6 (Confidentiality of Information).



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense 12.syn

AUTHOR: Bryan B. House

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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.01

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§ 12.01 Introduction

Federal law governs privileges that may be asserted during an SEC investigation. n1 In the context of SEC investigations, the SEC recognizes the attorney-client privilege, the work-product doctrine, the doctor-patient privilege, the priest-penitent privilege, the spousal privilege and, perhaps, the self-evaluative privilege. In addition, a person might also be able to resist producing tax returns. Although a detailed discussion of the federal law on privilege is beyond the scope of this treatise, n2 this section addresses some of the privilege issues frequently encountered in an SEC investigation.

In 2001, SEC Enforcement officials publicly stated that if a company wanted to receive credit for cooperation, it may have to produce materials otherwise protected by privilege at the outset of the SEC investigation and without any concrete assurance regarding the benefit(s) that the company would receive in return. n3 More recently, however, the Enforcement Staff has been instructed not to request that parties waive privilege under either the attorney-client or work-product doctrines. n4

A similar phenomenon has taken place with respect to criminal prosecutors. After criticism from the defense bar and Congress that the Department of Justice's ("DOJ") previously-stated positions regarding the waiver of privileges improperly eroded the attorney-client privilege, the DOJ's position has changed on more than one occasion since 2003. n5 In December 2006, the "McNulty Memorandum," written by then Deputy Attorney General Paul McNulty, provided that a prosecutor could not request that a company waive privileges without obtaining approval from a more senior DOJ official. Then, in August 2008, then Deputy Attorney General Mark Filip issued new guidance (the "Filip Memorandum") that emphasized the importance of the attorney-client privilege, as well as the work product protection, and expressly directed prosecutors not to ask for waivers of these privileges. n6

Comment

Despite recent clarifications that the Enforcement Staff and prosecutors should not request waiver of the attorney-client privilege, defense counsel should be aware that such a waiver may be a prudent course of action depending on the circumstances.

Companies should attempt to decide at the outset of an investigation whether the company will withhold materials from the SEC and from criminal prosecutors on the ground of privilege. On the one hand, production to law enforcement agencies of otherwise privileged materials is likely to waive the privilege as to private litigants. On the other hand, the perceived benefits of waiving privileges may be a wise strategic decision and may result in a company receiving considerable credit for cooperation.

There are several reasons why if the company ultimately decides to produce otherwise privileged materials it may be better for the company to make that decision earlier, rather than later. The company may receive more credit for cooperation if it produces otherwise privileged materials early in the process. The company reduces the risk that witnesses will be called back for more testimony if the company produces otherwise privileged materials before the witness's initial testimony. In addition, the process of screening for privilege is expensive and requires judgment calls that could be subject to second-guessing, especially if the company later produces the documents withheld on the ground of privilege.

Finally, the recent enforcement action against Bank of America suggests that courts may question SEC settlements if critical facts are shielded from discovery by assertion of the attorney-client privilege. In that case, the SEC sued Bank of America, but no individuals, for allegedly making materially false and misleading statements in its proxy statement in connection with its acquisition of Merrill Lynch, i.e., that Merrill had agreed not to pay discretionary bonuses to its executives prior to the acquisition without Bank of America's consent. Simultaneously with the Complaint, the SEC and Bank of America filed a proposed Consent Judgment, pursuant to which Bank of America agreed to pay a \$33 million civil penalty. The court rejected the proposed settlement because the settlement seemed unfair to the shareholders who would pay the penalty. n7 The court was critical of the SEC's argument that it could not sue company executives because the investigative record showed that lawyers for Bank of America and Merrill Lynch drafted the documents at issue and made the decisions regarding the disclosure. The court asked "why are the penalties not sought from the lawyers?" n8 The court, likewise, was critical of what it saw as Bank of America's failure to provide the court with a description of how the allegedly false proxy was prepared, noting "the truth may still emerge." n9 Only after Bank of America waived the attorney-client privilege and provided the court with a fully-developed evidentiary record (and the amount of the penalty rose to \$150 million) did the court reluctantly approve the settlement, still with the company alone, as a reasonable exercise of the SEC's authority in policing the securities markets. n10

FOOTNOTES:

(n1)Footnote 1. *See McMann v. SEC*, 87 F.2d 377, 378 (2d Cir.), *cert. denied*, 301 U.S. 684 (1937) (holding that Securities and Exchange Commission investigations are "subject to the same testimonial privileges as judicial proceedings").

(n2)Footnote 2. *See* Herbert E. Milstein, *Attorney-Client Privilege and Work-Product Doctrine: Corporate Applications*, 22-2nd C.P.S. (BNA).

(n3)Footnote 3. *See* Report of Investigation Pursuant to Section 21(a) of the *Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, *Exchange Act Rel. No. 44969*, 2001 SEC LEXIS 2210, AAER No. 1470 (Oct. 23, 2001) (the "Seaboard § 21(a) Report"). The Seaboard § 21(a) Report is further discussed in Chapter 17 and a copy of the Report is included in Appendix A.

(n4)Footnote 4. *Enforcement Manual* § 4.3 at p. 99 ("The staff should not ask a party to waive the attorney-client or work-product privileges and is directed not to do so."). The manual states that decisions regarding potential waiver of privilege need to be reviewed with the Assistant Director supervising the matter, as well as more senior members of the Enforcement Division.

(n5)Footnote 5. A copy of the 2003 "Thompson Memorandum," named for then-Deputy Attorney General Larry Thompson, is included in Appendix A.

(n6)Footnote 6. See Chapter 23 for a more detailed discussion of the DOJ memoranda.

(n7)Footnote 7. *SEC v. Bank of America Corp.*, 653 F. Supp. 2d 507 (S.D.N.Y. 2009) .

(n8)Footnote 8. 653 F. Supp. 2d at 509

(n9)Footnote 9. 653 F. Supp. 2d at 512 .

(n10)Footnote 10. See *SEC v. Bank of America Corp.*, 2010 U.S. Dist. LEXIS 15460 (S.D.N.Y. Feb. 22, 2010) .



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.02

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§ 12.02 Attorney-Client Privilege

[1] Federal Standard

The elements of the attorney-client privilege are set forth in *United States v. United Shoe Machinery Corp.* n1 According to the holding in *United Shoe*, in order for the attorney-client privilege to attach, the person asserting the privilege must:

- make a communication to an attorney whom he seeks or has retained to represent him;
- make the communication outside the presence of outsiders for the purpose of securing an opinion of law or legal services; and
- claim and not waive the privilege. n2

The attorney-client privilege also protects communications from the attorney to the client, where the communications could reveal, directly or indirectly, the client's privileged communications to the attorney. n3 In addition, a number of courts have held that the attorney-client privilege protects "any communication from an attorney to his client when made in the course of giving legal advice." n4

Sharing information with an attorney, however, does not make that information privileged. Underlying facts contained in a privileged communication, for example, are not privileged. n5 Likewise, involving an attorney in a meeting does not render the communications necessarily privileged. n6 For example, minutes of board of directors' meetings are only privileged if a lawyer present was providing legal advice. n7 Similarly, copying an attorney on a memorandum or other document will not create a privilege for a document otherwise not created for the purpose of securing legal advice. n8

[2] Application of the Privilege to Agents and Other Attorneys

Communication among attorneys may also be protected by the privilege. The Seventh Circuit, in *Natta v. Zletz* n9 stated that:

Insofar as inter-attorney communications or an attorney's notes contain information which would otherwise be privileged as communications to him from a client, that information should be entitled to the same degree of protection from disclosure. To hold otherwise merely penalizes those attorneys who write or consult with additional counsel representing the same client for the same purpose. As such it would make a mockery of both the privilege and the realities of current legal assistance. n10

Several other courts have also held that inter-attorney communication can be protected by the privilege. n11 Just as communication among attorneys may be protected, communications between a client and agents providing consulting services for the purposes of litigation may sometimes be protected. n12 Statements made to and from these agents may be privileged if the person's services "are a necessary aid to the rendering of effective legal services to the client." n13

For example, the D.C. Circuit held in *FTC v. GlaxoSmithKline* that documents prepared in anticipation of litigation that were shared by a client with its public relations and government affairs consultants were protected by the attorney-client privilege. n14 The documents at issue were circulated only to specifically named employees and contractors, all of whom "needed to provide input to the legal department and/or receive the legal advice and strategies formulated by counsel." n15 The court stated that "there is no reason to distinguish between a person on the corporation's payroll and a consultant hired by the corporation if each acts for the corporation and possesses the information needed by attorneys in rendering legal advice." n16

Some courts, however, have refused to extend the attorney-client privilege to public relations firms. n17 Recently, the attorney-client privilege was held not to extend to communications with an advertising agency. n18

It is important that practitioners document, to the extent possible, that the agent or expert has been retained to assist the attorney with the rendering of legal advice. In one case, the Second Circuit held that conversations between an attorney and an investment banker were not privileged even though they were for the purpose of assisting the attorney in better advising his client regarding the transaction proposed by the banker. n19 Noting that the primary purpose of the banker's communication was to provide information the client did not have regarding the transaction, the court distinguished cases upholding the privilege where the purpose of the third-party communication was to "improve the comprehension of the communications between attorney and client." n20

[3] Corporation as Client

The attorney-client privilege applies to communications where a corporation is the client. n21 As legal fictions, however, corporations act only through their agents. Until 1981, there had been considerable uncertainty regarding the test to be applied in determining whether an individual personified the corporation for purposes of the privilege. In its landmark 1981 decision, *Upjohn Co. v. United States*, the United States Supreme Court rejected what had been known as the "control group" test, a methodology analyzing whether an employee had enough control over the decisions of a corporation to be covered by the privilege. n22 The Supreme Court explicitly rejected the lower court's application of the test, claiming that such a test frustrated the fundamental purpose of the privilege. n23 Noting that the necessary information is often possessed by non-control group employees, the Supreme Court stated that "[t]he narrow scope given the attorney-client privilege by the court below ... makes it difficult for corporate attorneys to formulate sound advice when their client is faced with a specific legal problem." n24

In deciding that the material at issue in *Upjohn* was protected by the attorney-client privilege, the Supreme Court noted that:

- company employees communicated to corporate counsel;
- at the direction of their superiors;

- in order to secure legal advice for the corporation;
- regarding matters within the scope of their employment;
- a Congressional committee may threaten criminal contempt against a person who refuses to produce documents responsive to a committee subpoena based on an assertion of privilege; n25
- the employees knew they were being questioned in order to provide legal advice to the corporation;
- the communications were considered confidential when made; and
- the company had kept the communications confidential. n26

As noted above, the attorney-client privilege protects more than just communications from a client to an attorney. In the corporate context, communications among members of the client corporation have been held to fall within the scope of the privilege when the communication reflects either information that the corporation confided in counsel or any legal advice that resulted from such a confidence. n27 *In re Grand Jury* n28 involved a claim of attorney-client privilege for communications between a company's president and its board of directors regarding the advice of company counsel. The court reasoned that since the corporation was the client, the attorney-client privilege was still applicable because the communication from the corporation's president to the directors regarding legal advice was "merely making advice available to another part of this inanimate entity." n29

Because the corporation usually controls the privilege, how and when a corporation and its employees can waive the attorney-client privilege can present difficult issues for practitioners. The Second Circuit decided an important case on this issue in *In re Grand Jury Proceedings*, in which a corporation was vigorously asserting the privilege in the context of an investigation regarding unlawful sale of firearms. n30 The founder, chairman and controlling shareholder of the corporation were subpoenaed individually to provide grand jury testimony regarding the subject matter of a particular meeting. The chairman was aware that the corporation was asserting privilege, and he had been expressly instructed that he was not authorized to reveal the contents of that meeting. Nevertheless, when questioned, the chairman testified broadly with respect to the privileged subject matter. After the district court found waiver of the privilege, the corporation appealed, arguing that its corporate officer could not waive the privilege.

The Second Circuit rejected the *per se* rule argued by the corporation and remanded the case to the district court for analysis of whether fairness required that the chairman's testimony waived the corporation's privilege. The Second Circuit indicated that it did not believe a finding of waiver was appropriate. The court emphasized a number of points -- that the witness was not appearing on behalf of the corporation, the lack of counsel in the grand jury room during proceedings, that the defendant corporation had taken significant steps to avoid waiver, and that the government had failed to articulate any prejudice it would suffer by upholding the privilege. On remand, the district court held that there was no waiver of the attorney-client privilege.

Difficult problems can also arise in the opposite situation--those in which a corporation waives its privilege belonging to it, but the corporate officers or employees whose communications are at issue claim that the privilege applies to them individually. Cases suggest that the presumption in such cases is that corporate counsel represents the corporation *only* and the corporation is free to disclose communications that it has had with its agents and employees. n31 Several federal appellate courts have adopted a stringent five-factor test for determining whether this presumption should be set aside. To successfully prevent the corporation from disclosing their communications with corporate counsel, individuals must show: (1) they approached counsel for the purpose of seeking legal advice; (2) when they approached counsel they made it clear they were seeking legal advice in their individual rather than representative capacities; (3) counsel saw fit to communicate with them in their individual capacities, knowing a conflict could arise; (4) their conversations with counsel were confidential; and (5) the substance of their conversations with counsel did not concern matters relating to

the company or the general affairs of the company. n32 In adopting this test, these courts have rejected a "honest and reasonable belief" standard for recognizing a privilege between individuals and corporate counsel. n33

Corporate counsel must exercise extreme caution when communicating with agents and employees who might be personally liable for acts carried out in a representative capacity, as the individuals may later claim that their communications cannot be disclosed to third parties, including the government, without their permission. Courts have taken very seriously corporate counsel's obligation to provide a warning--typically called an "*Upjohn* warning"--letting the witness know that counsel represents the company, not the witness, and that the attorney-client privilege belongs to the company and may be waived by the company.

Two recent cases stand out as reminders of how corporate counsel can find themselves in difficult situations as employees challenge the lawyers' ability to share information with the government. In *In re Grand Jury Subpoena*,ⁿ³⁴(n34)Footnote 34. 415 F.3d 333 (4th Cir. 2005). corporate counsel interviewed key witnesses in the course of an internal investigation. Counsel told the witnesses "we represent the company" but that counsel "could" represent the witnesses "as long as no conflict appear[ed]." The Fourth Circuit called the use of the hypothetical "could" a "watered-down 'Upjohn warning' " in a "legal and ethical minefield," but concluded that, under the circumstances, the witnesses could not have reasonably believed that they had separate attorney-client relationships with corporate counsel.

In *United States v. Nicolas*, the district court suppressed the defendant CFO's statements to company counsel who interviewed him as part of an internal investigation regarding the alleged backdating of employee stock options. Finding that the statements were privileged, the court noted that the attorneys' notes did not reflect that any "*Upjohn* warning" was provided, the attorneys had represented the defendant and the company jointly in a related matter and the attorneys never told the defendant that they did not represent him. n35 The district court was so concerned by the attorneys' conduct, which he viewed as violating California's Rules of Professional Responsibility, that it reported them to the state bar association for possible disciplinary proceedings. The Ninth Circuit reversed, holding that the defendant could not establish the elements of the attorney-client privilege because the communications with the company's counsel were not made in confidence, but rather were intended to be shared with the company's outside auditors in order to convince the auditors of the integrity of the company's financial statements. n36

[4] Former Employees

Some courts have held that the attorney-client privilege protects communications between company counsel and former employees of the company. Courts extending the privilege in this way reason that former employees may have information important to the representation of the corporation and should be treated as current employees. n37 Indeed, it has been stated that "a formalistic distinction based solely on the timing of the interview cannot make a difference if the goals of the privilege as outlined in *Upjohn* are to be achieved." n38 Other courts have rejected the application of the privilege to former employees, particularly where the employee was not a decision maker. n39

FOOTNOTES:

(n1)Footnote 1. *United States v. United Shoe Mach. Corp.*, 89 F. Supp. 357 (D. Mass. 1950) ; *See also Constand v. Cosby*, 232 F.R.D. 494, 501 (E.D. Pa. 2006) .

(n2)Footnote 2. *United Shoe Mach. Corp.*, 89 F. Supp. at 358-359 .

(n3)Footnote 3. *Minebea Co. v. Papst*, 229 F.R.D. 1, 5 (D.D.C. 2005) ; *American Standard, Inc. v. Pfizer, Inc.*, 828 F.2d 734 (Fed. Cir. 1987) .

(n4)Footnote 4. *See, e.g., In re LTV Secs. Litig.*, 89 F.R.D. 595, 602 (N.D. Tex. 1981) .

(n5)Footnote 5. *See In re Six Grand Jury Witnesses*, 979 F.2d 939 (2d Cir. 1992) ("the underlying information in the privileged communication is not shielded from discovery").

(n6)Footnote 6. *See Yang v. Reno*, 157 F.R.D. 625 (M.D. Pa. 1994) (DOJ attorney in meeting with President did not transform meeting into one in which legal advice was sought or given).

(n7)Footnote 7. *See Kelly v. Ford Motor Co.*, 110 F.3d 954, 966 (3rd Cir. 1997) .

(n8)Footnote 8. *See U.S. v. Chevron Texaco Corp.*, 241 F. Supp. 2d 1065 (N.D. Cal. 2002) . *See also B.F.G. of Illinois, Inc. v. Ameritech*, 2001 U.S. Dist. LEXIS 18930 (N.D. Ill. Nov. 8, 2001) ("[D]ocument is nothing more than a business document given a veneer of privilege by routing through the in-house counsel.").

(n9)Footnote 9. *Natta v. Zletz*, 418 F.2d 633 (7th Cir. 1969) .

(n10)Footnote 10. *Natta v. Zletz*, 418 F.2d at 637 n.3 .

(n11)Footnote 11. *See, e.g., Smithkline Beecham Corp. v. Apotex Corp.*, 232 F.R.D. 467 (E.D. Pa. 2005) ; *Cedrone v. Unity Sav. Ass'n*, 103 F.R.D. 423, 429 (E.D. Pa. 1984) ; *Green v. IRS*, 556 F. Supp. 79, 85 (N.D. Ind. 1982) .

(n12)Footnote 12. *See In re Grand Jury Subpoenas*, 179 F. Supp.2d 270, 283 (S.D.N.Y. 2001) ; *United States v. Kovel*, 296 F.2d 918, 921-922 (2d Cir. 1961) (recognizing the privilege's applicability to ministerial employees, and extending it to experts--an accountant in this case).

(n13)Footnote 13. *United States v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972) . *See also Carter v. Cornell Univ.*, 173 F.R.D. 92, 94 (S.D.N.Y. 1997) (Associate Dean of Human Resources, who conducted interviews at request of counsel for the exclusive use of counsel in regarding legal advice, was representative of attorney for purposes of attorney-client privilege).

(n14)Footnote 14. *FTC v. GlaxoSmithKline*, 294 F.3d 141, 148 (D.C. Cir. 2002) . *See In re Grand Jury Subpoenas Dated March 24, 2003*, 265 F. Supp. 2d 321 (S.D.N.Y. 2003) (holding that both the attorney-client privilege and the work-product doctrine protect material that is the target of a grand jury investigation and was provided to a public relations firm hired by target's lawyers to aid in avoiding an indictment); *In re Copper Market Antitrust Litig.*, 200 F.R.D. 213 (S.D.N.Y. 2001) (holding that attorney-client privilege protected the work of public relations firm retained by Sumitomo to serve as its public relations department in response to scandal involving both regulatory and civil litigation aspects).

(n15)Footnote 15. *FTC v. GlaxoSmithKline*, 294 F.3d at 147 .

(n16)Footnote 16. *Id.* (citing *In re Copper Market Antitrust Litig.*, 200 F.R.D. 213, 219 (S.D.N.Y. 2001) .

(n17)Footnote 17. *See Sharon Haugh v. Schroder Inv. Mgmt. N. Am., Inc.*, 2003 U.S. Dist. LEXIS 14586 (S.D.N.Y. Aug. 25, 2003) (attorney-client privilege did not protect--but the work-product doctrine did protect--materials provided to or generated by public relations firm hired by defense counsel to help defend client from attacks in the media that client's counsel anticipated would be triggered by a lawsuit); *Calvin Klein Trademark Trust v. Wachner*, 198 F.R.D. 53 (S.D.N.Y. 2000) (attorney-client privilege did not protect documents held by a public relations firm that had been hired by counsel to assist counsel in understanding the possible reaction of the client's various constituencies to the litigation, rendering of legal advice, and shaping media interest in litigation but work-product doctrine protected some of the documents).

(n18)Footnote 18. *See LG Electronics U.S.A., Inc. v. Whirlpool Corp.*, 661 F. Supp. 2d 958 (N.D. Ill. 2009) .

(n19)Footnote 19. *United States v. Ackert*, 169 F.3d 136 (2d Cir. 1999) .

(n20)Footnote 20. *Ackert*, 169 F.3d at 139 .

(n21)Footnote 21. *Ross v. City of Memphis*, 423 F.3d 596, 600 (6th Cir. 2005) ; *Upjohn Co. v. United States*, 449

U.S. 383 (1981) ; Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 608 (8th Cir. 1977) .

(n22)Footnote 22. *See Philadelphia v. Westinghouse Elec. Corp., 210 F. Supp. 483 (E.D. Pa. 1962)* , (setting forth the "control group" test). Under this test, the inquiry focuses on whether the employee communicating with counsel "is in a position to control or ... take a substantial part in a decision about any action which the corporation may take upon the advice of the attorney." *210 F. Supp. at 485 .*

(n23)Footnote 23. *Upjohn, 449 U.S. at 392 .*

(n24)Footnote 24. *Upjohn, 449 U.S. at 392 .*

(n25)Footnote 25. L. Brever & S. Anthony, *Congressional Contempt: Both House and Senate Can Pierce Privileges and Punish if You Plead Confident*, Legal Times, Vol. XXIII, No. 43 (October 30, 2000).

(n26)Footnote 26. *Upjohn, 449 U.S. at 394 .*

(n27)Footnote 27. *See Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 611 (8th Cir. 1977)* (holding that material disseminated to those corporate employees involved in an internal investigation was still privileged).

(n28)Footnote 28. *In re Grand Jury, 758 F. Supp. 1411 (D. Colo. 1991) .*

(n29)Footnote 29. *In re Grand Jury, 758 F. Supp. at 1413 .* Even if the materials are protected by the federal attorney-client privilege and therefore not discoverable by the SEC, they might be discoverable in other contexts. For example, the state attorney-client privilege might be more limited, rendering the materials subject to discovery by a state law enforcement agency or in a civil action involving state claims. *See, e.g., Consolidation Coal Co. v. Bucyrus-Erie Co., 432 N.E.2d 250, 257 (1982)* (applying the group control test to attorney-client privilege). Moreover, some foreign jurisdictions provide only limited, if any, protection to communications in-house counsel or retained counsel from outside the jurisdiction at issue. *See, e.g., AM&S Europe Ltd. v. Comm'n of the European Community, 1982 E.C.R. 1575 (European Ct. of Justice 1982)* (the attorney-client privilege does not protect communications with in-house counsel or with retained counsel from outside the European Union).

(n30)Footnote 30. *219 F.3d 175 (2d Cir. 2000) .*

(n31)Footnote 31. *In re Grand Jury Subpoena, 274 F.3d 563 (1st Cir. 2001) .*

(n32)Footnote 32. *In re Grand Jury Subpoena, 274 F.3d at 571 , following In re Bevill, Bresler & Schulman Asset Mgmt. Corp., 805 F.2d 120 (3d Cir. 1986) ; accord Grand Jury Proceedings v. United States, 156 F.3d 1038, 1041 (10th Cir. 1998) ; United States v. Int'l Bhd of Teamsters, 119 F.3d 210, 215 (2d Cir. 1997) ; In re Sealed Case, 29 F.3d 715, 719 n. 5 (D.C. Cir. 1994) .*

(n33)Footnote 33. *Compare United States v. Aramony, 88 F.3d 1369 (4th Cir. 1996)* (privilege inapplicable to individual where neither individual nor counsel had reasonable belief that individual sought legal advice).

(n35)Footnote 35. *606 F. Supp. 2d 1109 (C.D. Cal. 2009) .*

(n36)Footnote 36. *U.S. v. Ruehle, 583 F.3d 600 (9th Cir. 2009) .*

(n37)Footnote 37. *See, e.g., United States ex rel. Hunt v. Merck-Medco Managed Care, LLC, 340 F.Supp.2d 554, 557 n. 2 (E.D. Pa. 2004) ; In re Coordinated Pretrial Proceedings in Petroleum Prods. Antitrust Litig., 658 F.2d 1355, 1361 n.7 (9th Cir. 1981) ; Allen v. McGraw, 106 F.3d 582 (4th Cir. 1997)* (holding that communications between a company's counsel and a company's former employees were protected by privilege). *See also In re Bank of Louisiana, 1998 U.S. Dist. LEXIS 17812 (E.D. La. 1998)* (collecting cases).

(n38)Footnote 38. John E. Sexton, *A Post-Upjohn Consideration of the Corporate Attorney-Client Privilege*, 57 *N.Y.U. L. Rev.* 443, 499 (1982) (arguing that communications with former employees should be granted the same protection as similar communications with current employees).

(n39)Footnote 39. See *Connolly Data Sys. V. Victor Tech.*, 114 *F.R.D.* 89 (S.D.N.Y. 1987) (former employee could not bind the corporation); *Verschoth v. Time-Warner, Inc.*, 2001 *U.S. Dist. LEXIS* 3174 (S.D.N.Y. Mar. 22, 2001) (former employee worked sporadically and had no management responsibilities).



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CHAPTER 12 PRIVILEGES

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§ 12.03 Work-Product Doctrine

The seminal case on the work-product doctrine is *Hickman v. Taylor*. n1 In *Hickman*, the Supreme Court adopted a broad definition of "work-product" as including interviews, memoranda, and statements, as well as mental impressions, conclusions, opinions, or legal theories prepared in connection with, or in anticipation of, litigation. n2 The Supreme Court noted that the requested information at issue in *Hickman* was outside the scope of the attorney-client privilege, but reasoned that sound policy should also protect the confidentiality of an attorney's work-product prepared in anticipation of litigation. n3

A lawyer does not necessarily have to prepare the document for it to receive work product protection. An auditor's memorandum of a meeting between a corporation, its auditor and outside counsel was held to be protected work product because *Hickman* extended work product protection to "intangible" things, including an attorney's "mental impressions." n4 Naturally, the work-product doctrine can extend to work prepared by an attorney's agents to help analyze and/or prepare a client's case. Thus, the work of trial consultants and public relations firms have been found to be work-product. n5 Unlike the attorney-client privilege, the work product privilege can be asserted by the client or the attorney. n6

As in the case of the attorney-client privilege, courts often consider whether work-product was created in anticipation of litigation or, rather, for a business purpose. In an often-cited case, the Second Circuit considered the case of a document containing a legal analysis of potential IRS challenges to the anticipated tax treatment of a proposed reorganization. n7 The Second Circuit reversed the district court's decision that the work-product doctrine did not apply because the document was not prepared "principally or exclusively to assist in ... litigation." n8 The Second Circuit found the district court's test too narrow and held that the proper standard was whether the documents were prepared "because of the prospect of" litigation. The fact that the analysis of litigation was created for a business purpose did not render the attorney's assessment "freely available to his litigation adversary." n9

Like the Second Circuit, most circuits have adopted a test that asks whether the document was created "because of" anticipated litigation. n10 The Fifth Circuit, however, utilizes a more stringent test, asking if anticipated litigation is the "primary motivating purpose" behind the creation of the document. n11 Recently, a more significant split with respect to the "in anticipation of litigation" test has developed. In *United States v. Textron*, the First Circuit, in an *en banc*

decision, purporting to apply the "because of" test, held that tax accrual workpapers prepared by attorneys and the corporation's tax department reflecting estimates of liability in the event the IRS challenged certain positions were not work product. n12 The court relied on language in *Hickman*, which it said protected documents prepared "for any litigation or trial." The documents at issue, it reasoned, were simply "tax documents" supporting the corporation's tax contingencies. n13 A sharply-worded dissent argued that the court did not, in fact, apply the "because of" test, but rather created a "prepared for use in possible litigation" test. n14 The Court of Appeals for the District of Columbia, in nearly identical circumstances relating to a company's tax workpapers, has held that such a document can be protected work product "even though it serves multiple purposes." n15 That court, while calling *Textron* "distinguishable," noted that the *Textron* dissent made a "strong argument" that the majority had not used the "because of" test. n16

While the impact of *Textron* remains unsettled, an argument can be made that a document prepared in the course of an SEC investigation is prepared in anticipation of litigation. n17 Some courts have held that a government investigation is not "litigation" for the purpose of the "in anticipation of litigation" test under the work-product doctrine. Thus, documents prepared in anticipation of an agency's investigation may not be protected. n18 However, "once a governmental investigation has begun, 'litigation' is sufficiently likely to satisfy the 'anticipation' requirement." n19 In addition, it is not necessary that a "specific claim" must have arisen at the time documents were prepared in order for them to be protected by the work-product doctrine. n20

FOOTNOTES:

(n1)Footnote 1. *Hickman v. Taylor*, 329 U.S. 495, 34 Ohio Op. 395 (1947) .

(n2)Footnote 2. *Hickman v. Taylor*, 329 U.S. at 509-510 . See also *Fed. R. Civ. P. 26(b)(3)* (protecting against "disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney ... concerning the litigation").

(n3)Footnote 3. *Hickman*, 329 U.S. at 508 . See also *United States v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981) (stating that litigation need not be imminent for work-product doctrine to apply, but purpose of material must be to aid possible future litigation).

(n4)Footnote 4. *United States v. Deloitte*, 2010 U.S. App. LEXIS 13226 (D.C. Cir. June 29, 2010) .

(n5)Footnote 5. See, e.g., *In re Cendant Corp. Sec. Litig.*, 343 F.3d 658 (3d Cir. 2003) (work product of trial consultant); *In re Cardinal Health, Inc. Sec. Litig.*, 2007 U.S. Dist. LEXIS 36000 (S.D.N.Y. 2007) (work product of accounting consultant); *Sharon Haugh v. Schroder Inv. Mgmt. N. Am., Inc.*, 2003 U.S. Dist. LEXIS 14586 (S.D.N.Y. Aug. 25, 2003) (work product of public relations firm).

(n6)Footnote 6. See *U.S. v. Under Seal (In re Grand Jury Proceedings #5)*, 401 F.3d 247 (4th Cir. 2005) .

(n7)Footnote 7. *U.S. v. Adlman*, 134 F.3d 1194 (2d Cir. 1998) .

(n8)Footnote 8. *Adlman*, 134 F.3d at 1203 .

(n9)Footnote 9. *Adlman*, 134 F.3d at 1200 .

(n10)Footnote 10. See, e.g., *Sandra T.E. v. S. Berwyn Sch. Dist. 100*, 600 F.3d 612, 622, (7th Cir. 2010) , *In re Professionals Direct Ins. Co.*, 578 F.3d 432, 439 (6th Cir. 2009) ; *In re Grand Jury Subpoena*, 357 F.3d 900, 907 (9th Cir. 2004) .

(n11)Footnote 11. See *United States v. El Paso Co.*, 682 F.2d 530, 542 (5th Cir. 1982) .

(n12)Footnote 12. *U.S. v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009) (*en banc*), cert. denied, 2010 U.S. LEXIS 4373 (U.S. 2010) .

(n13)Footnote 13. *577 F.3d at 28* .

(n14)Footnote 14. *577 F.3d at 32* .

(n15)Footnote 15. *United States v. Deloitte LLP, 2010 U.S. App. LEXIS 13226* (D.C. Cir., June 29, 2010) .

(n16)Footnote 16. *2010 U.S. App. LEXIS 13226, at *17* .

(n17)Footnote 17. *See In re Cardinal Health, Inc. Sec. Litig., 2007 U.S. Dist. LEXIS 36000, at *15* (S.D.N.Y. Jan. 26, 2007) (after receipt of document requests from the SEC, "likelihood of civil or criminal litigation was anticipated" by Audit Committee before hiring law firm to advise it with respect to internal investigation regarding accounting practices). *See also Scurto v. Commonwealth Edison Co., 1999 U.S. Dist. LEXIS 513, *6* (N.D. Ill. Jan. 11, 1999) , *quoting Pacamor Bearings Inc. v. Minebea Co., Ltd., 918 F. Supp. 491, 513 (D.N.H. 1996)* ("investigation by a federal agency presents more than a remote prospect of future litigation, and provides reasonable grounds for anticipating litigation sufficient to trigger application of the work product doctrine.").

(n18)Footnote 18. *In re Grand Jury Subpoena, 220 F.R.D. 130 (D. Mass. 2004)* ("The Court has found no authority suggesting that a government investigation itself constitutes litigation.") (*citing Guzzino v. Felterman, 174 F.R.D. 59, 63 (W.D. La. 1997)*) .

(n19)Footnote 19. *In re Grand Jury Subpoena, 220 F.R.D. at 147* .

(n20)Footnote 20. *In re Sealed Case, 146 F.3d 881 (D.C. Cir. 1998)* .



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.04

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§ 12.04 Internal Investigations

The Supreme Court has held that an internal investigation conducted for the purpose of assisting counsel in providing legal advice, and with appropriate safeguards to preserve the confidentiality of information communicated in the investigation, should be protected by the attorney-client privilege. n1 It is generally accepted that internal investigations conducted by counsel *may* be protected by the attorney-client privilege. The critical issue examined by courts in this context is whether the communication was for the purpose of giving legal advice, rather than business advice.

In re LTV Securities Litigation n2 is particularly instructive as to the privilege issues relating to an investigation by counsel in response to an SEC investigation. LTV retained a law firm shortly after receiving subpoenas from the SEC. The law firm, in responding to the subpoenas, reviewed files, interviewed LTV employees in order to understand the events that had transpired and the accounting issues involved, engaged in settlement negotiations with the SEC, and provided legal advice to the management and board of directors of LTV. Plaintiffs in a securities class action subsequently argued that attorney-client privilege and the work-product doctrine were inapplicable because:

- the law firm performed an investigative rather than strictly legal function; and
- the information gathered by the law firm was needed by corporate management in the normal course of business.

The court rejected both arguments, holding that:

- information that could have been gathered by nonlawyers does not lose its privilege when the information was gathered by lawyers, nor does
- it lose its privilege "solely because management makes other business use of the information;" n3 and
- "Investigation by a federal agency presents more than a 'remote prospect' of future litigation sufficient for the work-product rule to apply." n4

Likewise, in *Cardinal Health Securities Litigation*, the Audit Committee of the Board of Directors had retained the Kramer Levin law firm to conduct an internal investigation of legal and accounting issues that had been raised by documents that company counsel had reviewed in response to a request for documents in an SEC inquiry. In the securities class action, the plaintiff argued that the Kramer Levin documents were not protected by work product; specially, the plaintiff noted that Cardinal Health had retained two other law firms as defense counsel and that Kramer Levin had been "hired by the Audit Committee for business purposes to conduct an independent investigation and assessment of Cardinal's accounting documents, practices, and issues." n5 The Court rejected this argument on the ground that the Audit Committee knew of the SEC investigation when it retained Kramer Levin and knew that Cardinal employees might have engaged in false and misleading accounting practices. n6

While courts will typically conclude that communications between attorneys and corporate employees are protected by the attorney-client privilege, there is a danger that a court will find that an internal investigation was not conducted in anticipation of litigation for purposes of the work-product doctrine. For example, at least one court has stated, "[T]he simple fact that the Company foresaw securities fraud litigation or that the SEC had initiated its own investigation prior to the Audit Committee's investigatory efforts does not automatically qualify the Audit Committee's investigation materials as work-product." n7

Documents prepared by SEC attorneys in the course of an investigation can also be work product. In *SafeCard Services, Inc. v. SEC*, n8 a court found that documents prepared by SEC attorneys in the course of an SEC investigation were prepared in connection with litigation. Specifically, the court stated that:

[a] law enforcement agency may meet this standard by demonstrating that one of its lawyers prepared a document in the course of an investigation that was undertaken with litigation in mind. Such an investigation would have to be, and typically would be, based upon a suspicion of specific wrongdoing and represent an attempt to garner evidence and to build a case against the suspected wrongdoer. The existence of an active investigation, therefore, is strong circumstantial evidence that the agency lawyer prepared the document with future "litigation in mind." n9

The attorney-client privilege and work-product protection otherwise applicable to internal investigations can be waived by disclosure to third parties. n10 In one interesting case, *Ryan v. Gifford*, a Special Committee investigating the conduct of company officers and directors was deemed to have waived applicable privileges when counsel to the Special Committee presented its report to the board of directors, including some of the defendant directors whose conduct was at issue. n11 Even if the Special Committee's privilege extended to the board of directors, the court held that the privilege had been waived. The court issued another opinion shortly thereafter to clarify that the privilege likely would *not* have been waived if: (1) the board members had been acting in their fiduciary capacity in the meeting; (2) their personal attorneys had not been present; and (3) the directors had not used the privileged information to exculpate themselves. n12

The waiver of the attorney-client privilege and work-product through disclosure to outside auditors has generated considerable litigation. While the attorney-client privilege is generally waived by disclosure to outside auditors, there is no consensus with respect to work-product disclosure. In *Medinol, Ltd. v. Boston Scientific Corporation*, n13 the court found that the defendant had waived the work-product privilege with respect to meeting minutes and other materials generated by its special litigation committee when it disclosed those materials to an outside auditor, Ernst & Young. The court recognized that disclosing materials to accountants did not necessarily waive the privilege, as in circumstances where the accountant is retained by attorneys to help understand the technical aspects of a case and where the accountant's interests are therefore allied with the client. n14 An independent auditor's interests, however, are not necessarily aligned with those of the client. The court observed that, in fact, "[G]ood auditing requires adversarial tension between the auditor and the client." n15 Because the disclosure of the attorneys' work-product did not serve any litigation interest or any other public policy underlying the work-product doctrine, the court ordered that the documents

that had been disclosed to Ernst & Young had to be produced.

Similarly, a court has compelled production of documents produced during an internal investigation where those documents had been previously disclosed to Ernst & Young in order to obtain an unqualified audit opinion. The court ruled that the documents were not protected by the work-product privilege as they were not prepared in anticipation of litigation, but rather were prepared by counsel for the Audit Committee in order to investigate and remediate potential violations of generally accepted accounting principles. In addition, the court held that the attorney-client privilege had been waived by the strategic decision to disclose the information to Ernst & Young. n16

Other courts, however, have held that the disclosure of work product to an auditor does not constitute waiver. n17 These courts hold that waiver should be found only when disclosure "substantially increases the opportunity for potential adversaries to obtain the information." n18 In *United States v. Deloitte LLP*, the Court of Appeals, observed that no circuit had addressed the issue. After considering the cases on both sides, the court determined that, under the circumstances, the auditor was not a potential adversary for the company or a conduit to other adversaries. Accordingly, the company had not waived work product protection for documents disclosed to the auditors. n19

It is also worth noting that, other than for the mental impressions of the attorney, n20 work-product immunity is qualified rather than absolute. This means that the SEC may still discover the materials through a showing of hardship or prejudice. n21 The SEC, however, rarely seeks the production of work-product on this basis alone. n22

FOOTNOTES:

(n1)Footnote 1. *Upjohn Co. v. United States*, 449 U.S. 383, 396 (1981) . For a discussion of *Upjohn*, see the discussion of the corporation as client at § 12.02[3] above .

(n2)Footnote 2. *In re LTV Sec. Litig.*, 89 F.R.D. 595 (N.D. Tex. 1981) .

(n3)Footnote 3. *In re LTV Sec. Litig.*, 89 F.R.D. at 601 .

(n4)Footnote 4. *In re LTV Sec. Litig.* 89 F.R.D. at 612.

(n5)Footnote 5. *In re Cardinal Health, Inc. Sec. Litig.*, 2007 U.S. Dist. LEXIS 36000 at 13 (S.D.N.Y. Jan. 26, 2007) .

(n6)Footnote 6. *Cardinal Health*, 2007 U.S. Dist. Lexis 36000 at 15 .

(n7)Footnote 7. *In re Leslie Fay Cos., Inc. Sec. Litig.*, 161 F.R.D. 274 (S.D.N.Y. 1995) (finding that the internal investigation was conducted primarily for the business reasons of making disciplinary decisions, determining the magnitude of the fraud, implementing remedial measures, and reassuring creditors, and that the law firm had not made a sufficient showing that the internal investigation was conduct because of the prospect of litigation).

(n8)Footnote 8. *SafeCard Servs. Inc. v. SEC*, 926 F.2d 1197 (D.C. Cir. 1991) .

(n9)Footnote 9. *SafeCard Servs.*, 926 F.2d at 1202 .

(n10)Footnote 10. Defendants often disclose results of internal investigations to the SEC. For discussion of the effects of such disclosure, see Chapter 7.

(n11)Footnote 11. *Ryan v. Gifford*, 2007 Del. Ch. LEXIS 168 (Del. Ch. Nov. 30, 2007) .

(n12)Footnote 12. *Ryan v. Gifford*, 2008 Del. Ch. LEXIS 2 (Del. Ch. Jan. 2, 2008) .

(n13)Footnote 13. *Medinol, Ltd. v. Boston Scientific Corporation*, 214 F.R.D. 113 (S.D.N.Y. 2002) .

(n14)Footnote 14. *214 F.R.D. at 116-117.*

(n15)Footnote 15. *214 F.R.D. at 116* (citations omitted).

(n16)Footnote 16. *See In re Subpoena Duces Tecum Served on Willkie Farr & Gallagher, 1997 U.S. Dist. LEXIS 2927 (S.D.N.Y. 1997).* *See also U.S. v Ruehle, 583 F.3d 600 (9th Cir. 2009)* (no attorney-client privilege could be established where defendant agreed that fruits of investigation would be shared with outside auditor to provide comfort regarding the company's financial statements).

(n17)Footnote 17. *See, e.g., Lawrence E. Jaffee Pension Plan v. Household Int'l Inc., 237 F.R.D. 176 (N.D. Ill. 2006); In re JDS Uniphase Corp. Sec. Litig., 2006 U.S. Dist. LEXIS 76169 (N.D. Cal. Oct. 5, 2000).*

(n18)Footnote 18. *Merrill Lynch & Co. v. Allegheny Energy, Inc., 229 F.R.D. 441, 448 (S.D.N.Y. 2004).*

(n19)Footnote 19. *See United States v. Deloitte, LLP, 2010 U.S. App. LEXIS 13226, * 23-33 (D.C. Cir., June 29, 2010)*

(n20)Footnote 20. Of course, the mental impressions would have to satisfy the requirements of the work-product doctrine.

(n21)Footnote 21. *See Fed. R. Civ. P. 26(b)(3)* stating that discovery of work-product will be allowed "only upon a showing that the party seeking discovery has substantial need of the materials ... and that the party is unable without undue hardship to obtain ... the materials by other means." *See also In re Cardinal Health, Inc. Sec. Litig., 2007 U.S. Dist. LEXIS 36000* (plaintiffs had not shown "substantial need" for work product materials of counsel and consultant prepared in internal investigation). For a comprehensive treatment of the work-product doctrine's history and purpose, *see* Jeff A. Anderson et al., Special Project, *The Work Product Doctrine*, 68 *Cornell L. Rev.* 760 (1983). The doctrine has also been cited as a potential challenge to discovery in SEC investigations. William R. McLucas et al., *An Overview of Various Procedural Considerations Associated with the Securities and Exchange Commission's Investigative Process*, 45 *Bus. Law.* 625, 645 (1990).

(n22)Footnote 22. The SEC is more likely to raise this argument in the context of a subpoena enforcement action based primarily on other grounds.



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.05

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§ 12.05 Joint Defense Doctrine

The joint defense doctrine permits counsel and witnesses to share confidential information without waiving the protection of the attorney-client privilege or the work-product doctrine if the following conditions are satisfied:

- the witnesses have a community of interest;
- the communications were made in the course of the joint defense effort; and
- the parties to the communication understood that the communicated information was to be kept confidential. n1

While the joint defense privilege applies to cooperating defendants and cooperating plaintiffs, courts have held that it is not limited to co-parties. n2 In cases where an attorney for one party has disclosed information or documents to an attorney for a nonparty, courts finding that the work-product protection survives have found a "common interest" between the party and the nonparty. n3 In *United States v. American Telephone & Telegraph Co.*, n4 the D.C. Circuit stated that the "common interest" requirement was satisfied as long as the transferor and transferee anticipate litigation against a common adversary on the same issue. n5 There are limitations, however. A joint defense privilege can exist only if there is "a palpable threat of litigation at the time of the communication, rather than a mere awareness that one's questionable conduct might someday result in litigation." n6

The seminal case on the joint defense privilege is *Continental Oil Co. v. United States*. n7 In that case, counsel for Standard Oil Co. interviewed Standard Oil Co. employees (who were also their individual clients) and counsel for Continental Oil interviewed Continental Oil Co. employees (who were also their individual clients) in anticipation of possible litigation jointly involving their respective corporate and individual clients, and in preparation for such litigation, the attorneys exchanged their interview memoranda. The Ninth Circuit held that the exchange of the memoranda had not destroyed the attorney-client privilege because the Continental Oil Co. and the Standard Oil Co. attorneys had shared the memoranda for the limited purpose of assisting in the assertion of their common defense. n8

There is no consensus as to a test for determining whether materials and information should be protected by the joint

defense privilege. The district court opinion in *United States v. Weissman*, n9 rejecting the existence of an "implied" joint defense agreement with respect to discussions at certain meetings between the company and the defendant CFO, contains an extensive discussion of the varying standards. According to the district court, the most liberal test is applied by the Ninth Circuit, which has held that the joint defense privilege applies to communications where defendants share a common defense or have interests that are not adverse; n10 the strictest test is applied by the First Circuit, which has held that the privilege protects communications between an individual and an attorney for another individual when the parties had agreed to pursue a joint defense strategy and the communications are part of an ongoing and joint effort to pursue a common defense strategy. n11 On appeal after conviction, the Second Circuit affirmed the district court's ruling, noting that a joint defense agreement required a "joint strategy" that was lacking because, prior to the meetings at issue, the company did not know about the CFO's potential wrongdoing. n12

Careful consideration should be given to whether a written joint defense agreement should be prepared and to the terms of such an agreement. There are at least three major reasons to reduce the agreement to writing. First, some courts are reluctant to recognize the joint defense privilege absent a written agreement. Second, the written joint defense agreement can with some precision define the terms of the joint defense agreement. These terms can include:

- whether each of the counsel for the parties to the joint defense agreement is assuming an attorney-client relationship as to each of the other parties to the agreement;
- the extent to which the shared communications can be used in other matters;
- the steps that a person is to take upon receiving an SEC subpoena or other discovery request calling for production of the shared information or materials;
- the ability of the counsel receiving the information to share the information with others, including the client, other counsel to the client, and experts;
- procedures for terminating the joint defense arrangement if the parties' interests diverge;
- the limits on the ability of a former party to the joint defense agreement to utilize information or materials acquired pursuant to the joint defense relationship, and other obligations of the parties to the agreement; and
- the remedy for breach of the confidentiality provisions of the joint defense agreement (*e.g.*, the agreement might lay a foundation for injunctive relief by specifying that damages are not an adequate remedy).

Third, the written joint defense agreement can demonstrate the parties':

- belief that they share a common interest and that their intent is to advance the common interest through shared communications, and
- intention to keep the shared communications confidential from persons who do not share the common interest.

In *LTV*, n13 plaintiffs in a securities class action argued that the defendant corporation waived the attorney-client privilege as to communications made in connection with responding to an SEC investigation to the extent that such communications were made in the presence of representatives of the auditor. The court held that the joint defense privilege applied and that the privilege was not waived:

Federal courts ... have endorsed the joint defense exception to the general rule that no privilege attaches to communications made in the presence of third parties. We agree with Defendants that disclosure of privileged information by an attorney to actual or potential co-defendants, or to their counsel, in the course of a joint defense does not constitute a waiver of the attorney-client privilege. [citations omitted] For the purposes of the joint defense privilege, the term co-defendant is broadly construed. n14

The court found that the joint defense privilege applied because LTV had established that the joint conferences undertaken with representatives of the auditor were "confidential, concerned common issues, and were intended to facilitate representation in proceedings involving the SEC and potential shareholder litigants." n15

In re Grand Jury Subpoena Duces Tecum Dated November 16, 1974 n16 also involved the application of the joint defense privilege to interviews and other communications prompted by an SEC investigation. Prosecutors argued that the joint defense privilege did not protect certain materials generated in response to the investigation. The court rejected this argument, stating that:

Where there is consultation among several clients and their jointly retained counsel, allied in a common legal cause, it may reasonably be inferred that resultant disclosures are intended to be insulated from exposure beyond the confines of the group [and] that inference, supported by a demonstration that the disclosures would not have been made but for the sake of securing, advancing or supplying legal representation, will give sufficient force to a subsequent claim to the privilege. n17

The prosecutors also argued that the joint defense privilege did not apply to statements made by Robert Vesco, a former officer of International Controls Corp. ("ICC"), to the company's counsel because it was foreseeable at the time of these statements that ICC might institute a private action against Vesco. The court rejected this argument, stating that this possibility alone would not have prevented Vesco from sharing confidential information with ICC for the purpose of a joint defense against the immediate SEC action, even though the confidence might have placed Vesco in peril in the event that ICC eventually instituted a private action against him. The court reasoned that Vesco was entitled to risk such peril for the sake of strengthening his immediate defense by cooperation from and with ICC and his other co-defendants and stated, "That a joint defense may be made by somewhat unsteady bedfellows does not in itself negate the existence or viability of the joint defense." n18

A host of issues relating to joint defense agreements, including formation, waiver, withdrawal and modification were recently addressed in *United States v. LeCroy*. n19 In this case, an employer represented by counsel entered into a joint defense agreement with two employees and their respective counsel during a pending grand jury investigation of the company's activities. At a later point, the employer put the employees (and their attorneys) on notice that it intended to produce to the government notes of the employer's interviews of the employees if pushed to do so by the government. The individuals contended that the employer could not disclose the notes due to the parties' joint defense agreement, yet knowing the employer's position, they agreed to further interviews with the employer's counsel. The employer ultimately sought to comply with the government's request for all notes of the interviews, and the employees objected. The court held, contrary to the employer's position, that the first set of interview notes were protected by the joint defense agreement. With respect to the notes taken *after* the employer modified the joint defense agreement by informing the employees it intended to share interview notes with the government, the court held that the employees had waived their rights to protect those notes from the government. n20

Many counsel are less willing now than in the 1980's and 1990's to share information pursuant to a joint defense agreement. In part, this increased reluctance results from the increased likelihood that companies will waive the privilege and that witnesses will strike deals with criminal prosecutors and become cooperating government witnesses. As one court recently stated: "[A]lthough entering into a [joint defense agreement] is often, indeed generally, beneficial to its participants, like skating on thin ice, dangers lurk below the surface." n21

FOOTNOTES:

(n23)Footnote 1. *See United States v. Henke*, 222 F.3d 633, 637 (9th Cir. 2000) ("The joint defense privilege is an extension of the attorney-client privilege... . A joint defense agreement establishes an implied attorney-client relationship with the co-defendant"). *See also United States v. McPartlin*, 595 F.2d 1321, 1336 (7th Cir. 1979) ; *Wilson P. Abraham Constr. Corp. v. Armco Steel Corp.*, 559 F.2d 250, 253 (5th Cir. 1977) ; *Hunydee v. United States*, 355 F.2d 183, 185 (9th Cir. 1965) ; *Cont'l Oil Co. v. United States*, 330 F.2d 347, 350 (9th Cir. 1964) ; *W. Fuels Ass'n, Inc. v. Burlington N. R.R. Co.*, 102 F.R.D. 201, 203 (D. Wyo. 1984) .

(n24)Footnote 2. *Sedalcek v. Morgan Whitney Trading Group*, 795 F. Supp. 329, 331 (C.D. Cal. 1992) (citing *In re Grand Jury Subpoenas*, 902 F.2d 244, 249 (4th Cir. 1990) .

(n25)Footnote 3. *See e.g., Ferko v. NASCAR*, 219 F.R.D. 396, 401 (E.D. Tex. 2003) ("In civil litigation, the two types of communications protected by the common interest doctrine are: (1) communications between co-defendants actual litigation and their counsel and (2) communications between *potential* co-defendants and their counsel"); *see e.g., Wilson P. Abraham Constr. Corp. v. Armco Steel Corp.*, 559 F.2d 250, 253 (5th Cir. 1977) ; *Loustalet v. Refco, Inc.*, 154 F.R.D. 243, 247-248 , [1993-94 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 98,011*, at 98,271 (C.D. Cal. Nov. 9, 1993).

(n26)Footnote 4. *United States v. AT&T Co.*, 642 F.2d 1285, 1299 (D.C. Cir. 1980) .

(n27)Footnote 5. *See also In re Doe*, 662 F.2d 1073, 1081 (4th Cir. 1981) .

(n28)Footnote 6. *In re Santa Fe Int'l Corp.*, 272 F.3d 705, 711 (5th Cir. 2001) . *See also In re Grand Jury Subpoena*, 274 F.3d at 575 (rejecting alleged oral defense agreement between company and its officers purportedly entered into years before grand jury investigation into company's activities).

(n29)Footnote 7. *Cont'l Oil Co. v. United States*, 330 F.2d 347 (9th Cir. 1964) .

(n30)Footnote 8. *Cont'l Oil Co.*, 330 F.2d at 349-350 . The joint defense privilege is recognized by many courts. The United States Supreme Court and a number of courts of appeal, however, have not yet expressly recognized the privilege. Accordingly, at least in some circuits, there is a danger that even if the Federal Rules of Evidence apply, the court might not recognize the joint defense privilege or might define the privilege narrowly. *See, e.g., Russell v. General Elec. Co.*, Case No. C-1-92-343 (S.D. Ohio June 29, 1993) (a magistrate judge noting that neither the Supreme Court nor the Sixth Circuit had yet recognized the joint defense privilege, and expressing reluctance to recognize such a privilege).

(n31)Footnote 9. *U.S. v. Weissman*, 1996 U.S. Dist. LEXIS 19066 (S.D.N.Y. Dec. 26, 1996) .

(n32)Footnote 10. *Weissman*, 1996 U.S. Dist. LEXIS 19066 , citing *United States v. Montgomery*, 990 F.2d 1264 (9th Cir. 1993) and *Hunydee v. United States*, 355 F.2d 183, 185 (9th Cir. 1965) .

(n33)Footnote 11. *Weissman*, 1996 U.S. Dist. LEXIS 19066 , citing *In re Beville Bresler & Schulman Asset Mgmt. Corp.*, 805 F.2d 120 (3d Cir. 1986) .

(n34)Footnote 12. *See U.S. v. Weissman*, 195 F.3d 96 (2d Cir. 1999) .

(n35)Footnote 13. *In re LTV Sec. Litig.*, 89 F.R.D. 595 (N.D. Tex. 1981) .

(n36)Footnote 14. *In re LTV Sec. Litig.*, 89 F.R.D. at 604 . *See also United States v. Stepney*, 246 F.Supp.2d 1069, 1074-75 (N.D. Cal. 2003) ("The joint defense privilege initially arose as an extension of the attorney-client privilege against court-ordered disclosure against confidential communications. Ordinarily, the attorney-client privilege will be deemed waived where a client discloses the contents of an otherwise privileged communication to a third party or where

the communication occurs in the presence of third parties. The joint defense privilege has been adopted as an exception to this waiver rule, under which communications between a client and his own lawyer remain protected by the attorney-client privilege when disclosed to co-defendants or their counsel for purposes of a common defense.").

(n37)Footnote 15. *89 F.R.D. at 604.*

(n38)Footnote 16. *In re Grand Jury Subpoena Duces Tecum Dated Nov. 16, 1974, 406 F. Supp. 381, 388 (S.D.N.Y. 1975) .*

(n39)Footnote 17. *406 F. Supp. at, 386.*

(n40)Footnote 18. *406 F. Supp. at, 392.*

(n41)Footnote 19. *United States v. LeCroy, 348 F. Supp. 2d 375 (E.D. Pa. 2005) .*

(n42)Footnote 20. *348 F. Supp. 2d at 386-387 .*

(n43)Footnote 21. *348 F. Supp. 2d at 387 .*



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.06

AUTHOR: Bryan B. House

§ 12.06 Limited Waiver

In some circumstances, disclosing privileged communications or the results of work-product to the SEC, the DOJ or another law enforcement agency might be in the interest of the company. For example, counsel's thorough investigation might have uncovered substantial evidence indicating that the federal securities laws were not violated. In these circumstances, counsel might hope that disclosing materials generated by the investigation will either persuade the Staff that an inquiry is unnecessary or facilitate its rapid conclusion. Even if the results of the internal investigation are not as favorable, disclosure might be appropriate to limit the scope and duration of the inquiry and, perhaps, obtain a more favorable resolution than could be obtained after years of government investigation. n1

There is substantial uncertainty regarding the extent, if any, to which selective disclosure of privileged information will waive the privilege as to other entities and other information. Some courts have held that the voluntary disclosure to the SEC of otherwise privileged information does not waive the privilege. Most courts have rejected this position. Some have taken a more nuanced approach. In considering whether to provide the SEC with a report of an internal investigation that otherwise is protected by the attorney-client privilege and work-product doctrine, counsel should consider the substantial risk that such voluntary disclosure to the SEC might waive such protection and leave the report discoverable in, for example, a shareholders' class action.

The uncertainty associated with a decision to voluntarily disclose otherwise privileged material to a law enforcement agency is illustrated by the litigation involving McKesson. McKesson had been notified by the SEC that the SEC was conducting an informal inquiry into whether McKesson had filed materially false or misleading financial statements. After McKesson received this notice, McKesson's audit committee retained a law firm to conduct an internal investigation of the alleged wrongdoing. The law firm prepared a written report for the audit committee summarizing the relevant facts and legal principles involved in the pending investigations. On behalf of McKesson, the law firm offered to disclose the work-product generated from the internal investigation pursuant to a confidentiality agreement. Once the SEC, McKesson, and the Office of the United States Attorney for the Northern District of California executed a confidentiality agreement, most of the law firm's work-product was shared with the law enforcement agencies.

Later, discovery of these materials was sought by plaintiffs in civil litigation and by defendants in one criminal prosecution. In a derivative action, a Delaware Chancery Court held that the materials remained privileged despite the

voluntary production of the materials to law enforcement agencies pursuant to a confidentiality agreement. n2 In that action, McKesson resisted waiver on two grounds: (1) it had a "common interest" with the SEC; and (2) the work-product was shared pursuant to a confidentiality agreement. The Delaware court found no common interest, but found no waiver of the work-product nonetheless. In allowing McKesson to disclose to the SEC without eradicating the work-product privilege, the court relied on three factors: 1) McKesson disclosed the privileged materials pursuant to a confidentiality agreement; 2) McKesson selectively waived the privilege *vis-a-vis* a *government agency* rather than a private party; and 3) a strong public policy interest favors allowing such selective waivers. In reaching its decision, the court cited SEC briefs which asserted that the agency saved tens of thousands of hours and extensive resources by entering into the confidentiality agreement in order to obtain the privileged documents. The court noted that allowing selective waiver would encourage companies to cooperate with the SEC, which in turn would allow the SEC to undertake more enforcement actions than it otherwise would.

The assertion of privilege by McKesson was less successful in the other civil litigation and in the criminal prosecution. In *McKesson HOBBC Inc. v. Adler*, n3 a plaintiff investor similarly sought the fruits of the McKesson audit committee's internal investigation. The trial court found a waiver of the attorney-client privilege and, without addressing McKesson's work-product claim, ordered production of the documents. On appeal, the Court of Appeals of Georgia vacated the order requiring production of the documents, observing that work-product is "not necessarily waived by disclosure to a third party." The court remanded for the trial court to consider the extent of the work-product protection to be afforded the documents. n4 The unresolved issue was decided in *McKesson Corp. v. Green*, n5 yet another case involving the same set of facts. In *Green*, the Supreme Court of Georgia followed the majority rule concerning selective waiver and rejected McKesson's argument that it had a "common interest" with the SEC. The court held that the work-product protection was waived, relying, in part, on the fact that the confidentiality agreement with the SEC did not absolutely prohibit the SEC from disclosing the documents to others.

In the criminal action based on the same facts, two defendants moved to compel the SEC to produce to the defendants (pursuant to *Fed. R. Crim. P. 10* and the *Brady* rule) otherwise privileged material that McKesson had produced to the government. The district court found that disclosure of the materials to the government had waived the protection of the work-product doctrine. n6

The Eighth Circuit is the only United States Court of Appeals to hold squarely that voluntary disclosure to a law enforcement agency of materials protected by the work-product doctrine does not waive the protection of the doctrine. n7 In the 1977 *en banc* decision, the Eighth Circuit addressed whether Diversified Industries waived the attorney-client privilege with respect to certain materials by voluntarily surrendering those materials to the SEC pursuant to an agency subpoena. Fashioning a doctrine known as "selective waiver" or "limited waiver," the Eighth Circuit held that only a limited waiver of the privilege had occurred and that the materials were therefore protected from discovery in the private litigation. The Eighth Circuit reasoned that if voluntary disclosure to the SEC waives any privilege as to subsequent private litigants, parties might be discouraged from cooperating with governmental investigations, and corporations might also hesitate before initiating an independent investigation of wrongdoing within the corporation when asked to do so by government authorities. n8

In 1981, the D.C. Circuit found the doctrine of selective waiver "wholly unpersuasive." n9 Occidental Petroleum urged the D.C. Circuit to adopt the doctrine and prevent the SEC from providing to the Department of Energy certain otherwise privileged documents that Occidental Petroleum had voluntarily produced to the SEC based on an agreement between the SEC and Occidental that the SEC would keep the documents confidential until they were disclosed by Occidental. The D.C. Circuit rejected the selective waiver doctrine on the grounds that a "client cannot be permitted to pick and choose among his opponents, waiving the privilege for some and resurrecting the claim of confidentiality to obstruct others, or to invoke the privilege as to communications whose confidentiality he has already compromised for his own benefit." n10

In 1988, the Fourth Circuit addressed the selective waiver doctrine adopted by the Eighth Circuit. n11 Martin Marietta

Corporation had submitted a position statement to a United States Attorney describing why the company should not be indicted. In the statement, Martin Marietta asserted: "[O]f those consulted within the Company all will testify that any qualms they had about the arrangement had nothing to do with worries about fraud" and that there was "no evidence, testimonial or documentary" regarding a certain factual issue. In a related criminal prosecution, a former employee of Martin Marietta subpoenaed, *inter alia*, notes, transcripts, and electronic recordings of interviews and statements by certain Martin Marietta employees to company counsel. The company asserted that the witness's statements were protected by the attorney-client privilege and work-product immunity. The Fourth Circuit held that both the position statement and the "underlying details" were no longer protected by the work-product doctrine. The court explained that "disclosure by Martin Marietta to the federal government ... when the government and Martin Marietta were adversaries constitutes testimonial use" and thereby waived work-product protection as to all non-opinion work-product on the same subject matter as that disclosed. n12 The Fourth Circuit based this holding on three factors:

- the decidedly adversarial nature of the interests of Martin Marietta and the federal government;
- the company's express assurance of the completeness of its disclosure to the federal government; and
- the effort to use the disclosures to settle active controversies between the United States Attorney and the company. n13

The Fourth Circuit held, however, that the subject matter waiver did not extend to opinion work-product. n14

In 1991, the Third Circuit considered whether the production of otherwise privileged materials to the SEC and the DOJ waived the privilege as to other parties. n15 Westinghouse retained a law firm to conduct an internal investigation into whether company officials had made improper payments. The law firm prepared two letters reporting its findings. The law firm showed the SEC investigators one of the letter reports and orally presented its findings to the agency counsel, but did not supply the SEC with any of the documents underlying the presentation and the agency agreed not to retain the report. In response to a subsequent grand jury subpoena and pursuant to a confidentiality agreement with the DOJ (subsequently memorialized in a stipulated court order), Westinghouse produced to the grand jury the results of the internal investigation and the documents accumulated in connection with the internal investigation. The confidentiality agreement stated that the DOJ would review (but not obtain) copies of the subpoenaed materials and that such review would not constitute a waiver of Westinghouse's privileges. The Third Circuit rejected the doctrine of limited waiver and held that the work-product privilege no longer protected the documents that Westinghouse had shown to the SEC and the DOJ. n16

In 1993, the Second Circuit indicated that the disclosure to the SEC of materials protected by the work-product doctrine might not result in a waiver if the Commission agreed that the disclosure would not result in such a waiver. n17 After two meetings between the SEC and Steinhardt, the SEC requested that Steinhardt submit a memorandum addressing the facts and issues involved in the case and discussing the relevant legal theories. Steinhardt submitted the memorandum with a notice on the document reading "FOIA Confidential Treatment Requested." The district court held that Steinhardt had waived work-product protection in producing the memorandum to the SEC. Although it affirmed the district court, the Second Circuit stated that while disclosure of materials to the SEC will usually waive work-product protection, a rigid rule would fail to anticipate situations in which the disclosing party and the government may share a common interest in developing legal theories and analyzing information, or situations in which the SEC and the disclosing party have entered into an explicit agreement that the Commission will maintain the confidentiality of the disclosed materials. n18

In 2002, the Sixth Circuit addressed the discoverability of certain otherwise privileged materials that Columbia/HCA had voluntarily provided to the DOJ in exchange for the DOJ agreeing to certain stringent confidentiality provisions and that disclosure of any report, document or information by one party to the other did not constitute a waiver of any applicable privilege or claim under the work-product doctrine. n19 Plaintiffs in private litigation sought discovery of

materials that Columbia/HCA had provided to the DOJ and Columbia/HCA resisted, citing the attorney-client privilege and the work-product doctrine. After a detailed review of the previous appellate decisions addressing the doctrine of limited waiver, the Sixth Circuit rejected the doctrine.

In 2003, the Second Circuit again addressed the impact of disclosing otherwise privileged materials to the government. n20 Counsel to a company, Doe Co. ("Doe") had responded to a government investigation by submitting a lengthy letter setting forth the company's good faith belief that its conduct was lawful. The United States Attorney's office responded by issuing a grand jury subpoena to company counsel calling for the production of notes of meetings between attorneys for Doe and personnel of the Bureau of Alcohol, Tobacco and Firearms ("ATF") regarding possible violations of the United States' firearms laws. The government argued that Doe voluntarily waived the work-product privilege applicable to the attorneys' notes by sending a letter memorandum to the United States Attorney's office containing information about the meetings with the ATF.

The Second Circuit began its analysis by observing that "[b]ecause the words *implied* and *waiver* both tend to suggest that the party possessing the privilege *intended* to give it up, the terms *waiver*, and *implied waiver*, are not especially appropriate designations for circumstances in which the party possessing the privilege makes no representation, express or implied, that it intends to surrender its privilege. In such circumstances, the rule is perhaps more aptly described as one of forfeiture, rather than waiver." n21 The Second Circuit then explained:

Forfeiture of this nature is justified by considerations of fairness to the adversary... [B]ecause the doctrine is rooted in fairness we have also cautioned against broad generalizations, stressing that "whether fairness requires disclosure ... is best decided on a case by case basis, and depends primarily on the specific context in which the privilege is asserted." n22

The Second Circuit found that the successful assertion of privilege would not be unfair because there was no basis for concluding that the United States Attorney suffered any unfair prejudice in receiving the letter while Doe continued to assert its privilege with respect to the notes taken by its attorneys. n23 "The Government is in no way worse off as the result of its receipt of Doe's letter than it would be if the letter had never been delivered ... [t]here is in short no unfairness to the government and therefore no basis for holding that Doe forfeited its privileges." n24

In 2006, after a relatively detailed review of the prior U.S. Court of Appeals case law considering the selective waiver rule, the Tenth Circuit declined to adopt the rule in a case involving the voluntary disclosure of otherwise protected materials to the SEC and the Department of Justice by Qwest Communications. n25 Among other things, the Court of Appeals noted that the confidentiality agreements entered into by the SEC and the Department of Justice did not limit the ability of the two agencies to share the documents with other agencies or introduce them at trial, or otherwise deal with the information in any special way. n26

In 2007, Judge Patterson of the U.S. District Court for the Southern District of New York addressed whether the work-product privilege protected binders and memoranda that had been prepared by the law firm retained by the Audit Committee of the Board of Directors of Cardinal Health to investigate accounting and legal issues raised by an SEC investigation even though the binders and memoranda had been provided to the SEC and to the DOJ. Judge Patterson held that the protection was not waived because the Audit Committee's purpose in authorizing the investigation was to ensure that Cardinal's financial and accounting practices were appropriate and that the Audit Committee shared this common purpose with the Government. In light of this common purpose, Judge Patterson held that the privilege was not waived even though Cardinal had not obtained a confidentiality agreement from the Department of Justice. n27

The SEC remains willing to enter into confidentiality agreements with companies that perform their own investigations and share the fruits of those investigations with the SEC. There is often great pressure to enter into these agreements in order to be deemed cooperative with the SEC. Despite the SEC's best *amicus* briefs and public policy arguments, however, courts have been largely unreceptive to the concept of limited waiver. n28 This is also true with respect to

counsel's submission of Wells Submissions to the Enforcement Staff. n29

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, the Seaboard 21(a) Report (at Appendix A); the McNulty and Filip Memoranda discussed in Chapter 23; and the Sentencing Guidelines discussed in Chapter 23.

(n2)Footnote 2. *Saito v. McKesson HBOC, Inc.*, 2002 Del. Ch. LEXIS 125 (Del. Ch. Nov. 13, 2002) .

(n3)Footnote 3. *McKesson HOBC Inc. v. Adler*, 254 Ga. App. 500, 562 S.E.2d 809 (Ga. Ct. App. 2002) .

(n4)Footnote 4. The case settled before the trial court addressed the waiver of work-product protection on remand.

(n5)Footnote 5. *McKesson Corp. v. Green*, 610 S.E.2d 54 (Ga. 2005) .

(n6)Footnote 6. *United States v. Bergonzi*, 216 F.R.D. 487 (D. Calif. 2003) .

(n7)Footnote 7. *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1977) (*en banc*).

(n8)Footnote 8. *Diversified Indus., Inc.*, 572 F.2d at 611 .

(n9)Footnote 9. *Permian Corp. v. United States*, 665 F.2d 1214, 1220 (D.C. Cir. 1981) .

(n10)Footnote 10. *Permian Corp.*, 665 F.2d at 1221 . The D.C. Circuit reaffirmed this position three years later. *In re Subpoena Duces Tecum*, 738 F.2d 1367, 1370 (D.C. Cir. 1984) (finding that disclosure waived the attorney-client privilege and that the work-product doctrine was also waived unless the party producing the otherwise privileged materials insists "on a promise of confidentiality before disclosure to the SEC.").

(n11)Footnote 11. *In re Martin Marietta Corp.*, 856 F.2d 619 (4th Cir. 1988) .

(n12)Footnote 12. *Martin Marietta*, 856 F.2d at 625 .

(n13)Footnote 13. *Martin Marietta*, 856 F.2d at 625 .

(n14)Footnote 14. *Martin Marietta*, 856 F.2d at 626 . At least one district court applying *Martin Marietta* has found that the attorney-client privilege can be waived by "[a] summary, paraphrase or clear reference to the substance of a communication" during settlement discussions with the federal government. This court observed that the waiver encompassed all privileged communications that dealt with the same subject matter. *See United States v. Martin Marietta Corp.*, 886 F. Supp. 1243, 1249 (D. Md. 1995) .

(n15)Footnote 15. *Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414 (3d Cir. 1991) .

(n16)Footnote 16. *Westinghouse*, 951 F.2d at 1425 .

(n17)Footnote 17. *In re Steinhardt Partners*, 9 F.3d 230 (2d Cir. 1993) .

(n18)Footnote 18. *Steinhardt*, 9 F.3d at 236 ..

(n19)Footnote 19. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289, 292 (6th Cir. 2002) .

(n20)Footnote 20. *In re Grand Jury Proceedings John Doe Co.*, 350 F.3d 299 (2d Cir. 2003) .

(n21)Footnote 21. 350 F.3d at 302 (emphasis in original).

(n22)Footnote 22. *350 F.3d at 302 (quoting In re Grand Jury Proceedings, 219 F.3d 175, 183 (2d Cir. 2000))* .

(n23)Footnote 23. *350 F.3d at 304* .

(n24)Footnote 24. *350 F.3d at 305* .

(n25)Footnote 25. *In re Qwest Communications Int'l, Inc., 450 F.3d 1179 (10th Cir. 2006)* .

(n26)Footnote 26. *Quest, 450 F.3d at 1194*.

(n27)Footnote 27. *In re Cardinal Health, Inc., Sec. Litig., 2007 U.S. Dist. LEXIS 36000 (S.D.N.Y. Jan 26, 2007)* .

(n28)Footnote 28. In 2002, the SEC proposed a rule which provided that the sharing of confidential information with the SEC would not constitute a waiver of privilege. The SEC withdrew the proposed rule in 2003 because (1) it was uncertain whether it had the power to issue such a rule and (2) such a rule might be contrary to existing law. The Commission, however, made clear that it would continue to enter into confidentiality agreements in an effort to prevent waiver of the privilege. SEC Release No. 33-8185; 34-47276, *2003 SEC LEXIS 256* (Jan. 29, 2003) .

(n29)Footnote 29. *In re IPO Sec. Litig., 249 F.R.D. 457, 466-67 (S.D.N.Y. 2008)*



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.07

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§ 12.07 Self-Evaluative Privilege

Some courts have held that certain self-evaluative materials are privileged. n1 The SEC Staff, however, tends not to credit assertions that otherwise discoverable materials are protected from discovery because of the self-critical analysis or self-evaluative privilege. Accordingly, companies should hesitate before relying on this privilege to withhold otherwise discoverable materials.

FOOTNOTES:

(n1)Footnote 1. *See e.g., Bracco Diagnostics, Inc. v. Amersham Health, Inc., 2006 U.S. Dist. LEXIS 75359, at *8-9 (D.N.J. Oct. 13, 2006) (holding that when analyzing whether the self-critical analysis privilege is applicable, a court must balance six factors); Bredice v. Doctor's Hosp., Inc., 50 F.R.D. 249 (D.D.C. 1970), aff'd, 479 F.2d 920 (D.C. Cir. 1973) (recognizing qualified privilege for records of a hospital's internal investigation into death of patient); In re Crazy Eddie Sec. Litig., 792 F. Supp 197 (E.D.N.Y. 1992) (apply privilege to an accounting firm's internal review of an audit, a peer review report and a letter of comments on internal quality controls).*



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.08

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§ 12.08 Accountant-Client Privilege

In general, federal law does not recognize an accountant-client privilege. n1 The Supreme Court, in reversing the Second Circuit's creation of such a privilege, distinguished the roles of attorneys and accountants. The court explained that while an attorney acts as the client's private advisor, an accountant is also charged with guarding the investing public by verifying the veracity of filed statements. n2 Thus, the SEC Staff will expect production of accountant workpapers even if they would be protected by the accountant-client privilege under state law.

FOOTNOTES:

(n1)Footnote 1. *United States v. Mihalich*, 2006 U.S. Dist. LEXIS 77732, at *6 (N.D. Ohio Oct. 16, 2006) (holding that because no confidential accountant-client privilege exists under federal law, information exchanged between a defendant and his co-defendant accountant was discoverable); *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-818 (1984) (reversing the Second Circuit's creation of a work-product doctrine applicable to accountants).

(n2)Footnote 2. *Arthur Young & Co.*, 465 U.S. 805, 817-818 (1984) .



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.09

AUTHOR: Bryan B. House

§ 12.09 Spousal Privilege

For purposes of domestic peace and to protect the sanctity of marriage, n1 federal law recognizes a spousal privilege that allows the witness-spouse to choose whether or not to testify against his or her spouse. n2 In *Trammel v. United States*, n3 the Supreme Court stated that the witness "may be neither compelled to testify nor foreclosed from testifying," n4 reversing the earlier rule whereby a spouse could not testify regarding the other unless each spouse consented. Thus, under federal law, one spouse cannot be compelled to testify against the other, and one spouse cannot keep the other from testifying.

FOOTNOTES:

(n1)Footnote 1. *United States v. Benford*, 457 F. Supp. 589, 597 (E.D. Mich. 1978) (citing *Hawkins v. United States*, 358 U.S. 74 (1958)) . See also *United States v. Griffin*, 440 F.3d 1138, 1142 (9th Cir. 2006) (holding that "The marital communications privilege is designed to protect[] ... marital confidences, regarded as so essential to the preservation of the marriage relationship as to outweigh the disadvantages to the administration of justice which the privilege entails.").

(n2)Footnote 2. *United States v. Vo*, 413 F.3d 1010, 1016 (9th Cir. 2005) (holding that "There are two types of marital privileges that may be implicated when spouses testify against each other. The first permits a witness to refuse to testify against his or her spouse while they are married. ...The second privilege, the marital communications privilege, provides that communications between the spouses, privately made, are generally assumed to have been intended to be confidential, and hence they are privileged."). *Trammel v. United States*, 445 U.S. 40, 53 (1980) .

(n3)Footnote 3. *Trammel v. United States*, 445 U.S. 40, 53 (1980) .

(n4)Footnote 4. *Trammel v. United States*, 445 U.S. 40, 53 (1980) .



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.10

AUTHOR: Bryan B. House

§ 12.10 Priest-Penitent Privilege

The Third Circuit in *In re Grand Jury Investigation* n1 set forth the elements of the common law priest-penitent privilege. In order to obtain protection, a communication must be made:

- to a clergy person;
- in his or her spiritual and professional capacity; and
- with a reasonable expectation of confidentiality. n2

The privilege is meant to protect the quest for spiritual relief, as noted by the court in *United States v. Dube*. n3 In that case, the privilege was found not applicable where "[the priest's] testimony revealed nothing ... related in any way to defendant's spiritual confidences." n4

FOOTNOTES:

(n1)Footnote 1. *In re Grand Jury Investigation*, 918 F.2d 374, 384 (3d Cir. 1990) .

(n2)Footnote 2. *In re Grand Jury Investigation*, 918 F.2d 374, 384 (3d Cir. 1990) . See also, *Lawson v. McDonough*, 2007 U.S. Dist. LEXIS 41935, at *5 (N.D. Fla. June 7, 2007) .

(n3)Footnote 3. *United States v. Dube*, 820 F.2d 886 (7th Cir. 1987) .

(n4)Footnote 4. *Dube*, 820 F.2d at 890 .



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.11

AUTHOR: Bryan B. House

§ 12.11 Psychotherapist-Patient Privilege

In *Jaffee v. Redmond*,ⁿ¹ the United States Supreme Court recognized a psychotherapist-patient privilege protecting confidential communications made to licensed psychiatrists, licensed psychologists, and licensed social workers in the course of psychotherapy.ⁿ² While the Supreme Court has not defined the precise contours of this privilege, several circuits have had occasion to address its scope. Among other issues, courts have struggled with the scope of therapeutic personnel with whom communications may be privileged.ⁿ³ The privilege has been limited by some courts consistent with the law of other privileges. For example, waiver may occur where the patient places his or her medical condition at issue.ⁿ⁴ Courts may also apply a crime fraud exception to the psychotherapist-patient privilege.ⁿ⁵ A circuit split has developed as to whether a "dangerous patient" exception applies to the privilege.ⁿ⁶ Further uncertainty as to the scope of this privilege is to be expected until the Supreme Court clarifies its opinion in *Jaffee*.

FOOTNOTES:

(n1)Footnote 1. *Jaffee v. Redmond*, 518 U.S. 1, 116 S. Ct. 1923 (1996) .

(n2)Footnote 2. *Jaffee v. Redmond*, 518 U.S. at 15-17 .

(n3)Footnote 3. *Oleszko v. State Compensation Insurance Fund*, 243 F.3d 1154 (9th Cir. 2001) (extending privilege to unlicensed counselors); *United States v. Schwensow*, 151 F.3d 650 (7th Cir. 1998) (declining to extend the privilege to volunteers for association of alcoholics).

(n4)Footnote 4. *Schoffstall v. Henderson*, 223 F.3d 818 (8th Cir. 2000) .

(n5)Footnote 5. *In re Grand Jury Proceedings (Gregory P. Violette)*, 183 F.3d 71 (1st Cir. 1999) .

(n6)Footnote 6. *See United States v. Chase*, 301 F.3d 1019 (9th Cir. 2002) (holding that dangerous patient exception applies). *But see United States v. Hayes*, 227 F.3d 578 (6th Cir. 2000) .



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.12

AUTHOR: Bryan B. House

§ 12.12 Tax Returns

While tax returns are not privileged, courts recognize them as "highly sensitive documents," and have determined that agencies are not entitled to tax returns "as a matter of rote." n1 Instead, courts look to balance the interest in broad discovery against the desire of confidentiality for tax returns. n2 A two-pronged test has been used to determine whether tax returns should be discoverable. The returns must first be relevant, and the information must not be available elsewhere. n3 In addition, even when tax returns are discoverable, courts have demonstrated a willingness to consider a protective order against further disclosure. n4

FOOTNOTES:

(n1)Footnote 1. *CFTC v. Collins*, 997 F.2d 1230, 1233 (7th Cir. 1993) . See also *Aliotti v. Vessel Senora*, 217 F.R.D. 496, 497 (N.D. Cal. 2003) (holding that while tax returns are not absolutely privileged, the Ninth Circuit recognizes that "a public policy against unnecessary public disclosure [of tax returns] arises from the need, if the tax laws are to function properly, to encourage taxpayers to file complete and accurate returns.")

(n2)Footnote 2. *Trudeau v. New York State Consumer Prot. Bd.*, 237 F.R.D. 325, 331 (N.D.N.Y. 2006) ; *SEC v. Cymaticolor*, 106 F.R.D. 545, 547 (S.D.N.Y. 1985) (citing *Sharp v. Coopers & Lybrand*, 83 F.R.D. 343, 352 (E.D. Pa. 1979)) .

(n3)Footnote 3. *Smith v. Bader*, 83 F.R.D. 437, 438 (S.D.N.Y. 1979) .

(n4)Footnote 4. *Cymaticolor*, 106 F.R.D. at 549 (offering to consider a protective order should one be requested). See also *Rengifo v. Erevo Enters.*, 2007 U.S. Dist. LEXIS 19928, at *6-10 (S.D.N.Y. Mar. 20, 2007) (noting that defendants argued for the discoverability of documents containing plaintiff's tax identification number, such as tax returns. However, the court disagreed with the defendants and granted the plaintiff's request for a protective order barring defendants from inquiring into his tax identification number.").



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CHAPTER 12 PRIVILEGES

1-12 Securities Enforcement: Counseling and Defense § 12.13

AUTHOR: Bryan B. House

§ 12.13 State Statutory Protection

Various state laws provide limited protection for certain categories of documents, such as telephone and bank records. In *SEC v. First Tennessee Bank N.A. Memphis*, n1 a state law requiring the SEC to subpoena both a bank and the customer before receiving bank records was found to be "an unnecessary burden upon interstate commerce" and unconstitutional considering the delay and difficulty it imposed on the SEC. n2 Similarly, in *SEC v. Pacific Bell*, n3 a California statute prohibiting a telephone company from providing a customer's phone records without his consent was held to be preempted by federal law. The test cited in that case is whether the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." n4 The court held that the statute in question was preempted by the federal securities laws. n5

FOOTNOTES:

(n1)Footnote 1. *SEC v. First Tennessee Bank N.A. Memphis*, 445 F. Supp. 1341 (W.D. Tenn. 1978) .

(n2)Footnote 2. *First Tennessee Bank N.A. Memphis*, 445 F. Supp at 1343 (noting that such a delay is "fruitless in light of federal court decisions which refuse to recognize any proprietary right of a depositor in bank records of his accounts.").

(n3)Footnote 3. *SEC v. Pacific Bell*, 704 F. Supp. 11, 16 (D.D.C. 1989) .

(n4)Footnote 4. *Pacific Bell*, 704 F. Supp. at 15 (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)) .

(n5)Footnote 5. *Pacific Bell*, 704 F. Supp. at 15 (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)) .



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Securities Enforcement: Counseling and Defense

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CHAPTER 13 THE FIFTH AMENDMENT PRIVILEGE AGAINST SELF-INCRIMINATION

1-13 Securities Enforcement: Counseling and Defense 13.syn

AUTHOR: Kenneth B. Winer

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CHAPTER 13 THE FIFTH AMENDMENT PRIVILEGE AGAINST SELF-INCRIMINATION

1-13 Securities Enforcement: Counseling and Defense § 13.01

AUTHOR: Kenneth B. Winer

§ 13.01 Introduction

The *Fifth Amendment* states, in part, that no person "shall be compelled in any criminal case to be a witness against himself." n1 Asserting the *Fifth Amendment* privilege against self-incrimination is one of the few methods by which a witness may successfully resist a Securities and Exchange Commission ("SEC" or "Commission") subpoena. Moreover, criminal prosecution is a serious risk for individuals who arguably have violated the federal securities laws. Accordingly, one of the most important and difficult decisions to be made by a prospective witness early in the investigation may be whether to exercise the privilege.

[1] Scope of the Privilege

The privilege can only be asserted when the accused is "compelled to make a testimonial communication that is incriminating." n2 In addition, the compulsion must involve state action. The privilege may be asserted in civil, as well as criminal, matters. n3

[a] Compulsory Nature of Communication

A communication is not considered to have been "compelled" merely because it was made pursuant to subpoena. A communication is considered voluntary if the witness responds to a subpoena by producing documents or providing testimony instead of asserting the *Fifth Amendment* privilege. n4

[b] Testimonial Nature of the Communication

"[I]n order to be testimonial, an accused's communication must itself, explicitly or implicitly, relate a factual assertion or disclose information. Only then is a person compelled to be a 'witness' against himself." n5 The United States Supreme Court has recognized that the act of producing documents can be testimonial in nature. n6 The act of producing incriminating evidence may be protected where the act would have independent testimonial significance, such as communicating the holder's knowledge of the existence of the documents, his or her custody or control over the documents, or his or her belief that they fit the subpoena description. n7

Courts draw a distinction between compelling a witness to communicate and compelling a witness to engage in conduct

that may be incriminating. n8 Thus, even though the act may result in incriminating evidence, an individual may be compelled to provide a handwriting exemplar n9 or to make a voice recording. n10

A person may be required to produce specific documents even though they contain incriminating assertions of fact or belief because the creation of those documents was not "compelled" within the meaning of the privilege. The Supreme Court addressed this issue in a 1976 opinion which dealt with summonses issued by the Internal Revenue Service ("IRS") seeking working papers used in the preparation of tax returns. Because the papers had been voluntarily prepared prior to the issuance of the summonses, they could not be "said to contain compelled testimonial evidence, either of the taxpayers or of anyone else." n11 The Supreme Court held that the taxpayer therefore could not "avoid compliance with the subpoena merely by asserting that the item of evidence which he is required to produce contains incriminating writing, whether his own or that of someone else." n12

On the other hand, the Supreme Court has also made it clear that the act of producing documents in response to a subpoena may have a compelled testimonial aspect, holding that "the act of production" itself may implicitly communicate statements of fact. n13 By "producing documents in compliance with a subpoena, the witness would admit that the papers existed, were in his possession or control, and were authentic." n14 Moreover, when the custodian of documents responds to a subpoena, the custodian may be compelled to take the witness stand and answer questions designed to determine whether the custodian has produced everything demanded by the subpoena. n15 The answers to those questions, as well as the act of production itself, may certainly communicate information about the existence, custody, and authenticity of the documents. Whether the constitutional privilege protects the answers to such questions, or protects the act of production itself, is a question that is distinct from the question of whether the unprotected contents of the documents themselves are incriminating.

In *United States v. Hubbell*, the Supreme Court held that the immunity order given to former Deputy Attorney General Webster Hubbell prevented the Special Prosecutor from prosecuting Hubbell on tax charges even though the Special Prosecutor did not intend to refer to Hubbell's act of production in order to prove the existence, authenticity, or custody of any documents that it might offer in evidence at a criminal trial and would not even introduce into evidence at trial any of the documents that Hubbell produced pursuant to an immunity order. n16 The court explained that:

Given the breadth of the description of the 11 categories of documents called for by the subpoena, the collection and production of the materials demanded was tantamount to answering a series of interrogatories asking a witness to disclose the existence and location of particular documents fitting certain broad descriptions. The assembly of literally hundreds of pages of material in response to a request for "any and all documents reflecting, referring, or relating to any direct or indirect sources of money or other things of value received by or provided to" an individual or members of his family during a 3-year period ... is the functional equivalent of the preparation of an answer to either a detailed written interrogatory or a series of oral questions at a discovery deposition. Entirely apart from the contents of the 13,120 pages of materials that respondent produced in this case, it is undeniable that providing a catalog of existing documents fitting within any of the 11 broadly worded subpoena categories could provide a prosecutor with a "lead to incriminating evidence," or "a link in the chain of evidence needed to prosecute."

*

* * * *

... It was unquestionably necessary for respondent to make extensive use of "the contents of his own mind" in identifying the hundreds of documents responsive to the requests in the subpoena. *See Curcio v. United States*, 354 U.S. 118, 128 (1957) ; *Doe v. United States*, 487 U.S. at 210 . The assembly of those documents was like telling an inquisitor the combination to a wall safe, not like being forced to

surrender the key to a strongbox. [487 U.S. at 210, n.9]. n17

Thus, the *Fifth Amendment* analysis focuses on whether the "creation of the thing demanded" was compelled or whether the act of production constitutes compelled testimonial communication; it does not protect the contents of voluntarily prepared business or personal documents. n18 Where the existence and location of documents is a "foregone conclusion," courts may compel production by the party controlling them, even though the assertion of the *Fifth Amendment* privilege is otherwise valid. n19

Because the SEC usually does not know of the existence and location of documents when it issues a subpoena during an investigation, the act of producing documents in response to an SEC subpoena usually qualifies as a testimonial act under the standard established in *Fisher v. United States*. n20 The Staff might argue, however, that the testimonial act of producing documents is not incriminating even if the documents themselves are. In addition, the Commission might argue that the existence of the documents was a foregone conclusion.

[c] Incriminating Nature of the Communication

A witness may invoke the *Fifth Amendment* right against self-incrimination if the witness "reasonably believes [that his testimony] could be used in a criminal prosecution or could lead to other evidence that might be so used." n21 Generally, this protection is based on the existence of an actual danger that the testimony could harm the witness in future proceedings, n22 or where there is the possibility of injurious disclosure. n23 The privilege applies even if the testimony does not itself tend to establish an element of a crime, as long as the testimony provides a link in the chain of evidence. n24

Thus, a witness cannot be compelled to testify unless "the testimony sought cannot possibly be used as a basis for, or in aid of, a criminal prosecution against the witness." n25 Even if the testimony relates to conduct as to which the statute of limitations has run, the *Fifth Amendment* applies if the testimony might be admissible in a prosecution involving another crime. n26 It is sufficient that the witness establish the potential of the testimony to incriminate; it is not necessary that the witness establish that the government will prosecute, much less that it will prevail in such a prosecution. n27 However, "the claim of privilege cannot be sustained if the fear of self-incrimination rests on 'remote and speculative possibilities.'" n28

In the absence of a grant of immunity, the SEC will rarely, if ever, be able to establish during an investigation that there is no possibility of the testimony being self-incriminating. The Supreme Court has construed the privilege broadly as covering any individual who might be incriminated by the evidence in connection with which the privilege is asserted. The burden of overcoming an assertion of the *Fifth Amendment* privilege, even if prompted by a desire not to cooperate rather than any real fear of self-incrimination, is one that prosecutors would rarely be able to meet in the early stages of an investigation, despite the fact that they did not regard the witness as a suspect. n29

In *SEC v. Militano*, n30 a district court held that a witness could decline to testify based on the *Fifth Amendment* privilege against self-incrimination even though he had entered into a plea agreement with the United States Attorney for the Southern District of New York. The court explained that the witness's plea agreement bound only the United States Attorney, was not comprehensive even in the district, and did not preclude criminal prosecution at the state level.

In 1998, the United States Supreme Court held that a witness's fear that testimony that he is ordered to give in a proceeding in the United States will subject him to prosecution in another country is not a valid basis for asserting the *Fifth Amendment* privilege against compelled self-incrimination. n31

[d] State Action

Courts hold that the *Fifth Amendment* restricts only government conduct and constrains a private entity only insofar as

its actions are "fairly attributable" to the government, n32 The Second Circuit has held that "the NASD is not a government functionary" n33 and that the NYSE may compel testimony. n34 These cases focus on the facts that: (1) the NASD was a private corporation, not a government agency; (2) it received no federal or state funding; (3) it was not mandated by statute; and (4) the government did not appoint its members or serve on any NASD board or committee. The holding of *D.L. Cromwell* is questionable in that the court ignored such salient points as: the fact that by law the NASD could bar an individual from working in the broker-dealer industry, the SEC must approve NASD rules and regulations, and the SEC had the power to enforce NASD rules and regulations.

[2] Persons Who May Assert the Privilege

The *Fifth Amendment* right against self-incrimination protects natural persons. "The constitutional privilege against self-incrimination is essentially a personal one, applying only to natural individuals. It grows out of the high sentiment and regard of our jurisprudence for conducting criminal trials and investigatory proceedings upon a plane of dignity, humanity and impartiality." n35 Unlike individuals, collective entities do not have a *Fifth Amendment* right against self-incrimination. n36

A vital question then, is how courts determine whether an entity is properly considered "collective." The Supreme Court has defined a collective entity as:

an organization which is recognized as an independent entity apart from its individual members. The group must be relatively well organized and structured and not merely a loose, informal association of individuals. It must maintain a distinct set of organizational records, and recognize rights in its members of control and access to them. And the records subpoenaed must in fact be organizational records held in a representative capacity. n37

As collective entities, corporations are not protected by -- and cannot assert -- the *Fifth Amendment* right against self-incrimination. n38

Courts have held that a corporation may be required to produce business records even if those records are in the possession of an officer or principal who refuses to turn them over. n39 A corporation cannot be compelled, however, to produce the personal records of its officers and principals. n40

Courts look at the extent to which a partnership engages in "organized institutional activity" in assessing whether the *Fifth Amendment* can be asserted as to the production of its records. n41 In *Bellis v. United States*, n42 the Supreme Court considered a number of factors in determining whether a three-person partnership should be considered a collective entity:

- a bank account in the partnership's name;
- use of stationery with the firm's letterhead;
- specific examples of partners holding the firm out to third parties as an independent entity;
- the number of employees other than partners;
- the filing of separate partnership tax forms; and
- statutory provisions that treat a partnership as a distinct entity in other contexts. n43

The applicability of the privilege with respect to the possession of a partnership's financial records (in terms of whether

the records are being held in a representative capacity) may differ where the entity involved is a small family partnership or where there are pre-existing relationships of confidentiality among the partners. n44

The *Fifth Amendment* privilege protects a sole proprietor from compelled production of the business records of the sole proprietorship. n45 Similarly, individuals may assert their *Fifth Amendment* rights against production of documents generated while the individual was doing business under a fictitious name, even if the business was held out to the public as a corporation. n46

Additionally, an individual generally cannot assert the privilege with respect to documents that another individual or entity has been ordered to produce. n47 However, where "preexisting documents have been transferred to the attorney for the purpose of obtaining legal advice and the client claims attorney-client privilege, the attorney may refuse to produce the documents if the client, had he retained possession of them, would have had a *Fifth Amendment* privilege to refuse production." n48

[3] Assertion of the Privilege with Respect to Production of Documents

Because the compliance element is absent, the *Fifth Amendment* privilege does not extend to documents that were prepared voluntarily. n49 As discussed above, n50 the Supreme Court has held that while the production of the documents could be testimonial and incriminating, such production is not protected by the *Fifth Amendment* privilege if, among other things, the existence and location of the documents is a "foregone conclusion." n51 In addition, courts have held that an individual cannot refuse to produce records of a collective entity that are in his or her possession in a representative capacity and that are created and maintained pursuant to a federal mandate.

[a] Assertion of the Privilege with Respect to Corporate Documents

The SEC is likely to argue that an individual cannot rely upon the *Fifth Amendment* to avoid producing the records of a collective entity that are in his or her possession in a representative capacity. n52 In *Braswell v. United States*, n53 an individual who was the president of two corporations received a subpoena calling on him to produce corporate records to a grand jury. The Supreme Court held that the custodian of corporate records can be required to produce those records, but evidence of the act of production cannot be used against the custodian in a criminal case. Since a corporation can act only through its officers and employees, the court reasoned, an officer or employee who is a custodian of corporate records, "holds those documents in a representative rather than a personal capacity." n54 The government, therefore, "may make no evidentiary use of the 'individual act' against the individual." n55

The court concluded that a corporate custodian's "assumption of his representative capacity leads to certain obligations, including the duty to produce corporate records on proper demand by the Government." n56 According to the court, by acting in a representative capacity, the corporate custodian cannot assert his own *Fifth Amendment* rights with respect to records belonging to the corporation. n57 "Any claim of *Fifth Amendment* privilege asserted by the agent would be tantamount to a claim of privilege by the corporation -- which of course possesses no such privilege," n58 the court said.

Defense counsel can argue that once a company officer leaves the company, he no longer functions as a corporate representative and instead acts in an individual capacity with respect to corporate records in his or her possession. n59 Even if the former officer's possession of documents derived from wrongful misappropriation from the corporation, he or she may decline to produce the corporate documents based on the right against self-incrimination. n60

Comment

In assessing the application of the right against self-incrimination, it is important to ascertain whether the documents called for in the SEC subpoena are corporate documents.

The leading case on the distinction between personal and corporate documents is *Wilson v. United States*.ⁿ⁶¹ In *Wilson*, the president of a company was served with a subpoena requiring the production of "letter press copy books," which contained copies of correspondence that he had written. The Supreme Court held that copies of letters written by the president in the course of the company's business "were as much a part of its documentary property, subject to its control and to its duty to produce when lawfully required in judicial proceedings, as its ledgers and minute books."ⁿ⁶² The court held that the corporate status of particular documents turns not on the corporation's ownership of them, nor on whether a regulatory agency or the corporation required them to be prepared, but on their "nature" and "the capacity in which they are held."ⁿ⁶³ The letters in *Wilson* were written to further corporate business and, as such, were corporate documents.ⁿ⁶⁴

While it is often unclear whether documents will be viewed as corporate documents for the purpose of the privilege, some documents are clearly considered such. For example, "ledgers, receipt books, minutes of directors' meetings, and other official or quasi-official documents" are highly likely to be viewed as corporate documents.ⁿ⁶⁵ Records from a bank account that is in the corporation's name, run by the chief executive officer and president, and funded with corporate property may reasonably be considered records that are held on behalf of the corporation.ⁿ⁶⁶

Other types of documents are less clear. Courts have identified a number of factors to aid in assessing whether a document is corporate or personal:

- who prepared the document;
- the nature of its contents;
- its purpose or use;
- who maintained possession of the document;
- who had access to the document;
- whether the corporation required its preparation; and
- whether its existence was necessary to or in furtherance of the corporation's business.ⁿ⁶⁷

In determining whether such documents are corporate documents, some courts consider whether:

- the company supplied the document or required use of the document;
- the employee's secretary had access to the document;
- the document contained personal notations; and
- the document was in the officer's possession when sought by subpoena.ⁿ⁶⁸

Telephone bills have been found to be corporate records even though the telephone line was in an individual's name where the corporation paid the bills, the individual did not reimburse the corporation, the corporation deducted payments for the bills on its income tax returns, and the bills and statements had been stored in corporate files on corporate premises.ⁿ⁶⁹

Comment

It has been held that copies of corporate records do not become personal records merely because an individual caused them to be made, even where the original corporate records no longer exist. n70

[b] Assertion of the Privilege with Respect to Required Records

The SEC might argue that an individual cannot refuse to produce documents created or maintained by a sole proprietorship pursuant to a government mandate. n71 Courts have held that an individual who chooses to do business in an area in which the government requires records to be kept "may be deemed to have waived any *Fifth Amendment* protection which would otherwise be present." n72 In order for this exception to operate, however, the requested records must involve some public aspects. n73

The reasoning for the required records doctrine is explained in *CFTC v. Collins*: n74

The rationale of the required-records doctrine is that if an individual is under a duty to keep certain records and produce them on demand to the regulatory authority that has lawfully imposed the duty, he cannot complain, should that or some other governmental agency demand access to the records and the records contain incriminating matter, that if he complies he will be forced to testify against himself. The force will have been exerted not by the demand, but by the duty, assumed to be lawful because imposed as a necessary incident to a lawful regulatory scheme, to maintain the records and grant access to them. n75

[4] Tactical Considerations

The decision whether to assert the privilege against self-incrimination should be addressed before the witness produces the documents to the Staff or testifies before them. Asserting the privilege offers a number of tactical advantages. Assertion of the privilege might deny the SEC access to key incriminating evidence. n76

In addition, the witness avoids providing testimony to the Staff that might lead to incriminating evidence. The witness also avoids having to testify prior to obtaining discovery of the SEC's case. During an SEC investigation, a witness has only limited access to the evidence gathered by the Staff. n77 If an enforcement action is brought against the witness, he or she will be able to obtain the evidence gathered by the Staff and can then testify with the benefit of such discovery.

This discovery reduces the risk of inadvertent conflicts in testimony that could otherwise (1) undermine the witness's credibility or (2) give rise to a risk of perjury or obstruction of justice charges. An additional factor to consider, where there is a risk of prosecution against not only the individual but others, is that asserting the privilege provides the foundation for obtaining immunity from the Department of Justice or otherwise negotiating a resolution of the criminal prosecution. Finally, the witness can defer the significant expenditure of time and money in preparing for and giving testimony before the Staff. n78

The primary disadvantages of asserting the privilege against self-incrimination in an investigation are:

- the Staff is likely to infer that the testimony of the witness would have been incriminatory;
- the division might not give the witness an opportunity to submit a Wells statement or might be less willing during the Wells submission process to identify the facts on which it has based its tentative decision to recommend an enforcement proceeding against the witness; n79
- if the witness asserts the privilege as to all questions after the preliminary questions, he or she sacrifices providing testimony that might be exculpatory;

- there is some risk that the trier of fact in the subsequent enforcement action might draw an inference from the assertion of the privilege in the investigation;
- some companies have a policy of terminating employees who refuse to testify based on the *Fifth Amendment* right against self-incrimination; n80 and
- if the SEC brings an enforcement action, it might include an allegation that the individual refused to testify based on the *Fifth Amendment* right against self-incrimination. n81

The decision whether to assert the privilege should be made based on the facts of the particular investigation. In some instances, it will be relatively clear whether the witness should assert the privilege. Where the witness is unlikely to be the subject of an enforcement action or criminal prosecution if he or she testifies, it is often appropriate for the witness to testify. Where there is a significant risk of criminal prosecution, it is usually appropriate for the witness to assert the privilege against self-incrimination. n82 Where the witness is likely to be named in an enforcement proceeding regardless of whether he or she testifies, it is often better for the witness to assert the privilege.

On some occasions, it might appear that the optimal course for the witness is to testify in response to questions to which the answers are exculpatory and decline to testify in response to questions where the answers would be incriminating. In such instances, the witness, with the advice of counsel, must determine whether to assert the privilege against self-incrimination in response to all questions after the preliminaries or whether to assert the privilege more selectively.

Traditionally, if a witness intended to assert the privilege as to any questions posed during testimony before the SEC, he or she asserted the privilege as to all questions to which it could validly be asserted. n83 There are several reasons for this approach. First, and most importantly, because of the uncertainties created by the doctrine of testimonial waiver, there is a risk that a witness will be found to have waived the *Fifth Amendment* right against self-incrimination by testifying in response to some questions. n84 Second, there is the risk that testimony initially believed to be exculpatory will later pose difficulties. Third, there is a perception that selective assertion of the privilege will rarely avert an SEC enforcement proceeding. Fourth, precision in asserting the privilege would reveal the precise areas of sensitivity. For example, a witness in an insider trading case arguably reveals too much when he denies knowing four individuals who traded in the security and asserts the privilege when asked if he knows a fifth such individual.

Some practitioners believe, however, that there are circumstances where it is prudent for a witness selectively to assert the privilege. n85 In a 1989 article, Richard Morvillo and Andrew Koblenz identify circumstances that might warrant selective assertion of the privilege:

- a witness might be able to provide mitigating evidence not available through any other source or may help to put his role as a peripheral player in context, and
- the sensitive area might be sufficiently peripheral to the investigation that the Staff might not ask questions that require the assertion of the privilege. n86

Moreover, while noting that the doctrine of testimonial waiver is ambiguous, and selective assertion of the privilege therefore risks inadvertent waiver, Morvillo and Koblenz argue that courts rarely find such a waiver. n87

[5] Doctrine of Testimonial Waiver

The law on testimonial waiver of the privilege against self-incrimination is ambiguous. Courts usually hesitate to find that by answering certain questions, a witness has waived the right against self-incrimination with respect to certain additional questions. This area is marked, however, by a dangerous uncertainty in application. Thus, reliance on the right against self-incrimination is usually "an all or nothing -- not a selective -- process." n88

The ambiguity of the doctrine of testimonial waiver is demonstrated by the majority opinion in the Supreme Court case of *Rogers v. United States*.ⁿ⁸⁹ In *Rogers*, the court held that a witness who had testified that she was treasurer of the Community Party of Denver, Colorado, and had possessed the membership lists and dues records of the party had waived her right to decline to identify her successor.ⁿ⁹⁰ As Justice Black noted in dissent, the majority's approach "makes the protection [of the privilege] depend on timing so refined that lawyers, let alone laymen, will have difficulty in knowing when to claim it."ⁿ⁹¹

The majority opinion articulated two factors in determining whether the privilege has been waived. First, the court expressed concern that a witness should not be permitted to distort facts by selecting any stopping place in the testimony.ⁿ⁹² Second, the court held that "where criminating facts have been voluntarily revealed, the privilege cannot be invoked to avoid disclosure of the details" unless the disclosure of additional details would "subject the witness to a 'real danger' of further crimination."ⁿ⁹³

Comment

The witness's decision to stop testifying where she did would not appear, however, to distort the record. Moreover, one can readily imagine that by identifying her successor, the witness would be providing a link in a chain of evidence that could incriminate her.ⁿ⁹⁴

In *Klein v. Harris*,ⁿ⁹⁵ the Second Circuit inferred a waiver of the privilege against self-incrimination from a witness's prior testimony in the proceeding based on a two-pronged analysis:

- 1) the witness'[s] prior statements have created a significant likelihood that the finder of fact will be left with and prone to rely on a distorted view of the truth, and
- 2) the witness had reason to know that his prior statements would be interpreted as a waiver of the *Fifth Amendment's* privilege against self-incrimination.ⁿ⁹⁶

Other courts have held that "an ordinary witness may pick the point beyond which he will not go, and refuse to answer any questions about a matter already discussed, even if the facts already revealed are incriminating, so long as the answers sought may tend to *further* incriminate him."ⁿ⁹⁷

Once a witness becomes aware of the risk of self-incrimination, the witness may assert the *Fifth Amendment* privilege despite having previously testified.ⁿ⁹⁸

[6] Procedure for Asserting the Privilege

If the witness plans to assert the privilege against self-incrimination as to all substantive questions, it often is appropriate to provide advance notice of this decision to the Enforcement Staff. In many (but not all) instances, the Staff will agree that, in lieu of testimony, the witness may submit an affidavit or declaration declaring his or her intention to invoke the *Fifth Amendment's* protection. The affidavit or declaration will usually set forth the specific topics as to which the witness is asserting the *Fifth Amendment*. In some instances, however, the Staff might insist that the witness appear pursuant to the subpoena and assert the privilege with respect to each individual question, even though the United States Attorneys' Manual discourages this practice.

The intention to assert the privilege does not ordinarily excuse a witness from having to appear in response to a subpoena, and respond to individual questions. In *SEC v. First Financial Group of Texas, Inc.*,ⁿ⁹⁹ the court held that a blanket assertion of the *Fifth Amendment* privilege against self-incrimination during civil discovery is improper regardless of whether the privilege is claimed by a plaintiff, defendant, or witness. Thus, a claimant must present himself with his records for questioning, and for each question or record raise the defense of privilege with particularity.

n100

The Staff typically responds to the assertion of the privilege in testimony with a statement by which it notifies the witness that while it will ask additional questions, it does not have authority to offer immunity, and any further testimony will be completely voluntary. In many instances, it is advisable for counsel to provide the witness with a card that contains a short assertion of the privilege that the witness can recite in response to each question. No particular formulation or statement is required for successfully asserting the privilege against self-incrimination. n101

If the SEC believes that the assertion of the right against self-incrimination is inappropriate, it must bring a subpoena enforcement action in a federal district court. n102 If the danger is not readily apparent from the question asked or circumstances surrounding the inquiry, but only speculative, the burden of establishing the privilege rests with the person claiming the privilege. n103 The claimant, however, must demonstrate only a "reasonable possibility" that his testimony will incriminate him; he need not satisfy the "preponderance of the evidence" standard. n104 As long as a witness can demonstrate more than a "fanciful possibility" of prosecution, he will have satisfied the constitutional standard for invoking the privilege (i.e., the "likelihood" of prosecution is sufficient). n105 Where the incriminating nature of information is facially evident, the reasonableness of a defendant's fear of prosecution should be assumed unless there are reasons to question the government's ability to prosecute (e.g., statute of limitations, double jeopardy, or immunity defenses). n106

In assessing whether the assertion of the privilege with respect to the production of documents is appropriate, the district court might inspect them *in camera*. The Supreme Court has indicated that it looks favorably upon *in camera* review of certain asserted privileges. n107 The decision to conduct an *in camera* review rests with the court. n108

[7] Implications of Asserting the Privilege

The Staff appears to treat the assertion of the privilege against self-incrimination as evidence of wrongdoing, and is widely believed to be likely to recommend an enforcement proceeding against individuals who assert the privilege during testimony. While there is a substantial body of case law permitting the drawing of an adverse inference from the assertion of the right against self-incrimination by a party during civil discovery or at trial, there is little authority for the Staff's apparent view that the assertion of the privilege by a witness during an SEC investigation justifies the drawing of an adverse inference with respect to a proposed civil enforcement action. n109

In *Penfield v. Venuti*, n110 the district court denied a motion *in limine* seeking the exclusion of evidence indicating that the defendant had asserted his *Fifth Amendment* right against self-incrimination in September 1979 during a pre-trial deposition in a substantially identical state action, even though he had been willing to testify at a deposition in 1981. The court reasoned that a trier of fact could infer from the initial assertion of the *Fifth Amendment* privilege that "his later responses were a more recent fabrication." n111 The court rejected the argument "that because 'assertion of the privilege, particularly on the advice of counsel, is an ambiguous response' and because there is a danger that jurors will regard any party invoking the privilege as 'a criminal who has probably eluded justice,' the admission in a civil case of a party's refusal to answer on *Fifth Amendment* grounds may constitute unfair prejudice." n112 Instead, the court concluded that the probative value of evidence regarding the invocation of the *Fifth Amendment* privilege may outweigh any prejudice, as such evidence is "hardly the equivalent" of passing a bloody shirt among the jury or introducing a dying accusation of poisoning." n113

[a] Adverse Inference Against Individual Asserting the Privilege

In civil or administrative litigation, a court may draw an adverse inference from an individual's assertion during that litigation of his or her *Fifth Amendment* privilege against self-incrimination. The Supreme Court has held that "the *Fifth Amendment* does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them" n114 The ability to draw an adverse inference in civil cases is permissive;

the drawing of an adverse inference is *not* required. n115 Therefore, a court may refuse to draw such an inference. n116 Some courts have indicated a reluctance to draw an adverse inference where the party claiming the privilege is a defendant in a parallel criminal proceeding. n117

The Supreme Court has held that the assertion of the right against self-incrimination must not be given more probative value than the facts of the case warrant. n118 The defendant's silence, alone, does not trigger liability. n119

The primary reason that courts articulate for permitting triers of fact to draw an adverse inference from the assertion of the privilege is to provide a civil litigant, disadvantaged by the opposing party's silence, a means of tempering this disadvantage. n120

Comment

Given the courts' reliance on the argument that a party should not be disadvantaged by the opposing party's assertion of the privilege, a strong argument can be made that an adverse inference should not be drawn in an administrative or court proceeding from a witness's having asserted the privilege during an investigation. n121

[b] Adverse Inference Against the Employer of the Individual Asserting the Privilege

The SEC might seek to have an adverse inference drawn against the employer of a person who asserts the *Fifth Amendment* right against self-incrimination. n122 Strong arguments can be made, however, that the drawing of such an inference is inappropriate. An employer cannot compel an employee to waive his *Fifth Amendment* right. The most that an employer can do is terminate or otherwise discipline an employee who asserts the right against self-incrimination. n123

There are many reasons why a person might assert the *Fifth Amendment* right against self-incrimination. A person might prudently assert the *Fifth Amendment* for reasons having no bearing on the SEC investigation (e.g., a person might decline to testify in a Commission investigation because of false statements that person had previously made in court during a divorce proceeding).

The Second Circuit has identified four factors that should be considered in determining whether it is appropriate to draw an inference against a party based on an invocation of the *Fifth Amendment* by a non-party:

1. *The Nature of the Relevant Relationships*: While no particular relationship governs, the nature of the relationship will invariably be the most significant circumstance. It should be examined, however, from the perspective of a non-party witness' loyalty to the plaintiff or defendant, as the case may be. The closer the bond, whether by reason of blood, friendship or business, the less likely the non-party witness would be to render testimony in order to damage the relationship.

2. *The Degree of Control of the Party Over the Non-Party Witness*: The degree of control which the party has vested in the non-party witness in regard to the key facts and general subject matter of the litigation will likely inform the trial court whether the assertion of the privilege should be viewed as akin to testimony approaching admissibility under *Fed. R. Evid. 801(d)(2)*, and may accordingly be viewed, as in *Brink's*, as a vicarious admission.

3. *The Compatibility of the Interests of the Party and Non-Party Witness in the Outcome of the Litigation*: The trial court should evaluate whether the non-party witness is pragmatically a noncaptioned party in interest and whether the assertion of the privilege advances the interests of both the non-party witness and the affected party in the outcome of the litigation.

4. *The Role of the Non-Party Witness in the Litigation*: Whether the non-party witness was a key figure in the litigation and played a controlling role in respect to any of its underlying aspects also logically merits consideration by the trial court. n124

[c] Preclusion Order

In assessing the impact of an assertion of the *Fifth Amendment* right against self-incrimination, counsel should be aware of case law suggesting that a witness who asserts the privilege during civil discovery can be precluded from presenting affirmative evidence at trial or in response to dispositive motions. n125 In *SEC v. Graystone Nash, Inc.*, n126 the Third Circuit, however, reversed an order of summary judgment in favor of the Commission that was based on an order precluding the defendants from offering evidence on topics regarding which they had asserted their right against self-incrimination in discovery. Noting that the SEC had gathered substantial evidence regarding these topics, the court held that the preclusion order was excessive:

[Only those remedial steps should be imposed] that are necessary to prevent a party from being unduly prejudiced and to allow for reimbursement of any additional sums a party actually incurred as a direct result of its opposition's invocation of the privilege. It is not always possible or necessary that such adjustments be computed precisely, but some rough justice evaluations would be in order. n127

The Third Circuit found that "[t]he preclusion [order] did not level the playing field, but tilted it strongly in favor of the SEC." n128

If a corporate defendant fails to respond to civil discovery because the officers and employees with relevant knowledge assert the privilege against self-incrimination, the SEC might argue that the corporation should also be precluded from introducing relevant evidence. n129 In *In re Anthracite Coal Antitrust Litigation*, n130 the district court issued an order precluding the corporate defendant from introducing evidence relating to certain matters where corporate officers, based on their *Fifth Amendment* privilege, refused to disclose to representatives of the corporation information relating to those matters so that the corporation could disclose that information in response to discovery requests. n131

[d] Section 8(e) Stop Order

There is some authority indicating that the SEC can obtain a stop order pursuant to § 8(e) of the Securities Act based upon the assertion of the *Fifth Amendment* privilege against self-incrimination. Securities Act § 8(e) provides, in relevant part: "If the issuer or underwriter shall fail to cooperate, or shall obstruct or refuse to permit the making of an examination, such conduct shall be proper ground for the issuance of a stop order." n132 The Commission has asserted that a claim of *Fifth Amendment* privilege constitutes failure to cooperate or obstruction, providing grounds for the issuance of a stop order. n133

[e] Suspension of the Regulation A Exemption

Regulation A provides an exemption from the registration provisions of the Securities Act for certain transactions. Rule 258 under the Securities Act provides that the SEC may, at any time after the filing of an offering statement, enter an order temporarily suspending the Regulation A exemption, if it has reason to believe that "the issuer or any promoter, officer, director or underwriter has failed to cooperate or has obstructed or refused to permit the making of an investigation by the Commission in connection with any offering made or proposed to be made in reliance on Regulation A." n134

[f] Wells Statement

The Staff might take the position that the witness is not entitled to submit a Wells Statement if he or she asserted the *Fifth Amendment* right against self-incrimination during the investigation. Alternatively, the Staff might refuse to

identify for the witness the facts on which the SEC has based its tentative decision to recommend an enforcement proceeding.

There are strong arguments, however, that the Commission and Staff should welcome Wells Statements from persons who have asserted the *Fifth Amendment* right against self-incrimination. The Wells Statement is an important mechanism for reducing the risk that the SEC will initiate an enforcement proceeding that is not warranted.

Comment

The Commission should not deny itself the benefits of this mechanism merely because of some misguided desire to penalize an individual for the assertion of a constitutional right.

If a witness submits a Wells Statement that contains factual arguments, the Staff might argue that the Statement is testimonial and should be deemed a waiver of the witness's *Fifth Amendment* right against self-incrimination.

[g] Other Consequences

The assertion of the *Fifth Amendment* right against self-incrimination can have other consequences. The assertion of the privilege by an officer or director of a public company or regulated entity might move the board of directors to request that person's resignation. The assertion of the privilege will undoubtedly cause the Staff some frustration or pique its interest in pursuing the witness in the belief that the incriminating evidence might relate to a securities law violation.

[8] Orders Granting Use Immunity

[a] Use Immunity Under the Organized Crime Control Act

If a witness asserts the right against self-incrimination, the Staff can attempt to obtain an order granting use immunity to the witness pursuant to the Organized Crime Control Act of 1970 ("OCCA"). n135 In general, while the SEC is reluctant to request use immunity, its requests are usually granted.

Under OCCA, certain officials of the Department of Justice ("DOJ") may authorize the SEC to issue "an order requiring the individual to give testimony or provide other information which he refuses to give or provide on the basis of his privilege against self-incrimination." n136 The Act provides that when

the person presiding over the proceeding communicates to the witness an order issued under [OCCA], the witness may not refuse to comply with the order on the basis of his privilege against self-incrimination; but no testimony or other information compelled under the order (or any information directly or indirectly derived from such testimony or other information) may be used against the witness in any criminal case, except a prosecution for perjury, giving a false statement, or otherwise failing to comply with the order. n137

This grant of immunity protects the witness against "direct or derivative use of his testimony in any later domestic prosecution against him, federal or state," n138 except that the witness's testimony may be used in any subsequent prosecutions for perjury, false statements, or failure to comply with the order requiring the witness to testify in accordance with the order. n139

Use immunity does not protect the witness against the use of the testimony in a civil case. n140 The SEC may use the immunized testimony unless the remedy it seeks is deemed to be punitive in nature. n141 In *SEC v. Willis*, n142 an immunized witness asserted his *Fifth Amendment* right against self-incrimination contending, among other things, that despite the grant of use immunity he remained exposed to the risk that his testimony would be used against him in actions ostensibly civil in form, but which nevertheless sought to impose punitive sanctions. These sanctions included

monetary penalties and revocation or suspension of either his registration or trading privileges. n143 The court ruled that this argument was premature, as the court had not yet determined whether the defendant had violated the federal securities laws. n144

[b] Seeking Use Immunity

The topic of use immunity can be raised either by the Staff or counsel to the witness. n145 If the witness desires to obtain a grant of use immunity, his or her counsel should consider making a proffer to the Staff of the testimony and information that the witness could be expected to provide if immunized. At times, however, the Staff will seek use immunity, sometimes without the knowledge of the witness, when the witness is uncooperative and has not made a proffer of testimony.

Even if the witness is seeking a grant of use immunity, his or her counsel usually should make the proffer orally to the Staff only after a number of ground rules have been agreed upon. First, counsel should obtain a written commitment that the Staff will not use the proffer as evidence against the witness. In order to ensure that the proffer cannot be introduced against the witness by either the Staff or others, counsel should allude to only the possibility rather than the fact of the client's being able to testify to certain matters (e.g., "What if my witness could say ...?"). Second, counsel should secure a representation from a senior member of the Staff that it is genuinely considering seeking use immunity and is not seeking the proffer merely as a ploy to obtain discovery.

In addition, because the Staff will rarely, if ever, agree in advance not to use the fruits of a proffer of testimony, counsel should consider proceeding in phases, providing more detail only as the Staff expresses the appropriate level of interest in seeking authority to grant use immunity. n146 Thus, counsel might begin by proffering:

- "What if my client could identify the person who provided the information to John Doe [the person who traded in these securities]?"
- "What if my client could identify the person who provided the information to John Doe, and that person is a senior executive of the issuer?"
- "What if my client could identify the person who provided the information to John Doe, that person is a senior executive of the issuer, and my client's testimony would be admissible against both the person who provided the information and John Doe?" and ultimately proffer:

"What if my client could testify that he met with Jane Roe [president of the issuer] and John Doe at XYZ Restaurant on Feb. 12, 1992, and Jane Roe agreed to provide John Doe with status reports regarding a potential tender offer in return for John Doe giving Jane Roe \$25,000 in cash and John Doe later gave my client the \$25,000 to forward to Jane Roe?"

In determining whether to seek immunity, the Staff considers such factors as:

- whether the witness is a primary malefactor,
- the likelihood that a criminal prosecution would be brought against the witness absent the grant of use immunity,
- whether appropriate enforcement actions can be successfully brought against the primary malefactors in the absence of immunized testimony, and
- the expected content of the witness's testimony and whether the witness is likely to be persuasive.

OCCA affords the DOJ broad discretion in determining whether immunity would be necessary to the public interest. n147 "The decision to seek use immunity necessarily involves a balancing of the Government's interest in obtaining information against the risk that immunity will frustrate the Government's attempts to prosecute the subject of the investigation." n148 Grants of use immunity need only cover the act of production and need not cover the records produced. n149

In recommending that the DOJ authorize a grant of use immunity, the Staff typically prepares an inter-agency memorandum to assist the DOJ in determining whether to authorize the issuance of the order. n150 In this memorandum, the Staff typically provides details regarding its investigation, the need for the testimony or information from the witness, and the expected nature of the witness's testimony, as well as any other information that is likely to assist the DOJ in making its determination.

The Staff rarely, if ever, agrees not to bring an enforcement proceeding against an individual in return for his or her cooperation. It will generally refuse to refrain from making a referral of its investigative records to a United States Attorney's office or the DOJ in return for such cooperation. In addition, the grant of use immunity does not preclude federal prosecutors from prosecuting the witness based on evidence independent of that provided pursuant to the grant of such immunity.

Comment

As a practical matter, however, it will often be difficult for the prosecutor to establish that the prosecution's evidence is not tainted by the immunized testimony.

A witness who testifies regarding a subject matter in one proceeding pursuant to a grant of use immunity cannot be compelled to testify in another proceeding regarding that subject matter unless another grant of use immunity is granted. Thus, a witness can assert the right against self-incrimination in SEC testimony even if he or she has previously testified pursuant to a grant of use immunity. n151

FOOTNOTES:

(n1)Footnote 1. *U.S. Const., amend. V.*

(n2)Footnote 2. *Fisher v. United States*, 425 U.S. 391, 408 (1976) (emphasis in original). *See also In re Three Grand Jury Subpoenas*, 847 F.2d 1024, 1028 (2d Cir. 1988) ("Proper invocation of the *Fifth Amendment* privilege against self-incrimination requires a showing of all of the following three elements: compulsion, a testimonial communication and the incriminating nature of that communication.").

(n3)Footnote 3. *Kastigar v. United States*, 406 U.S. 441, 444 (1972) (The privilege may be asserted "in any proceeding, civil or criminal, administrative or judicial, investigatory or adjudicatory.").

(n4)Footnote 4. *Minnesota v. Murphy*, 465 U.S. 420, 427 (1984) ("[I]n the ordinary case, if a witness under compulsion to testify makes disclosures instead of claiming the privilege, the government has not 'compelled' him to incriminate himself.", quoting *Garner v. United States*, 424 U.S. 648, 654 (1976) (footnote omitted)).

(n5)Footnote 5. *Doe v. United States*, 487 U.S. 201, 210 (1988) .

(n6)Footnote 6. *See Fisher*, 425 U.S. at 409-411 ; *United States v. Dean*, 989 F.2d 1205, 1207 (D.C. Cir. 1993) .

(n7)Footnote 7. *In re Sealed Case*, 877 F.2d 83, 84-85 (D.C. Cir. 1989) .

(n8)Footnote 8. *United States v. Hubbell*, 530 U.S. 27 (2000) .

(n9)Footnote 9. *Gilbert v. California*, 388 U.S. 263 (1967) .

(n10)Footnote 10. *United States v. Wade*, 388 U.S. 218 (1967) .

(n11)Footnote 11. *Fisher v. United States*, 425 U.S. 391 (1976) .

(n12)Footnote 12. 425 U.S. at 410 . See also *United States v. Doe*, 465 U.S. 605, 611-612 . ("Respondent does not contend that he prepared the documents involuntarily or that the subpoena would force him to restate, repeat, or affirm the truth of their contents. The fact that the records are in respondent's possession is irrelevant to the determination of whether the creation of the records was compelled. We therefore hold that the contents of those records are not privileged.") (footnote omitted).

(n13)Footnote 13. See, e.g., *United States v. Hubbell*, 530 U.S. 27, 36 (2000) ; *Baltimore City Department of Social Services v. Bouknight*, 493 U.S. 549 (1990) ; *United States v. Doe*, 465 U.S. 605, 612-614 (1984) (*Fifth Amendment* right against self-incrimination protects act of producing voluntarily prepared papers because act admitted existence, defendant's control, and authenticity of documents).

(n14)Footnote 14. *United States v. Hubbell*, 530 U.S. 27, n.19 (2000) ("The issue presented in those cases was whether the act of producing subpoenaed documents, not itself the making of a statement, might nonetheless have some protected testimonial aspects. The Court concluded that the act of production could constitute protected testimonial communication because it might entail implicit statements of fact: by producing documents in compliance with a subpoena, the witness would admit that the papers existed, were in his possession or control, and were authentic."); citing *United States v. Doe*, 465 U.S. at 613 , and n.11. See also *Fisher*, 425 U.S. at 409-410 ; 425 U.S. at 428 , 432 (concurring opinions); *Braswell v. United States*, 487 U.S. 99, 104 ; 487 U.S. at 122 (dissenting opinion). "Thus, the Supreme Court made clear that the *Fifth Amendment* privilege against self-incrimination applies to acts that imply assertions of fact." *United States v. Hubbell*, 530 U.S. at 36 n.19 .

(n15)Footnote 15. *United States v. Hubbell*, 530 U.S. at 37 .

(n16)Footnote 16. *United States v. Hubbell*, 530 U.S. at 41 .

(n17)Footnote 17. *United States v. Hubbell*, 530 U.S. at 41 .

(n18)Footnote 18. *In re Grand Jury Subpoena Duces Tecum Dated October 29, 1992*, 1 F.3d 87, 93 (2d Cir. 1993) . The focus of the analysis has shifted regarding the *Fifth Amendment* privilege. Where once the primary concern was whether the contents of the subpoenaed item would be incriminating, now the question is whether the act of production may incriminate. *United States v. Wujkowski*, 929 F.2d 981, 983 (4th Cir. 1991) .

(n19)Footnote 19. *Fisher v. United States*, 425 U.S. 391, 411 (1976) (holding that taxpayer could be compelled to produce workpapers prepared by his accountants, in that the workpapers were prepared by the accountants, the existence and location of the workpapers was already known to the government, and the taxpayer could not authenticate the workpapers since he had not prepared them and could not otherwise vouch for their accuracy).

(n20)Footnote 20. *Fisher v. United States*, 425 U.S. 391 (1976) .

(n21)Footnote 21. *Kastigar v. United States*, 406 U.S. 441, 444-445 (1972) . See also *Hoffman v. United States*, 341 U.S. 479, 486 (1951) (holding that a witness may invoke the privilege when there is "a reasonable cause to apprehend danger from a direct answer").

(n22)Footnote 22. *Femia v. McLaughlin*, 126 F.R.D. 426, 429 (D. Mass. 1989) ("The prohibition of compelling the testimony of a witness in any setting is predicated upon there being a real danger that the testimony might be used against the witness in later criminal proceedings.") (*quoting Andover Data Servs. v. Statistical Tabulating Corp.*, 876

F.2d 1080, 1082 (2d Cir. 1989) .

(n23)Footnote 23. *McIntyre's Mini Computer Sales Group, Inc. v. Creative Synergy Corp.*, 115 F.R.D. 528, 530 (D. Mass. 1987) .

(n24)Footnote 24. *Hoffman v. United States*, 341 U.S. 479, 486 (1951) ; *In re Fisher v. Commissioner of Internal Revenue*, 905 F.2d 645, 648-649 (2d Cir. 1990) .

(n25)Footnote 25. *Pillsbury Co. v. Conboy*, 459 U.S. 248, 273 (1983) (Blackmun, J., concurring) (*quoting Brown v. Walker*, 161 U.S. 591, 596 (1896)) .

(n26)Footnote 26. *See, e.g., Femia v. McLaughlin*, 126 F.R.D. 426, 429-430 (D. Mass. 1989) (holding that privilege against self-incrimination applies where testimony might be admissible as a prior bad act showing the witness's intent, or the witness's knowledge of the existence of a scheme).

(n27)Footnote 27. *In re Fisher*, 905 F.2d at 649 .

(n28)Footnote 28. *Zicarelli v. New Jersey State Commission of Investigation*, 406 U.S. 472, 480 (1972) .

(n29)Footnote 29. *Zurcher v. Stanford Daily*, 436 U.S. 547, 561-562 n. 8 (1978) .

(n30)Footnote 30. SEC v Militano, U.S. Dist. LEXIS 17819 (S.D.N.Y. Dec. 10, 1991).

(n31)Footnote 31. *United States v. Balsys*, 524 U.S. 666 (1998) .

(n32)Footnote 32. *D.L. Cromwell Investments v. NASD Regulation*, 279 F.3d 155, 161 (2d Cir. 2002) .

(n33)Footnote 33. 279 F.3d at 162 (*citing Desidario v. National Association of Securities Dealers, Inc.* 191 F.3d 198, 206 (2d Cir. 1999)) .

(n34)Footnote 34. *See United States v. Solomon*, 509 F.2d 863, 867 (2d Cir. 1975) (holding that New York Stock Exchange may compel incriminating testimony).

(n35)Footnote 35. *United States v. White*, 322 U.S. 694, 698 (1944) ; *see also Bellis v. United States*, 417 U.S. 85, 89-90 (1974) (The Fifth Amendment privilege against self-incrimination is a purely personal privilege that "protect[s] only the natural individual from compulsory incrimination through his own testimony or personal records.") (*quoting White*, 322 U.S. at 701) .

(n36)Footnote 36. *Hale v. Henkel*, 201 U.S. 43 (1906) .

(n37)Footnote 37. *Bellis*, 417 U.S. at 92 .

(n38)Footnote 38. *Braswell v. United States*, 487 U.S. 99, 105-106 (1988) ; *United States v. Dean*, 989 F.2d 1205, 1207 (D.C. Cir. 1993) ; *SEC v. First Jersey Secs., Inc.*, 843 F.2d 74 (2d Cir. 1988) .

(N39)Footnote 39. *In re Three Grand Jury Subpoenas*, 847 F.2d 1024, 1029 (2d Cir. 1988) (*citing In re Grand Jury*, 836 F.2d 150 (3d Cir. 1987)) .

(n40)Footnote 40. *In re Three Grand Jury Subpoenas*, 847 F.2d at 1030 . *See § 13.01[3][a] below* discussing the classification of documents as either corporate or personal.

(n41)Footnote 41. *Bellis*, 417 U.S. at 93-94 .

(n42)Footnote 42. *Bellis v. United States*, 417 U.S. 85 (1974) .

(n43)Footnote 43. *417 U.S. at 96-97* .

(n44)Footnote 44. *417 U.S. at 101* .

(n45)Footnote 45. *Bellis, 417 U.S. at 88-89* ; *see also In re Grand Jury, 680 F.2d 327 (3d Cir. 1982)* ; *In re Grand Jury Subpoena, 144 F.R.D. 357, 361 (D. Minn. 1992)* .

(n46)Footnote 46. *In re Sealed Case, 877 F.2d 83, 89-91 (D.C. Cir. 1989)* .

(n47)Footnote 47. *SEC v. Jerry T. O'Brien, Inc., 467 U.S. 735, 742-743 (1984)* .

(n48)Footnote 48. *In re Grand Jury Subpoenas, 959 F.2d 1158, 1163 (2d Cir. 1992)* (permitting the client to argue that the documents subpoenaed from his law firm were protected by the right against self-incrimination). *See also Fisher v. United States, 425 U.S. 391, 403 (1976)* .

(n49)Footnote 49. *See United States v. Doe, 465 U.S. 605, 612 (1984)* (defendant's business papers not protected because voluntarily prepared).

(n50)Footnote 50. *See Chapter 13.01[1][a] and [b], above*.

(n51)Footnote 51. *See Fisher, 425 U.S. at 411* .

(n52)Footnote 52. *Braswell v. United States, 487 U.S. 99, 117-118 (1988)* (where the organization was a corporation); *Bellis v. United States, 417 U.S. 85, 87 (1974)* ; *United States v. White, 322 U.S. 694, 699 (1944)* (where the organization was a union); *In re Grand Jury Subpoenas, 959 F.2d 1158, 1163* ; *In re Grand Jury Proceedings, 633 F.2d 754, 756 (9th Cir. 1980)* (involving a trust).

(n53)Footnote 53. *Braswell v. United States, 487 U.S. 99 (1988)* .

(n54)Footnote 54. *Braswell, 487 U.S. at 109-110* .

(n55)Footnote 55. *Braswell, 487 U.S. at 117-118* . *See also SEC v. Oxford Capital Sec., Inc., 794 F. Supp. 104, 108 (S.D.N.Y. 1992)* .

(n56)Footnote 56. *Braswell, 487 U.S. at 110* .

(n57)Footnote 57. *Braswell, 487 U.S. at 111-112* .

(n58)Footnote 58. *Braswell, 487 U.S. at 110* . *See also Bellis, 417 U.S. at 90* . ("In view of the inescapable fact that an artificial entity can only act to produce its records through its individual officers or agents, recognition of the individual's claim of privilege with respect to the financial records of the organization would substantially undermine the unchallenged rule that the organization itself is not entitled to claim any *Fifth Amendment* privilege, and largely frustrate legitimate governmental regulation of such organizations.")

(n59)Footnote 59. *In re Grand Jury Subpoenas, 722 F.2d 981, 986-987 (2d Cir. 1983)* .

(n60)Footnote 60. *In re Grand Jury Subpoenas, 722 F.2d 981, 987* .

(n61)Footnote 61. *Wilson v. United States, 221 U.S. 361 (1911)* .

(n62)Footnote 62. *Wilson, 221 U.S. 361, 377* .

(n63)Footnote 63. *Wilson, 221 U.S. 361, 378-382* .

(n64)Footnote 64. *See also Wheeler v. United States*, 226 U.S. 478 (1913) (holding that documents corporate in their "essential character" are corporate even if they are held and owned by an individual).

(n65)Footnote 65. *In re Grand Jury Subpoena*, 522 F. Supp. 977, 980 (S.D.N.Y. 1981) .

(n66)Footnote 66. *In re Sealed Case*, 877 F.2d 83, 88 (D.C. Cir. 1989) .

(n67)Footnote 67. *United States v. Wujkowski*, 929 F.2d 981, 984 (4th Cir. 1991) ; *In re Sealed Case*, 877 F.2d at 87-89 ; *In re Grand Jury Subpoena*, 657 F.2d 5, 8 (2d Cir. 1981) ; *United States v. MacKey*, 647 F.2d 898, 900-901 (9th Cir. 1981) .

(n68)Footnote 68. *See, e.g., Wujkowski*, 929 F.2d at 982 .

(n69)Footnote 69. *In re Grand Jury Subpoenas*, 959 F.2d 1158, 1162-1163 (2d Cir. 1992) .

(n70)Footnote 70. *In re Grand Jury Subpoenas*, 959 F.2d at 1165 .

(n71)Footnote 71. *United States v. Dean*, 989 F.2d 1205, 1209 (D.C. Cir. 1993) (citing *Shapiro v. United States*, 335 U.S. 1 (1948)) ; *In re Grand Jury Subpoenas*, 722 F.2d 981, 987 n.5 (2d Cir. 1983) (defining required records as records that must be kept pursuant to a government regulatory scheme and that relate to information of a public character).

(n72)Footnote 72. *In re Grand Jury Subpoena*, 781 F.2d 64, 70 (6th Cir. 1986) .

(n73)Footnote 73. *In re Grand Jury Subpoena*, 522 F. Supp. 977, 981 (S.D.N.Y. 1981) (Person doing business as an individual proprietor may not assert the *Fifth Amendment* privilege against self-incrimination with respect to records that the government requires an individual business proprietor to prepare as long as the specified records involve some "public aspects.").

(n74)Footnote 74. *CFTC v. Collins*, 997 F.2d 1230 (7th Cir. 1993) .

(n75)Footnote 75. *CFTC* 997 F.2d 1230, 1232-1233 (citing *Shapiro*, 335 U.S. at 32-33 (1948) (holding that the required records doctrine does not apply to documents, or copies of documents, that are maintained as a matter of convenience)).

(n76)Footnote 76. *See Seymour Glanzer et al., The Use of the Fifth Amendment in SEC Investigations*, 41 Wash. & Lee L. Rev. 895, 913 (1984) ("where there is a lack of documentary evidence or witnesses other than the targets ... it is possible that if the witness invokes the privilege, the [SEC] Staff will not have sufficient evidence to bring a public enforcement proceeding.").

(n77)Footnote 77. *See the discussion in Chapter 8, above.*

(n78)Footnote 78. Moreover, the initial assertion of the privilege against self-incrimination does not necessarily preclude the witness from testifying later in the investigation. In many instances, a witness who asserted the privilege when initially subpoenaed will be permitted to testify if he or she requests the opportunity after being notified that the Staff intends to recommend that the SEC authorize an enforcement proceeding against the individual. While the Staff might urge otherwise, the Commission will probably read any affidavit submitted as part of the witness's Wells submission.

(n79)Footnote 79. *See Chapter 16, below.*

(n80)Footnote 80. P. McGeehan and D. Barboza, *Merrill Fires 2 for Avoiding Enron Inquiry*, The New York Times (Sept. 19, 2002).

(n81)Footnote 81. Complaint PP 9, 11, SEC v. Merrill Lynch, Civil Action No. H-03-0946 (Hoyt) (S.D.N.Y. Feb. 12, 2003).

(n82)Footnote 82. As one commentator noted, "[I]nnocence in the eyes of God is not at all dispositive on the issue of an individual's risk of indictment" Stanley S. Arkin & Jeffrey M. Kaplan, *A Primer on Grand Jury Representation*, 24 Rev. Sec. Commodities Reg. 69, 74 (1991).

(n83)Footnote 83. See Richard Morvillo & Andrew Koblenz, *Testimonial Waiver of the Fifth Amendment in SEC Investigations*, 22 Rev. Sec. Commodities Reg. 115, 117 (1989).

(n84)Footnote 84. See § 13.01[5] below.

(n85)Footnote 85. See Morvillo & Koblenz, 22 Rev. Sec. Commodities Reg. 115, 116.

(n86)Footnote 86. Morvillo & Koblenz, 22 Rev. Sec. Commodities Reg. 115, 117.

(n87)Footnote 87. Morvillo & Koblenz, 22 Rev. Sec. Commodities Reg. 115, 118.

(n88)Footnote 88. Mark W. Williams, *Pleading the Fifth in Civil Cases*, 20 *Litigation* 31, 32 (1994).

(n89)Footnote 89. *Rogers v. United States*, 340 U.S. 367 (1951) .

(n90)Footnote 90. *Rogers*, 340 U.S. at 373-375 .

(n91)Footnote 91. *Rogers*, 340 U.S. at 378 .

(n92)Footnote 92. *Rogers*, 340 U.S. at 371 .

(n93)Footnote 93. *Rogers*, 340 U.S. at 373-374 .

(n94)Footnote 94. See also *SEC v. Parkersburg Wireless LLC*, Fed. Sec. L. Rep. (CCH) 98,383 , 156 F.R.D. 529 (D.D.C. July 29, 1994) (finding that by testifying regarding a certain transaction, a defendant to a securities fraud action brought by the SEC had waived her *Fifth Amendment* privilege against self-incrimination to not testify regarding correct name, address, and phone number of an individual who participated in the transaction).

(n95)Footnote 95. *Klein v. Harris*, 667 F.2d 274 (2d Cir. 1981) .

(n96)Footnote 96. *Klein*, 667 F.2d at 287 .

(n97)Footnote 97. *Femia v. McLaughlin*, 126 F.R.D. 426, 431 (D. Mass. 1989) (quoting *In re Master Key Litig.*, 507 F.2d 292, 294 (9th Cir. 1974)) . See also *United States v. LaRiche*, 549 F.2d 1088, 1096 (6th Cir. 1977) ("Although disclosure of an incriminating fact generally waives the privilege as to details, waiver does not occur where further disclosure carries a risk of incrimination beyond that raised by previous testimony.") (citations omitted).

(n98)Footnote 98. *United States v. Trejo-Zambrano*, 582 F.2d 460, 464 (9th Cir.) , cert. denied sub nom. *Fierro-Soza v. United States*, 439 U.S. 1005 (1978) .

(n99)Footnote 99. *SEC v. First Fin. Group of Texas, Inc.*, 659 F.2d 660, 668 (5th Cir. 1981) .

(n100)Footnote 100. See also *N. River Ins. Co. v. Stefanou*, 831 F.2d 484, 487 (4th Cir. 1987) (requiring specificity in asserting the privilege).

(n101)Footnote 101. See *Quinn v. United States*, 349 U.S. 155, 160 (1955) (holding a vague reference to the *Fifth Amendment* sufficient to invoke the privilege).

(n102)Footnote 102. *See, e.g.*, Securities Exchange Act § 27(a).

(n103)Footnote 103. *In re Fisher v. Comm'r of Internal Revenue*, 905 F.2d 645, 649 (2d Cir. 1990) .

(n104)Footnote 104. *In re Fisher*, 905 F.2d at 650 . *See also McIntyre's Mini Computer Sales Group, Inc. v. Creative Synergy Corp.*, 115 F.R.D. 528, 532 (D. Mass. 1987) ("As long as sufficient reasons are given from which the Court may independently determine that a real and appreciable danger might exist, the privilege will be upheld").

(n105)Footnote 105. *In re Folding Carton Antitrust Litig.*, 609 F.2d 867, 871 (7th Cir. 1979) .

(n106)Footnote 106. *United States v. Sharp*, 920 F.2d 1167, 1171 (4th Cir. 1990) .

(n107)Footnote 107. *In re Fisher*, 905 F.2d at 650 (collecting cases).

(n108)Footnote 108. *In re Fisher*, 905 F.2d at 651 ; *In re Sealed Case*, 950 F.2d 736, 738-739 (D.C. Cir. 1991) (stating that district court should conduct *in camera* review rather than rely solely on *ex parte* submissions).

(n109)Footnote 109. In *SEC v. Seibald*, 1997 U.S. Dist. LEXIS 14940 , [Current Binder *Fed. Sec. L. Rep. (CCH) P 99,586* (S.D.N.Y. Sept. 30, 1997), the defendants moved in advance of trial for a ruling prohibiting the SEC from using their invocations during the Commission's investigation of their *Fifth Amendment* privileges to establish adverse inferences. While ruling that the motion was premature, the court instructed that there be no reference to defendants' uses of the *Fifth Amendment* in the opening statements or before the jury and that no evidence in that respect should be elicited without prior notice to the court and opposing counsel.

(n110)Footnote 110. *Penfield v. Venuti*, 589 F. Supp. 250 (D. Conn. 1984) .

(n111)Footnote 111. *Penfield*, 589 F. Supp. at 256 .

(n112)Footnote 112. *Penfield*, 589 F. Supp. at 256-257 (quoting *Farace v. Independent Fire Ins. Co.*, 699 F.2d 204, 210-211 (5th Cir. 1983)) .

(n113)Footnote 113. *Penfield*, 589 F. Supp. at 257 (quoting *Brinks, Inc. v. City of New York*, 539 F. Supp. 1139, 1140-1141 (S.D.N.Y. 1982)) .

(n114)Footnote 114. *Baxter v. Palmigiano*, 425 U.S. 308, 318 (1976) . *See also SEC v. Colello*, 139 F.3d 674, 677-678 (9th Cir. 1998) .

(n115)Footnote 115. *Daniels v. Pipefitters' Ass'n Local Union No. 597*, 983 F.2d 800, 802 (7th Cir. 1993) .

(n116)Footnote 116. *Daniels v. Pipefitters' Ass'n Local Union No. 597*, 983 F.2d 800, 802 (7th Cir. 1993) .

(n117)Footnote 117. *SEC v. Musella*, 578 F. Supp. 425, 430-431 (S.D.N.Y. 1984) (expressing misgivings regarding the potential for prosecutorial misconduct); *SEC v. Keith Group of Companies*, 1998 U.S. Dist. LEXIS 13011, at *7 (S.D. Fla. July 7, 1998) (declining to grant summary judgment where invocation of privilege prevented defendant from mounting only defense); *SEC v. Margolin*, 1996 U.S. Dist. LEXIS 11299, at *112 (S.D.N.Y. Aug. 8, 1996) ("[I]n a civil proceeding, such as this one, the Court may draw the inference that on all matters on which the defendant has invoked his privilege, his testimony would not have satisfied his burden of production.")

(n118)Footnote 118. *Lefkowitz v. Cunningham*, 431 U.S. 801, 808 n.5 (1977) ; *see also SEC v. Grossman*, 121 F.R.D. 207, 210 (S.D.N.Y. 1987) (noting that the adverse inference is just one of several factors, no more important than the others).

(n119)Footnote 119. *SEC v. Rehtorik*, 755 F. Supp. 1018, 1020 (S.D. Fla. 1990) (noting that the defendant's

silence, while not necessary to the SEC findings, supports them); *SEC v. Scott*, 565 F. Supp. 1513, 1533-1534 & n.33 (S.D.N.Y. 1983) (holding that even in the face of defendant's silence, the SEC still must carry its burden of proving fraud).

However, a witness associated with a broker-dealer may be sanctioned by a self-regulatory organization such as the National Association of Securities Dealers, the NYSE, or the American Society of Engineers, for asserting the privilege during an SRO investigation. See *United States v. Solomon*, 509 F.2d 863, 867-871 (2d Cir. 1975) (holding that because the NYSE is not an agent of the government, an individual can be sanctioned for asserting the privilege during an NYSE investigation).

(n120)Footnote 120. See *Musella*, 578 F. Supp. at 429 (noting that particularly in insider trading cases, "where the nature of the violation makes the proof inherently difficult to obtain, assertion of the privilege may lead to a complete failure of proof. ... [S]uch a defense strategy clearly cripples plaintiff's efforts to conduct meaningful discovery and to marshal proof in an expeditious fashion, if at all.").

(n121)Footnote 121. See Seymour Glanzer, *The Use of the Fifth Amendment in SEC Investigations*. 41 Wash. & Lee L. Rev. 895 (1984).

(n122)Footnote 122. See, e.g., *Brinks, Inc. v. City of New York*, 717 F.2d 700, 708-710 (2d Cir. 1983) (stating that adverse inference may be drawn against an employer based on an employee's assertion of privilege).

(n123)Footnote 123. See also Stephen A. Jonas and Robert D. Keefe, "Government Investigations and Litigation Bulletin" (Aug. 1, 1998) (available at <http://www.wilmerhale.com/publications/whPubsDetails.aspx?publication=1234>); A. Van Oort, "Invocations as Evidence: Admitting Non-Party Witness Invocations of the Privilege Against Self-Incrimination," 65 U. of Chi. L. Rev. 1435 (1998); Stanley S. Arkin & Jeffrey M. Kaplan, *A Primer on Grand Jury Representation*, 24 Rev. Sec. Commodities Reg. 69, 74 (1991); *LiButti v. United States*, 107 F.3d 110, 121 (2d Cir. 1997). In *LiButti*, the Second Circuit considered whether an adverse inference could appropriately be drawn against the defendant based on his father's assertion of the *Fifth Amendment* right against self-incrimination. The Second Circuit held that the propriety of the inference depended on "the circumstances of a given case." 107 F.3d at 121. The circumstances to be considered included: (1) the nature of the relationship between the witness and the party (the closer the relationship, the more appropriate the inference would be); (2) the degree of control that the party maintains over the witness; (3) the compatibility between the witness' interests and the party's interests; and (4) the role of the witness in the litigation. 107 F.3d at 124. But see *In re Handy & Harman Refining Group*, 266 B.R. 32 (D. Conn. 2001) (holding that it would not be appropriate to draw inference against corporation based on the assertion of the privilege by its former controller).

(n124)Footnote 124. *LiButti v. United States*, 107 F.3d 110, 123-124 (2d Cir. 1997).

(n125)Footnote 125. See, e.g., *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 855 (S.D.N.Y. 1997) (barring defendant from testifying later about matters previously hidden from discovery through invocation of the privilege); *SEC v. Grossman*, 121 F.R.D. 207, 210 (S.D.N.Y. 1987) ("The Court recognizes that if a party fails to allow pre-trial discovery of evidence on his claim of privilege, a preclusion order should be entered to bar his subsequent use of the evidence."); *SEC v. Benson*, 657 F. Supp. 1122 (S.D.N.Y. 1987) (precluding defendant who asserted *Fifth Amendment* right against self-incrimination from offering evidence in opposition to motion for summary judgment); *SEC v. Cymaticolor*, 106 F.R.D. 545, 549-550 (S.D.N.Y. 1985) (holding that defendant should be precluded from offering into evidence "any matter relating to the factual bases for his denials and defenses as to which he has asserted his *ffifth amendment* rights" and rejecting defendant's argument that he should not be precluded from offering evidence that the SEC has received from other sources). But see *SEC v. Graystone Nash, Inc.*, [1993-94 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P* 98,230 (3d Cir. 1994).

(n126)Footnote 126. *SEC v. Graystone Nash, Inc.*, 25 F.3d 187 (3d Cir. 1994).

(n127)Footnote 127. *Graystone Nash*, 25 F.3d 187, 194 .

(n128)Footnote 128. *Graystone Nash*, 25 F.3d 187, 194 .

(n129)Footnote 129. See *In re Anthracite Coal Antitrust Litig.*, 82 F.R.D. 364, 370 (M.D. Pa. 1979) (deciding on appropriate sanctions where a corporation cannot comply with a discovery order because of the *Fifth Amendment* assertions of its own officers); *C&W Constr. Co. v. Bhd. of Carpenters*, 108 F.R.D. 389, 393 (D. Haw. 1985) (involving sanctions against a union resulting from the assertion of *Fifth Amendment* privilege by its agents).

(n130)Footnote 130. *In re Anthracite Coal Antitrust Litig.*, 82 F.R.D. 364 (M.D. Pa. 1979) .

(n131)Footnote 131. *Anthracite Coal Antitrust Litig.*, 82 F.R.D. at 370-371 .

(n132)Footnote 132. Securities Act § 8(e).

(n133)Footnote 133. See, e.g., *In re Nat'l Car Care, Inc.*, 50 S.E.C. 383, 384, Securities Act Release No. 6875 (1990) (stating that assertion of the *Fifth Amendment* privilege against self-incrimination by one associated with an issuer or underwriter constitutes a failure to cooperate within the meaning of § 8(e), and is proper grounds for issuance of a stop order); *In re Hughes Capital Corp.*, 48 S.E.C. 802, 813-814, Securities Act Release No. 6725 (1987) (refusal of subpoenaed officers, directors, and employees to testify constitutes obstruction, warranting the issuance of a stop order).

(n134)Footnote 134. Rule 258(a)(7), 17 C.F.R. § 230.258(a)(7).

(n135)Footnote 135. 18 U.S.C.S. §§ 6001 to 6005.

(n136)Footnote 136. 18 U.S.C.S. §§ 6001, 6004(a).

(n137)Footnote 137. 18 U.S.C.S. § 6002.

(n138)Footnote 138. *In re Grand Jury Subpoena of Flanagan*, 691 F.2d 116, 121 (2d Cir. 1982) (citing *Kastigar v. United States*, 406 U.S. 441, 462 (1972)) .

(n139)Footnote 139. *United States v. Tramunti*, 500 F.2d 1334, 1342 (2d Cir.) , cert. denied, 419 U.S. 1079 (1974) (reasoning that false statements are not within the scope of immunity, which is designed to protect evidence of past behavior).

(n140)Footnote 140. See, e.g., *United States v. Cappetto*, 502 F.2d 1351 (7th Cir.) , cert. denied, 420 U.S. 925 (1974) .

(n141)Footnote 141. See, e.g., *SEC v. Willis*, 142 F.R.D. 100 (S.D.N.Y. 1992) .

(n142)Footnote 142. *SEC v. Willis*, 142 F.R.D. 100 (S.D.N.Y. 1992) .

(n143)Footnote 143. *Willis*, 142 F.R.D. at 102-103 .

(n144)Footnote 144. *Willis*, 142 F.R.D. at 103 .

(n145)Footnote 145. Of course, the topic of use immunity can also be raised in discussions between federal prosecutors and counsel for the witness, if there is a parallel criminal proceeding. See generally Lionel Pashkoff, *Obtaining Immunity in Securities and Exchange Commission Investigations*, 5 Sec. Reg. L.J. 165 (1977).

(n146)Footnote 146. See Lionel Pashkoff, *Obtaining Immunity in Securities and Exchange Commission Investigations*, 5 Sec. Reg. L.J. 177 (1977).

(n147)Footnote 147. *United States v. Hooks*, 848 F.2d 785, 798-799 (7th Cir. 1988) .

(n148)Footnote 148. *United States v. Doe*, 465 U.S. 605, 616 (1984) .

(n149)Footnote 149. *United States v. Doe*, 465 U.S. 605, 616 (1984) .

(n150)Footnote 150. *See generally* Pashkoff, 5 Sec. Reg. L. J. 177, (discussing SEC practice in the various stages of proceedings).

(n151)Footnote 151. *See Pillsbury Co. v. Conboy*, 459 U.S. 248, 256-257 (1983) (holding that a defendant cannot be compelled to answer questions over a valid assertion of his *Fifth Amendment* rights without valid assurance of immunity).



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CHAPTER 14 DEFENDING AN INSIDER TRADING INVESTIGATION

1-14 Securities Enforcement: Counseling and Defense 14.syn

AUTHOR: Kenneth B. Winer

§ 14.syn Synopsis to Chapter 14: DEFENDING AN INSIDER TRADING INVESTIGATION

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CHAPTER 14 DEFENDING AN INSIDER TRADING INVESTIGATION

1-14 Securities Enforcement: Counseling and Defense § 14.01

AUTHOR: Kenneth B. Winer

§ 14.01 Introduction

Bringing enforcement actions involving unlawful insider trading has long been one of the priorities of the Securities and Exchange Commission ("SEC" or "Commission") Enforcement Staff. Accordingly, the Enforcement Staff ("Staff") conducts a substantial number of investigations each year in order to determine whether persons have purchased or sold securities while in possession of material nonpublic information. To defend such an investigation, counsel must understand the Staff's investigative techniques and processes, the relevant securities laws, the *Fifth Amendment* privilege against self-incrimination, and the factors that federal prosecutors consider in deciding whether to bring a criminal prosecution.

In insider trading cases, the SEC was once largely limited to seeking an injunction prohibiting future violations of the anti-fraud provisions of the federal securities laws and an order that the trader disgorge the unjust enrichment (including back interest) derived from the insider trading. If the trader was a securities professional (such as a person associated with a broker-dealer or an investment adviser) and the SEC concluded that he or she engaged in unlawful insider trading, the SEC would likely seek to suspend or bar the individual as well. In the mid-1980s, Congress conferred on the SEC a substantial array of additional enforcement remedies to address insider trading. Since then, the SEC can, and does, seek penalties of up to three times the amount of any profit gained or loss avoided as a result of insider trading. n1 In addition, with increasing frequency, the SEC seeks an order barring the trader from serving as an officer or director of public companies. n2

There have been a number of high profile criminal prosecutions involving insider trading, including Dennis Levine, Ivan Boesky and most recently Samuel Waksal. n3 In general, an insider trading violation is more likely to result in a criminal prosecution if the matter involves aggravating factors such as:

- the insider trading was by a senior corporate official through nominee accounts;
- the insider trading was accompanied by the tippee's passing money to the tipper;
- the trader engaged in a pattern of insider trading over a significant period of time involving a number of securities; or

- during the investigation, the trader attempted to obstruct justice by fabricating evidence or participating with others in the creation of a cover-up story.

In addition, criminal charges relating to a potential defendant's misconduct during the course of an SEC investigation for perjury or obstruction of justice, for example, may result from an SEC insider trading investigation, regardless of whether criminal authorities decide to pursue a criminal insider trading case. This is exemplified by the criminal case that prosecutors charged and won in March 2004 against Martha Stewart for obstruction of justice and lying to federal officials during the course of the government's insider trading investigation relating to Imclone and its former CEO, Samuel Waksal.

This chapter describes the various phases of an SEC investigation into insider trading and discusses measures for effectively defending an individual in such an investigation. Most of this chapter also applies to the defense of an individual whom the Enforcement Staff suspects unlawfully "tipped" (i.e., provided material nonpublic information in breach of a fiduciary duty and for a personal benefit).

FOOTNOTES:

(n1)Footnote 1. Insider Trading Sanctions Act, *15 U.S.C.S. § 78u-1(a)(2)*.

(n2)Footnote 2. Securities Exchange Act Section § 21(d)(2), *15 U.S.C.S. § 78u(d)(2)*. For further information regarding officer and director bars, *see* Chapter 18, *above* and *Liability of Corporate Officers and Directors: Seventh Ed.* (Matthew Bender & Co., Inc. 2006).

(n3)Footnote 3. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, *102 Stat. 4677 (1987)*.



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CHAPTER 14 DEFENDING AN INSIDER TRADING INVESTIGATION

1-14 Securities Enforcement: Counseling and Defense § 14.02

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§ 14.02 Preliminary Matters

[1] Initiation of an Insider Trading Investigation

An SEC insider trading investigation may be prompted by any of a number of factors. Insider trading investigations often result from the market surveillance activities of the self-regulatory organizations and of the SEC. For example, the SEC, NASDAQ and the NYSE each monitor the securities markets for public announcements of material events, such as a negative earnings release or a merger, that are preceded by a suspicious movement in the price of a security or an increase in the volume of trading in the security or in related options. In addition, insider trading investigations may result from press reports and from referrals from companies.

The SEC also brings insider trading cases in connection with investigations into whether a company's financial disclosures are materially false and misleading. For example, if the SEC concludes that a company's financial statements overstated the company's revenue or understated the company's expenses, the SEC may bring insider trading charges against company personnel who sold the company's stock while in possession of that information. Similarly, the SEC brings insider trading cases against executives of companies who trade in the securities of the company while in possession of material nonpublic information concerning regulatory actions by government agencies which impact their companies' business, prior to the announcement of such actions.

There are two types of SEC investigations: informal inquiries and formal investigations. The Staff conducts informal inquiries on a voluntary basis, asking witnesses to cooperate by voluntarily producing documents and providing testimony. In a formal investigation, the Commission issues a Formal Order authorizing the Staff to issue subpoenas calling for the production of documents and testimony. Most insider trading investigations that result in enforcement actions begin as informal inquiries and evolve into formal investigations.

When price movements or increases in trading volume trigger an insider trading investigation, the Staff typically begins the investigation by attempting to identify suspicious trades. Typically, the Staff employs two procedures to identify suspicious trades. The Staff sends to brokerage firms requests for information (known as "blue sheets") asking the firms to identify the customers who, during the period immediately prior to the public announcement, purchased (if the material information was positive) or sold (if the material information was negative) the relevant security or engaged in

suspicious transactions in options in the security. The Staff also asks the relevant company or companies voluntarily to provide the Staff with chronologies describing the events leading to the announcement, identifying the individuals with prior knowledge of the material nonpublic information, and identifying whether any of the persons whom the Staff has identified as having engaged in timely securities transactions have known links to the companies. Companies usually comply with this request.

Comment

If the matter is initiated by an SRO, the SRO staff may take similar steps to identify suspicious trades. If it appears that persons not associated with a broker-dealer engaged in unlawful trading, the SRO will likely refer the matter to the SEC.

[2] Identifying Suspicious Trades

Based on the information gathered as a result of the above procedures, the Staff identifies trades that warrant further inquiry. It employs a number of criteria in determining whether a trade warrants further inquiry. The Staff is likely to focus on trades that:

- were placed by a person who has some connection to the inside information either through employment or personal relationships;
- involve options or margin transactions, especially if the trader had rarely if ever engaged in such transactions;
- were large, especially if the trader rarely, if ever, engaged in trades of that magnitude;
- form a suspicious pattern (i.e., the trader engaged in a number of transactions in the security, and the times of the transactions appear to correlate with nonpublic events material to the issuer); or
- were placed by entities located in countries with secrecy laws or other laws that would impede the SEC from obtaining information regarding the identity of the principals behind the entities.

[3] Building a Circumstantial Case

Once the SEC has focused on certain trades, the Staff seeks additional materials regarding the trader who initiated the trades in order to build a circumstantial case that the trades were based on material nonpublic information. Defense counsel should consider these steps so that he or she can independently gather and assess the materials likely to be gathered by the Staff.

The Staff often will subpoena the trader's telephone records, including those relating to the trader's telephone calling card or cell phone, from the relevant telephone companies. The Staff will also subpoena personal e-mail records and, depending upon the scope of the investigation, may seek to obtain e-mails from the company whose securities are being traded. The Staff will review the records for evidence that the trader was in contact either with a person who had access to the material information before the information was public or other persons who traded in the relevant security during the relevant period. The Staff will usually be able to obtain records of long distance calls and will sometimes obtain records of local calls.

Comment

Some telephone companies have a practice of notifying customers when their telephone records have been subpoenaed.

The Staff will often subpoena records from the relevant banks. For accounts in the name of an individual, the subpoenas often must comply with the Right to Financial Privacy Act. ⁿ¹ These bank records may establish that money flowed between the trader and either a person who possessed the material, nonpublic information or another person who traded in the relevant security during the relevant period. In addition, these records might show that the securities transactions were disproportionate to the trader's financial resources. For example, the SEC is likely to view with suspicion a purchase of options that was financed by a bank line of credit. The Staff often obtains the trader's account records from the relevant brokerage firms in order to assess whether the trade was aberrational in terms of the nature of the security (e.g., the first time that person had traded in out-of-the-money call options), the magnitude of the trade, and the financing of the trade. In many circumstances, the Staff will also assess whether the trader has an unusual pattern of trading in advance of the disclosure of material, nonpublic information. If there is such an unusual pattern, the Staff tends to suspect that the trader is obtaining information from a source such as a law firm, an investment banking firm, an accounting firm, or a financial printer.

In addition, the Staff will often question the trader's stockbroker, friends, co-workers, and relatives in an effort to learn whether the trader mentioned the security or having any material, nonpublic information or had connections with any person who had such information.

[4] Contacting the Trader

The Staff often attempts to obtain information directly from the persons who engaged in the suspicious trades and the persons whom the Staff suspects tipped the information. While the timing and nature of the Staff's initial contact varies, it is often a telephone call from the Staff in which the Staff identifies itself, asks the trader voluntarily to answer certain questions over the telephone and, if he or she consents, asks a series of questions. The Staff places this telephone call at the outset of the probe to learn the trader's explanation of the suspicious trading. Sometimes, the Staff places the telephone call because it is only marginally suspicious and is prepared to be persuaded not to focus on the individual, or to limit its focus on the individual, if he or she provides a convincing explanation for the purchase. In contrast, the Staff may place the telephone call even though it views the trades as highly suspicious because it hopes that the trader will either provide valuable information or provide a demonstrably false response (e.g., denying that he or she knows a certain person who did have material nonpublic information when the telephone records will show that calls were placed between the residences of the trader and suspected tippee at crucial times).

Sometimes, the initial contact consists of a subpoena calling on the individual to produce documents and appear for testimony. Usually, the Staff does not serve a subpoena until the Staff has gathered evidence for the purpose of building a circumstantial case.

The Enforcement Staff does not provide any notice of its investigations to persons who have engaged in securities transactions under investigation. Rather, such persons typically learn of such investigations either directly, as a result of being contacted by the Staff as discussed above, or indirectly (e.g., as a result of the SEC request for a chronology or from another person who has been asked to provide information).

Comment

The Staff always identifies itself when contacting members of the public for information.

FOOTNOTES:

(n1)Footnote 1. Right to Financial Privacy Act, *12 U.S.C.S. §§ 3401 to 3422. See Chapter 6, above.*



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CHAPTER 14 DEFENDING AN INSIDER TRADING INVESTIGATION

1-14 Securities Enforcement: Counseling and Defense § 14.03

AUTHOR: Kenneth B. Winer

§ 14.03 Defense Strategy

[1] Initial Measures in Defending an Individual

Counsel should consider several measures promptly after being retained. First, counsel should conduct an investigation in order to learn the relevant facts and gather the relevant evidence. Counsel should begin by interviewing the client about the transaction(s) in question and other securities transaction(s) in which he or she engaged and by obtaining from the client copies of relevant documents, such as the trader's telephone bills, brokerage account statements, bank account records, and personal telephone and address books. In addition, counsel should independently attempt to gather and assess the types of information likely to be gathered by the Staff. Counsel should also consider contacting, and sharing information with counsel representing other relevant witnesses. n1

Second, counsel should impress on the trader the importance of not obstructing justice. The risk of a criminal prosecution related to an insider trading investigation increases dramatically if the Staff believes that the trader attempted to obstruct justice. Thus, counsel should urge the trader not to fabricate or destroy evidence and not to participate with others in the creation of a cover-up story.

Third, sometimes the trader learns of the investigation and retains counsel before the Staff has contacted the trader. For example, the trader might learn from a friend that the Staff has requested a chronology from a company. In this circumstance, a decision must be made as to how the trader should respond if the Staff telephones and asks the trader to answer some questions over the telephone. In most instances, it is advisable for the trader to decline to respond to questions when he or she is not in the presence of counsel. In some comparatively rare instances, however, it might be appropriate for the trader to provide carefully prepared responses to questions posed by the Staff. In such instances, the trader should understand that he or she should terminate the interview if the Staff asks questions that have not been anticipated. The trader should be instructed to call defense counsel immediately after the call and (if the trader does not reach defense counsel) prepare a memorandum to counsel detailing the questions posed and answers provided.

Fourth, defense counsel should also prepare the witness for questioning by criminal law enforcement agents (i.e., FBI agents). Law enforcement agents frequently appear unannounced at a witness's home or office. They often press witnesses to provide information, using a variety of law enforcement interrogation techniques. In general, witnesses

should be advised to state that they wish to consult with counsel before answering any questions.

Fifth, if the trader retained counsel after the Staff spoke with the trader, counsel should carefully assess the significance of the telephone conversation. Counsel should press the trader to provide as detailed a description of the interview as possible. In addition, it may be appropriate to ask the Staff to provide its understanding of the interview; however, the Staff may refuse to provide this information.

Counsel must then determine whether the trader made any false statements during the interview. Unless counsel can somehow remedy the situation, making false statements during the initial conversation is likely to militate toward the trader asserting the *Fifth Amendment* privilege against self-incrimination during testimony.

Sixth, counsel must decide whether to have the trader fully cooperate with the SEC in the hopes that the SEC will take the trader's cooperation into consideration in determining the appropriate sanction. The Enforcement Staff claims that the SEC does reward cooperation. Many members of the defense bar, however, are skeptical of these claims and, at least absent a deal with criminal prosecutors, rarely advise their clients to cooperate fully in the hopes of clemency.

Seventh, if a Formal Order has been issued, once the Staff has contacted the trader, counsel should request a copy of the order. Typically, the order provides only a limited amount of information regarding the focus of the probe. In an insider trading investigation, the Formal Order usually indicates that the Staff is focusing on insider trading in an identified security during a specified time period.

[2] Deciding Whether to Invoke the Fifth Amendment Privilege Against Self-Incrimination

When a trader receives a subpoena calling for production of documents or testimony, the threshold question is whether the individual should assert the *Fifth Amendment* privilege against self-incrimination. Unless the trader has previously testified in the investigation, the trader will almost always meet the legal prerequisites for being able to decline on the basis of the privilege to testify or produce documents.

Thus, the decision whether to assert the privilege is a tactical issue that should be based on the results of counsel's factual investigation. It almost always is advisable for a witness to assert the privilege against self-incrimination if, based on counsel's factual investigation, it appears likely that the prosecutors or the SEC will bring an enforcement proceeding even if the trader testifies and is believed. Even if a witness determines during the investigative stage to assert the *Fifth Amendment* privilege, he may decide to testify at trial and waive the privilege at that time. The majority of courts do not allow a negative inference to be drawn under those circumstances from the earlier assertion of the *Fifth Amendment* privilege. Nevertheless, a factual discussion of such prior assertion can be introduced at trial for consideration by the trier of fact, who may consider the defendant's assertion of the *Fifth Amendment* privilege in determining his credibility at trial.

More difficult is deciding whether a trader should assert the privilege when the potential testimony is exculpatory. In making this decision, the following factors should be considered:

- whether the circumstantial evidence is such that the Staff is unlikely to credit the witness's exculpatory testimony;
- whether some portions of the testimony are incriminating (e.g., a trader arguably should not testify if he is a good friend of a corporate insider who knew the nonpublic information and talked to the insider shortly before the trade, even if they did not discuss the material, nonpublic information);
- the risk that the government will perceive the trader as not telling the truth and will charge the trader with perjury or obstruction of justice if he or she testified; and

- the probability that the SEC will authorize an enforcement action against an individual who asserts the privilege during the investigation, if there is any significant amount of circumstantial evidence that the trade was based on material nonpublic information in violation of the federal securities laws.

In determining whether the trader should assert the privilege against self-incrimination, counsel should consider whether the trader's testimony is likely to reveal violations of other provisions of the federal securities law or of any other state or federal laws. The Formal Order does not limit the range of the enforcement actions that can result from an insider trading investigation.

Comment

The SEC will bring enforcement proceedings on matters unrelated to the initial focus of the probe. In addition, the SEC may refer violations of other federal and state laws to other law enforcement agencies.

[3] Deciding Whether to Seek Use Immunity

If the matter appears likely to result in a criminal prosecution, counsel should consider seeking use immunity that would protect the trader from the direct or indirect use of his or her testimony in a later domestic criminal prosecution. It is extremely rare, however, for the SEC to agree not to use a witness's testimony in an enforcement proceeding against the witness.

The SEC does not have authority to grant use immunity. Rather, pursuant to the Organized Crime Control Act of 1970, n3 it must request that the Department of Justice approve the agency's granting such immunity.

[4] Producing Documents

If the trader decides not to assert the privilege against self-incrimination, the Staff will usually require that he or she produce records in advance of testimony. In producing these records, counsel should request confidential treatment pursuant to the Freedom of Information Act. n4

[5] Preparing for Testimony

If the trader decides not to assert the privilege against self-incrimination, it is crucial that he or she testify effectively and accurately. Witness preparation necessarily builds on counsel's investigation of the facts. If, as is often the case, there is inadequate time to conduct a thorough factual investigation before the return date on the subpoena, counsel should insist that the return date be extended. Usually, the Staff will agree to extend the date, particularly if counsel emphasizes that additional time is needed for the witness to be adequately represented by counsel. If the Staff does not agree to such an extension, and testifying without further investigation presents risk to the witness, the witness can either fight a subpoena enforcement action or appear on the return date and refuse to testify based on Rule 7(c) of the SEC Rules Relating to Investigations, which states that a witness has a right to be advised by counsel before testimony, and on the *Fifth Amendment* privilege against self-incrimination.

The trader should be prepared for testimony in much the same manner as an important witness would be prepared for deposition in a case in which the parties expect to settle before trial. That is, the trader should be prepared to address effectively the issues likely to raise concerns with the Staff. n5 For example, if the trader made his or her investment decision based on certain magazine or newspaper articles, counsel should attempt to obtain those articles and should consider having the trader review the articles in advance of testimony. Indeed, it might be appropriate to provide those articles to the Staff in advance of the testimony.

Although the witness should be urged not to volunteer information during testimony, an exception should be made for

certain facts that are important to the defense. For example, if the trader purchased the security based on the recommendation of his or her broker and has repeatedly followed similar recommendations in the past, the trader probably should be advised to volunteer these facts in testimony when appropriate.

[6] Defending Testimony

The Staff usually takes testimony in a conference room in either a government office building in the region where the witnesses are located or in the SEC's Washington offices. The testimony often is taken by two or more members of the Staff and is recorded by a court reporter.

Counsel performs a limited, but important, role during testimony. Counsel should monitor the performance of the witness, advising the witness as to whether he or she is testifying as effectively as possible. Counsel should, as necessary, object to questions that are ambiguous or confusing, contain implicit premises that are contrary to fact, or call for privileged information. In the artificial context of testimony, a witness may fail to recall information that is called for by the questions posed by the Staff; counsel must consider whether the witness has inadvertently provided information that does not accurately reflect the knowledge of the witness and, if appropriate, take steps to refresh his or her recollection.

The SEC Rules of Practice do not provide for the witness's counsel to ask clarifying questions until the end of the testimony. Most Staff attorneys, however, will permit clarifying questions during testimony and will, in general, permit questions intended to elicit related information. Thus, if the Staff's questioning fails to uncover facts that are helpful to the defense, counsel may ask questions that will elicit such facts. n6

[7] Engaging in the Wells Process

If the Staff decides to recommend that the SEC authorize an enforcement proceeding against the trader, the trader will ordinarily be provided an opportunity to submit a written or videotape statement to the SEC setting forth the reasons such a proceeding would be inappropriate. The Staff usually is willing to meet with counsel for a prospective defendant in order to discuss the grounds for its recommendation. These discussions provide counsel with an opportunity both to prepare an effective submission to the Staff and to attempt to persuade it to drop at least some portions of its recommendation.

Deciding whether to submit a Wells statement requires careful consideration of numerous factors. In general, however, if the matter is unlikely to result in a criminal prosecution, and there is a reasonable possibility that the Enforcement Staff or the Commission can be persuaded to drop or limit the proposed enforcement proceeding, submission of the statement probably would be advisable.

A Wells statement should be drafted with an eye to at least three audiences:

- the Division of Enforcement,
- the Commission, and
- the person or persons who will act as a trier of fact if an enforcement proceeding must be litigated.

Although the SEC release regarding Wells statements suggests otherwise, the statements can make factual arguments, as well as legal arguments and policy arguments. Wells statements can be designed to serve a variety of goals, including:

- persuading the Staff or the Commission that the federal securities laws have not been violated,

- persuading the Staff or the Commission that no enforcement action is warranted even if there has been a violation of the federal securities laws, and
- persuading the Staff or the Commission that even if an enforcement proceeding is appropriate, the nature and scope of the proceeding being considered by the Division of Enforcement is excessive.

After submitting the Wells statement to the Division of Enforcement, counsel should contact the Division in order to address any issues raised by the Wells statement. In some instances, the Division will respond to a Wells statement by changing the basis for its recommendation without further notice to the prospective defendant/respondent. n7

FOOTNOTES:

(n1)Footnote 1. *See* Chapter 12, *above*, for a discussion of joint defense agreements.

(n2)Footnote 2. *See* Chapter 13, *above*, for a discussion of the *Fifth Amendment* privilege against self-incrimination.

(n3)Footnote 3. *18 U.S.C. § 6004.*

(n4)Footnote 4. *17 C.F.R. § 200.83(c).* *See* Chapter 9, *above*.

(n5)Footnote 5. *See* Chapter 10, *above*.

(n6)Footnote 6. For a more complete discussion of the role of counsel in defending testimony, see Chapter 10, *above*.

(n7)Footnote 7. For a more complete discussion of the Wells Process, see Chapter 16, *below*.



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CHAPTER 14 DEFENDING AN INSIDER TRADING INVESTIGATION

1-14 Securities Enforcement: Counseling and Defense § 14.04

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§ 14.04 Resolving the Investigation

[1] Initiating Settlement Discussions

Counsel should carefully consider whether and when to initiate settlement discussions. Typically, if the Commission authorizes the Staff to initiate an enforcement proceeding, the Commission will simultaneously authorize the Enforcement Staff to initiate settlement discussions. Defense counsel, however, often initiates settlement discussion during the evidence-gathering phase of the investigation or during the Wells statement process.

Although the SEC's rules suggest that the Staff can negotiate settlements only if the Commission has authorized such negotiations, in many instances, the Staff will respond to discussions initiated by counsel for a prospective defendant. In general, the Staff is more willing to discuss settlement during the Wells process than during the earlier phases of the investigation. The Staff usually hesitates to agree to a settlement before completing an investigation for fear that the trader is willing to settle only because he or she wants to prevent the Staff from uncovering other violative conduct.

Although many SEC enforcement actions are settled before they are brought, in appropriate circumstances the trader should be prepared to litigate. The SEC sometimes takes aggressive positions and consequently loses a substantial number of the enforcement matters that it litigates.

There are several reasons why prospective defendants, nevertheless, often settle these proceedings. Defending against an SEC enforcement proceeding can be expensive and disruptive. The SEC usually settles insider trading probes for less than the maximum statutory penalty. In the absence of a parallel criminal proceeding, the Staff will ordinarily agree to a settlement in which the defendant/respondent neither admits nor denies the allegations of wrongdoing. Litigation of the matter may lead to the SEC developing a strong case that results in a criminal referral.

In negotiating a settlement, counsel can attempt to negotiate a number of items, including the trades alleged in the complaint as having been placed in violation of the federal securities laws. Defense counsel may also be able to negotiate the amount of disgorgement. Specifically, defense counsel may be able to negotiate with the Staff regarding the extent to which market movements should be attributed to the insider information. Historically, the Commission routinely settled for disgorgement of the amount of the profits gained or loss avoided, back interest, and a penalty equal

to the disgorgement amount. The Commission has more recently shown more flexibility regarding the amount of the penalties, sometimes settling for less than the amount of the disgorgement and sometimes insisting on more than the disgorgement amount. The language of the charging document can also be negotiated. This language is important because it influences press coverage and will likely be considered by other law enforcement agencies and prospective employers. If the trader is a securities professional or corporate officer or director, defense counsel should negotiate the extent of any bar or suspension.

[2] Conclusion

SEC probes into insider trading pose substantial risks to individuals who engaged in securities transactions that, in retrospect, look suspicious. The effective defense of such individuals requires thorough preparation and a keen understanding of both the federal securities laws and the workings of the Division of Enforcement.



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CHAPTER 15 DISCOVERY OF INFORMATION FROM THE SECURITIES AND EXCHANGE COMMISSION

1-15 Securities Enforcement: Counseling and Defense 15.syn

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§ 15.syn Synopsis to Chapter 15: DISCOVERY OF INFORMATION FROM THE SECURITIES AND EXCHANGE COMMISSION

§ 15.01 Freedom of Information Act

[1] Exemptions from FOIA

[a] Exemption 4

[b] Exemption 6

[c] Exemption 7

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§ 15.03 Discovery Requests Directed to the SEC

[1] Deliberative Process Privilege

[2] Law Enforcement Investigatory Privilege

Kenneth B. Winer



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CHAPTER 15 DISCOVERY OF INFORMATION FROM THE SECURITIES AND EXCHANGE COMMISSION

1-15 Securities Enforcement: Counseling and Defense § 15.01

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§ 15.01 Freedom of Information Act

Persons producing documents to the Securities and Exchange Commission should be aware that third parties might be able to obtain copies of those documents from the SEC through the Freedom of Information Act n1 ("FOIA"). FOIA provides a mechanism by which persons can obtain federal agency records from the government. Pursuant to FOIA, a person may submit a written request to the SEC seeking production of certain described documents. n2

[1] Exemptions from FOIA

In general, FOIA requires the SEC to search for the described documents and produce them to the person making the request -- unless the documents are protected from disclosure pursuant to one of the nine exemptions specified in the statute. n3 Persons who submit confidential documents to the SEC most frequently invoke § 552(b)(4), (6), and (7) as the basis for protecting documents from disclosure to FOIA requestors.

[a] Exemption 4

The "Justice Department Guide to the Freedom of Information Act" provides a detailed discussion of the case law interpreting this and other exemptions. n4

Exemption 4 of the FOIA protects "trade secrets and commercial or financial information obtained from a person [that is] privileged or confidential." n5 The SEC frequently relies on Exemption 4 in denying FOIA requests. The exemption encourages submitters to voluntarily furnish useful commercial or financial information to the government and it correspondingly provides the government with an assurance that such information will be reliable. The exemption also provides protection to submitters of commercial or financial information to the government by safeguarding them from the competitive disadvantages that could result from disclosure. n6 The exemption covers two broad categories of information in SEC records: (1) trade secrets; and (2) information that is (a) commercial or financial, *and* (b) obtained from a person, *and* (c) privileged or confidential.

For the purpose of Exemption 4, the District of Columbia Circuit in *Public Citizen Health Research Group v. FDA*, n7 adopted a narrow definition of the term "trade secret" as "a secret, commercially valuable plan, formula, process, or device that is used for the making, preparing, compounding, or processing of trade commodities and that can be said to

be the end product of either innovation or substantial effort." n8 This definition requires that there be a "direct relationship" between the trade secret and the productive process. n9

Trade secret protection has been recognized for product manufacturing and design information, n10 but has been denied for general information concerning a product's physical or performance characteristics or a product formula when release would not reveal the actual formula itself. n11 Moreover, one appellate court has concluded that "where the submitter or owner of documents held by the government grants the government permission to loan or release those documents to the public, those documents are no longer 'secret' for purposes of [trade secret protection under] Exemption 4" and so must be released. n12

Most Exemption 4 cases focus on whether the withheld information falls within its second, much larger category of commercial or financial information that is obtained from a person and is privileged or confidential. n13 If information relates to business or trade, courts readily consider the information "commercial" or "financial." n14 The District of Columbia Circuit has had that the terms, "commercial and financial" should be given their "ordinary meanings" holding that records are commercial so long as the submitter has a "commercial interest" in them. n15 Similarly, the Second Circuit has held that the term, "commercial" means "anything pertaining or relating to or dealing with commerce." n16 Protection for financial information is not limited to economic data generated solely by corporations or other business entities, but rather has been held to apply to personal financial information as well. n17

The second of Exemption 4's specific criteria, that the information be "obtained from a person," is quite easily met in almost all circumstances. The term "person" refers to a wide range of entities, n18 including corporations, banks, state and local governments, and individuals. n19 The reach of Exemption 4 is "sufficiently broad to encompass financial and commercial information concerning a third party" and protection is therefore available regardless of whether the information pertains directly to the commercial interests of the party that provided it -- as is typically the case -- or pertains to the commercial interests of another. n20

The third requirement of Exemption 4 is met if information is "privileged or confidential." Most Exemption 4 litigation has focused on whether information is "confidential" for purposes of Exemption 4. In *National Parks & Conservation Ass'n v. Morton*, n21 the District of Columbia Circuit held that the test for confidentiality was an objective one. n22 Thus, whether information would customarily be disclosed to the public by the person from whom it was obtained was not considered dispositive. n23 Likewise, an agency's promise that information would not be released was not considered dispositive. n24 Instead, the D.C. Circuit declared in *National Parks* that the term "confidential" should be read to protect governmental interests as well as private ones, according to a two-part test under which commercial or financial matter is "confidential" for purposes of the exemption if disclosure of the information is likely to have either of the following effects: (1) to impair the Government's ability to obtain necessary information in the future (the "impairment" prong); or (2) to cause substantial harm to the competitive position of the person from whom the information was obtained (the "competitive harm" prong). n25 Information is "confidential" under the competitive harm prong if disclosure "is likely ... to cause substantial harm to the competitive position of the person from whom the information was obtained." n26 The District of Columbia Circuit has "emphasize[d]" that the "important point for competitive harm in the FOIA context ... is that it be limited to harm flowing from the affirmative use of proprietary information *by competitors*" and that this "should not be taken to mean simply any injury to competitive position, as might flow from customer or employee disgruntlement." n27

In 1992, the D.C. Circuit issued an *en banc* decision in *Critical Mass* reaffirming the *National Parks* test and correcting "some misunderstandings as to [*National Park's*] scope and application." n28 In *Critical Mass*, the court established two distinct standards to be used in determining whether commercial or financial information submitted to an agency is "confidential" under Exemption 4. n29 Specifically, the tests for confidentiality set forth in *National Parks & Conservation Ass'n v. Morton*, n30 were confined "to the category of cases to which [they were] first applied; namely, those in which a FOIA request is made for financial or commercial information a person was obliged to furnish the Government." n31 The D.C. Circuit announced a new test for the protection of information that is "voluntarily"

submitted: Such information is now categorically protected provided it is not "customarily" disclosed to the public by the submitter. n32 The court also emphasized that this categorical test for voluntarily submitted information is "objective" and that the agency invoking it "must meet the burden of proving the provider's custom."

In *Center for Auto Safety v. National Highway Traffic Safety Administration*, the D.C. Circuit rejected the "argument that if a recipient does not assert that a submission is voluntary before submitting" requested information, it has somehow "waived" its ability to assert that the submission was voluntary. n33 In 2001, the District Court for the District of Columbia held that a submission made by a grant recipient was "required" because the agency had by regulation a "right of access" to the documents and therefore "the legal authority to compel" the submission of the information. n34 Moreover, the court found, the letter sent to the grant recipient sufficed as the agency's "exercise" of that authority. n35 In a 1992 case, the District Court for the District of New Jersey found that when a submitter provided documents to agency officials during a meeting concerning its tax status, it did so voluntarily, because "if the submission of the documents were obligatory, there would be a controlling statute, regulation or written order." n36 In the absence of any such "mandate," the court concluded that the submission was voluntary. n37 In a 1996 ruling that has been criticized by some, the Eastern District of Missouri held that a submission was voluntary even though the agency not only had the authority to issue a subpoena for the documents, but had in fact exercised that authority by actually issuing such a subpoena. n38 The court rejected the agency's argument that the issuance of the subpoena rendered the submission "required," finding that that "conclusion ignore[d] the fact that subpoenaed parties may challenge [the subpoena], both administratively and through objections to enforcement proceedings." n39 Although no challenge to the subpoena was actually brought, the court found it "highly likely" that such a challenge would have been successful given the fact that the court had previously ruled that the same documents were privileged and hence did not have to be disclosed to private parties who were in litigation with the submitter. n40 "This," the court declared, "shows that the production in fact was voluntary, not required." n41 For information that is "required" to be submitted to an agency, the District of Columbia Circuit held that the tests for confidentiality originally established in *National Parks & Conservation Ass'n v. Morton* n42 continued to apply. n43

Actual competitive harm need not be demonstrated for purposes of the competitive harm prong; evidence of "actual competition and a likelihood of substantial competitive injury" is sufficient. n44 In assessing whether a submitter would suffer competitive harm, courts have held that "elaborate antitrust proceedings" are not required. n45 On the other hand, mere conclusory allegations of harm are unacceptable. Neither the willingness of the requester to restrict circulation of the information n46 nor a claim by the requester that it is not a competitor of the submitter n47 should logically defeat a showing of competitive harm. n48 The question is whether "public disclosure" would cause harm; there is no "middle ground between disclosure and nondisclosure." n49 The D.C. Circuit has emphasized that it is incumbent upon the courts -- and, logically, upon agencies in the first instance -- to consider whether it is possible to redact requested information "in order to avoid application of Exemption 4." n50 (See the further discussions of this point under Procedural Requirements, "Reasonably Segregable" Obligation, *above*, and Litigation Considerations, "Reasonably Segregable" Requirements, *below*.)

Numerous types of competitive injury have been identified by the courts as properly cognizable under the competitive harm prong, including the harms generally caused by disclosure of: detailed financial information such as a company's assets, liabilities, and net worth; n51 a company's actual costs, break-even calculations, profits and profit rates; data describing a company's workforce which would reveal labor costs, profit margins and competitive vulnerability; n52 a company's selling prices, purchase activity and freight charges; n53 shipper and importer names, type and quantity of freight hauled, routing systems, cost of raw materials, and information constituting the "bread and butter" of a manufacturing company; n54 and type and volume of sales. n55

[b] Exemption 6

Exemption 6 protects those documents for which "disclosure ... would constitute a clearly unwarranted invasion of personal privacy." n56 In determining whether an invasion of privacy is "unwarranted," courts balance an individual's

expectation of privacy and the public's right of inquiry. n57 Exemption 6 has a companion privacy exemption that applies to law enforcement records.

Despite Exemption 6, the SEC sometimes produces to the press personal records in response to FOIA requests. For example, the SEC provided to the *Washington Post* the rolodex of Oded Aboodi, a prominent financier associated with Time Warner, Inc. The *Post* then published a story on the front page of its business section describing Mr. Aboodi's rolodex. n58 As illustrated, parties should be aware that Exemption 6 cannot be relied upon to shield all personal records from disclosure.

[c] Exemption 7

Exemption 7 protects investigatory records -- records that are compiled for law enforcement purposes, the release of which would result in any of six specified harms. n59 For example, under Exemption 7(A), the SEC does not have to disclose documents that "could reasonably be expected to interfere with enforcement proceedings." n60 This exemption has been held to protect investigatory records as long as enforcement proceedings are pending or are a concrete possibility. n61 Even when the SEC terminates an investigation that is directly responsible for the generation or acquisition of the requested material, the SEC can and does invoke Exemption 7(A) when it believes that the information in question may be used in future investigations. n62 Similarly, the SEC may withhold information that was originally generated for purposes unrelated to law enforcement so long as it is being used for a law enforcement purpose at the time that the government invokes the exemption. n63 The SEC routinely relies on this exception in resisting FOIA requests seeking documents relating to an ongoing investigation.

Under Exemption 7(C), the SEC need not disclose information that "could reasonably be expected to constitute an unwarranted invasion of personal privacy." n64 In *SafeCard Services, Inc. v. SEC*, the SEC successfully withheld the identities of certain individuals under this exemption. n65 In that case, the company sought certain documents relating to the SEC's investigation into the manipulation of SafeCard stock. The SEC deleted from certain documents the names and addresses of certain third parties. SafeCard sought access to the names and addresses of potential witnesses or litigants in the SEC's stock manipulation investigation, claiming this would provide SafeCard and the public with insight into the SEC's conduct with respect to SafeCard in particular, and shortselling practices in general. n66

The court held that privacy protection afforded by Exemption 7(C) involved a balancing between the privacy interest and the public interest identified by SafeCard in disclosure. n67 Applying this test, the court found the public interest identified by SafeCard was insubstantial when compared to the grave potential harm of exposing persons as targets of an investigation. n68 The court went on to hold that unless the addresses of private individuals appearing in files within the ambit of Exemption 7(C) were necessary to confirm or refute compelling evidence that the agency was engaged in illegal activity, such information would be exempt from disclosure. n69 This protection extends to the conclusion of all law enforcement proceedings, when the companion privacy exemption of 7(C) might be available even when the privacy protection of Exemption 6 is not.

FOOTNOTES:

(n1)Footnote 1. *5 U.S.C § 552*. See also THOMAS C. PAPON & CHARLOTTE D. YOUNG, BUSINESS USES OF THE FREEDOM OF INFORMATION ACT, 14-2nd C.P.S. (BNA).

(n2)Footnote 2. The procedures for submitting an FOIA request to the SEC are available at www.sec.gov/foia/howfo2.htm.

(n3)Footnote 3. The recognized exemptions protect documents that: 1) are properly classified as secret in the interest of national defense or foreign policy; 2) relate solely to internal personnel rules and practices; 3) are specifically exempted by other statutes; 4) are trade secrets or privileged or confidential commercial or financial information obtained from an individual; 5) are privileged inter-agency or intra-agency memoranda or letters; 6) contain personnel,

medical or similar information, the release of which would constitute a clearly unwarranted invasion of personal privacy; 7) are compiled for law enforcement purposes (discussed further in the text); 8) are contained in or related to examination, operating, or condition reports about financial institutions that the SEC regulates or supervises; or 9) contain exempt information about gas or oil wells. *See* 5 U.S.C.S. § 552(b)(1)-(9).

(n4)Footnote 4. The guide can be found at www.usdoj.gov/oip/foi-act.htm.

(n5)Footnote 5. 5 U.S.C.S. § 552(b)(4) (2000).

(n6)Footnote 6. *See* Attorney General's Memorandum for Heads of All Federal Departments and Agencies Regarding the Freedom of Information Act (Oct. 12, 2001), *reprinted in FOIA Post* (posted 10/15/01) (recognizing fundamental societal value of "protecting sensitive business information").

(n7)Footnote 7. 704 F.2d 1280, 1288 (D.C. Cir. 1983) .

(n8)Footnote 8. 704 F.2d 1280, 1288 (D.C. Cir. 1983) .

(n9)Footnote 9. 704 F.2d 1280, 1288 , *accord*; *Center For Auto Safety v. National Highway Traffic Safety Admin*, 244 F.3d 144, 150-151 (D.C. Cir. 2001) (reiterating the *Public Citizen* definition and emphasizing that it "narrowly cabins trade secrets to information relating to the 'productive process' itself").

(n10)Footnote 10. *See, e.g., Herrick v. Garvey*, 200 F. Supp. 2d 1321, 1326 (D. Wyo. 2000) ("technical blueprints depicting the design, materials, components, dimensions and geometry of " 1935 aircraft (quoting agency declaration)), *aff'd*, 298 F.3d 1184, 1190 n.3 (10th Cir. 2002) (noting requester's concession at oral argument that blueprints remained commercially valuable); *Heeney v. FDA*, No. 97-5461, 1999 U.S. Dist. LEXIS 23365, *19 n.13 (C.D. Cal. Mar. 18, 1999) ("compliance testing" and "specification of the materials used in constructing" electrode catheter), *aff'd*, 7 Fed. Appx. 770 (9th Cir. 2001) ; *Sokolow v. FDA*, No. 1:97-CV-252, slip op. at 7 (E.D. Tex. Feb. 19, 1998) (description of how drug is manufactured, including "analytical methods employed to assure quality and consistency" and "results of stability testing"), *aff'd*, 162 F.3d 1160 (5th Cir. 1998) (unpublished table decision).

(n11)Footnote 11. *See Center for Auto Safety*, 244 F.3d at 151 (airbag characteristics relating "only to the end product -- what features an airbag has and how it performs -- rather than to the production process"); *Northwest Coalition for Alternatives to Pesticides v. Browner*, 941 F. Supp. 197, 201-202 (D.D.C. 1996) ("common names and Chemical Abstract System ... numbers of the inert ingredients" contained in pesticide formulas).

(n12)Footnote 12. *Herrick v. Garvey*, 298 F.3d 1184, 1194, n.10 (10th Cir. Wyo. 2002) (distinguishing the facts of the case before it, and upholding trade secret protection nonetheless, based upon the subsequent revocation of that permission and the requester's failure to challenge both whether such revocation could legally operate to "restore the secret nature of the documents" and, if so, whether such revocation could properly be made after the documents had been requested under the FOIA).

(n13)Footnote 13. *See, e.g., Gulf & W. Indus. v. United States*, 615 F.2d 527, 529 (D.C. Cir. 1979) ; *Consumers Union v. VA*, 301 F. Supp. 796, 802 (S.D.N.Y. 1969) , *appeal dismissed*, 436 F.2d 1363 (2d Cir. 1971) .

(n14)Footnote 14. *See, e.g., Dow Jones Co. v. FERC*, 219 F.R.D. 167, 176 (C.D. Cal. 2002) (information relating "to business decisions and practices regarding the sale of power, and the operation and maintenance" of generators (quoting agency declaration)); *Merit Energy Co. v. United States Dep't of the Interior*, 180 F. Supp. 2d 1184, 1188 (D. Colo. 2001) ("information regarding oil and gas leases, prices, quantities and reserves"), *appeal dismissed*, No. 01-1347 (10th Cir. Sept. 4, 2001); In *Def. of Animals v. HHS*, No. 99-3024, 2001 U.S. Dist. LEXIS 24975, *28 (D.D.C. Sept. 28, 2001) (letter detailing "financial situation" of private primate research facility); *Lepelletier v. FDIC*, 977 F. Supp. 456, 459 (D.D.C. 1997) , *aff'd in part, rev'd in part*, 164 F.3d 37 (D.C. Cir. 1999) ; *Cohen v. Kessler*, No. 95-6140, slip op. at 9 (D.N.J. Nov. 25, 1996) ("rat study's raw data" submitted to support application for approval of new animal drug);

Bangor Hydro-Elec. Co. v. United States Dep't of the Interior, No. 94-0173-B, slip op. at 7 (D. Me. Apr. 18, 1995) ("information relating to proposed [land] usage charges"); *Allnet Communication Servs. v. FCC*, 800 F. Supp. 984, 987 (D.D.C. 1992) (software "output data and reports and extensive descriptive and instructional materials"), *aff'd*, 1994 U.S. App. LEXIS 40831 (D.C. Cir. May 27, 1994) ; *RMS Indus. v. DOD*, No. C-92-1545, slip op. at 6 (N.D. Cal. Nov. 24, 1992) ("interim pricing, type and quality of machines owned" and names and background of key employees and suppliers); *M/A-COM Info. Sys. v. HHS*, 656 F. Supp. 691, 692 (D.D.C. 1986) (settlement negotiation documents reflecting "accounting and other internal procedures").

(n15)Footnote 15. *Public Citizen Health Research Group v. FDA*, 704 F.2d 1280, 1290 (D.C. Cir. 1983) (citing *Washington Post Co. v. HHS*, 690 F.2d 252, 266 (D.C. Cir. 1982) , and *Board of Trade v. Commodity Futures Trading Comm'n*, 627 F.2d 392, 403 (D.C. Cir. 1980)) ; *accord Judicial Watch, Inc. v. Export-Import Bank*, 108 F. Supp. 2d 19, 28 (D.D.C. 2000) (finding export-insurance applications containing detailed information on goods and customers to be "commercial or financial"); *Brockway v. Department of the Air Force*, 370 F. Supp. 738, 740 (N.D. Iowa 1974) (concluding that reports generated by commercial enterprise "must generally be considered commercial information"), *rev'd on other grounds*, 518 F.2d 1184 (8th Cir. 1975) .

(n16)Footnote 16. *American Airlines, Inc. v. National Mediation Bd.*, 588 F.2d 863, 870 (2d Cir. 1978) .

(n17)Footnote 17. *See Washington Post*, 690 F.2d at 266 .

(n18)Footnote 18. *See, e.g., Nadler v. FDIC*, 92 F.3d 93, 95 (2d Cir. 1996) (term "person" includes " 'an individual, partnership, corporation, association, or public or private organization other than an agency' " (quoting definition found in Administrative Procedure Act, 5 U.S.C.S. § 551(2) (2000))); *Dow Jones Co. v. FERC*, 219 F.R.D. 167, 176 (C.D. Cal. 2002) (same).

(n19)Footnote 19. *See, e.g., FlightSafety Servs. v. Dep't of Labor*, 326 F.3d 607, 611 (5th Cir. 2003) (per curiam) (business establishments); *Stone v. Exp.-Imp. Bank*, 552 F.2d 132, 137 (5th Cir. 1977) (foreign government agency); *Flathead Joint Bd. of Control v. United States Dep't of the Interior*, 309 F. Supp. 2d 1217, 1221 (D. Mont. 2004) (Indian tribes (citing *Indian Law Res. Ctr. v. Dep't of the Interior*, 477 F. Supp. 144, 146 (D.D.C. 1979) (holding that an Indian tribe, "as a corporation that is not part of the Federal Government, is plainly a person within the meaning of the Act"))) (appeal pending); *Lepelletier v. FDIC*, 977 F. Supp. 456, 459 (D.D.C. 1997) , *aff'd in part, rev'd in part*, 164 F.3d 37 (D.C. Cir. 1999) ; *Hustead v. Norwood*, 529 F. Supp. 323, 326 (S.D. Fla. 1981) (state government).

(n20)Footnote 20. *Board of Trade v. Commodity Futures Trading Comm'n*, 627 F.2d 392, 405 (D.C. Cir. 1980) (holding that the "plain language" of Exemption 4 "does not in any way suggest that" the requested information "must relate to the affairs of the provider"); *accord Critical Mass Energy Project v. NRC*, 830 F.2d 278, 281 (D.C. Cir. 1987) , *vacated on other grounds*, 975 F.2d 871 (D.C. Cir. 1992) .

(n21)Footnote 21. 498 F.2d 765 (D.C. Cir. 1974) .

(n22)Footnote 22. 498 F.2d at 766 .

(n23)Footnote 23. 498 F.2d at 767 .

(n24)Footnote 24. *See Washington Post Co. v. HHS*, 690 F.2d 252, 268 (D.C. Cir. 1982) (citing *National Parks*, 498 F.2d at 766).

(n25)Footnote 25. 498 F.2d at 770 .

(n26)Footnote 26. 498 F.2d at 770 .

(n27)Footnote 27. *Public Citizen Health Research Group v. FDA*, 704 F.2d 1280, 1291 n.30 (D.C. Cir. 1983)

(quoting Mark Q. Connelly, *Secrets and Smokescreens: A Legal and Economic Analysis of Government Disclosures of Business Data*, 1981 *Wis. L. Rev.* 207, 235-236); accord *CNA Fin. Corp. v. Donovan*, 830 *F.2d* 1132, 1152 & n.158 (D.C. Cir. 1987) (reiterating "policy behind Exemption 4 of protecting submitters from external injury" and rejecting submitter objections that did "not amount to 'harm flowing from the affirmative use of proprietary information by competitors' " (quoting *Public Citizen*, 704 *F.2d* at 1291 n.30)) (reverse FOIA suit). *But see McDonnell Douglas Corp. v. NASA*, 180 *F.3d* 303, 306-307 (D.C. Cir. 1999) (accepting as legally valid -- without any reference to D.C. Circuit precedent apparently to the contrary -- submitter's claim that disclosure of government contract prices would cause submitter harm by permitting its "commercial customers to bargain down ('ratchet down') its prices more effectively") (reverse FOIA suit), *reh'g en banc denied*, No. 98-5251, slip op. at 2 (D.C. Cir. Oct. 6, 1999) (Silberman, J., concurring) (attempting to explain the panel's acceptance of the submitter's claim by opining that "[o]ther than in a monopoly situation anything that undermines a supplier's relationship with its customers must necessarily aid its competitors"), *dismissed as moot on motion for entry of judgment*, 102 *F. Supp. 2d* 21 (D.D.C.), *reconsideration denied*, 109 *F. Supp. 2d* 27 (D.D.C. 2000) .

(n28)Footnote 28. 975 *F.2d* 871, 875 (D.C. Cir. 1992) .

(n29)Footnote 29. 975 *F.2d* 871, 879 (D.C. Cir. 1992) .

(n30)Footnote 30. 498 *F.2d* 765, 770 (D.C. Cir. 1974) .

(n31)Footnote 31. *Critical Mass*, 975 *F.2d* at 880.

(n32)Footnote 32. 975 *F.2d* at 879 ; accord *Center for Auto Safety v. National Highway Traffic Safety Admin.*, 244 *F.3d* 144, 147-148 (D.C. Cir. 2001) (emphasizing that there are two distinct standards to be used in determining confidentiality under Exemption 4, depending on whether information is provided on a "mandatory" or a "voluntary" basis); *Bartholdi Cable Co. v. FCC*, 114 *F.3d* 274, 281 (D.C. Cir. 1997) (reiterating that "[t]he test for whether information is 'confidential' depends in part on whether the information was voluntarily or involuntarily disclosed to the government") (non-FOIA case brought under Administrative Procedure Act, 5 *U.S.C.S.* § 706 (2000)).

(n33)Footnote 33. *Center For Auto Safety*, 244 *F.3d* at 148 .

(n34)Footnote 34. In *Def.*, No. 99-3024, 2001 *U.S. Dist. LEXIS* 24975, (D.D.C. Sept. 28, 2001) .

(n35)Footnote 35. In *Def.*, No. 99-3024, 2001 *U.S. Dist. LEXIS* 24975 (D.D.C. Sept. 28, 2001) .

(n36)Footnote 36. *AGS Computers, Inc. v. United States Dep't of Treasury*, No. 92-2714, 1993 *U.S. Dist. LEXIS* 21445, (D.N.J. Sept. 16, 1993) .

(n37)Footnote 37. *AGS Computers, Inc. v. United States Dep't of Treasury*, 1993 *U.S. Dist. LEXIS* 21445, at *9-10 .

(n38)Footnote 38. *McDonnell Douglas Corp. v. EEOC*, 922 *F. Supp.* 235, 242 (E.D. Mo. 1996) (reverse FOIA suit), *appeal dismissed*, No. 96-2662 (8th Cir. Aug. 29, 1996).

(n39)Footnote 39. *McDonnell Douglas Corp. v. EEOC*, 922 *F. Supp.* 235, 242 (E.D. Mo. 1996) (reverse FOIA suit), *appeal dismissed*, No. 96-2662 (8th Cir. Aug. 29, 1996).

(n40)Footnote 40. *McDonnell Douglas Corp. v. EEOC*, 922 *F. Supp.* 235, 242 (E.D. Mo. 1996) (reverse FOIA suit), *appeal dismissed*, No. 96-2662 (8th Cir. Aug. 29, 1996).

(n41)Footnote 41. *McDonnell Douglas Corp. v. EEOC*, 922 *F. Supp.* 235, 242 (E.D. Mo. 1996) (reverse FOIA suit), *appeal dismissed*, No. 96-2662 (8th Cir. Aug. 29, 1996).

(n42)Footnote 42. *498 F.2d 765, 770 (D.C. Cir. 1974)* .

(n43)Footnote 43. *See Critical Mass Energy Project v. NRC, 975 F.2d 871, 880 (D.C. Cir. 1992) (en banc)*.

(n44)Footnote 44. *CNA Fin. Corp. v. Donovan, 830 F.2d 1132, 1152 (D.C. Cir. 1987)* ; *accord Frazee v. United States Forest Serv., 97 F.3d 367, 371 (9th Cir. 1996)* (reverse FOIA suit); *GC Micro Corp. v. Def. Logistics Agency, 33 F.3d 1109, 1113 (9th Cir. 1994)* ; *Gulf & W. Indus. v. United States, 615 F.2d 527, 530 (D.C. Cir. 1979)* . *See, e.g., National Broadcasting Company v. United States Small Business Admin. 836 F. Supp. 121, 124 n.3 (S.D.N.Y. 1993)* (noting that agency "should have provided more details" regarding possible competitive harm, but ruling nonetheless that generalized sworn declaration from submitter was sufficient); *HLI Lordship Indus. v. Commission For Purchase from the Blind & Other Severely Handicapped, 663 F. Supp. 246, 251 (E.D. Va. 1987)* (concluding that competitive harm was likely, based upon fact that requester, who was a competitor of the submitter, had requested confidential treatment for its own similar submission).

(n45)Footnote 45. *National Parks & Conservation Ass'n v. Kleppe, 547 F.2d 673, 681 (D.C. Cir. 1976)* ; *accord GC Micro, 33 F.3d at 1115* ("law does not require [agency] to engage in a sophisticated economic analysis of the substantial competitive harm ... that might result from disclosure"); *Public Citizen, 704 F.2d at 1291* .

(n46)Footnote 46. *See Seawell, Dalton, Hughes & Timms v. Export-Import Bank, No. 84-241, slip op. at 2 (E.D. Va. July 27, 1984)*. *Cf. Schiffer v. FBI, 78 F.3d 1405, 1411 (9th Cir. 1996)* ("limited access" to exempt records, subject to protective order, "not authorized by FOIA") (Exemption 7(C) case).

(n47)Footnote 47. *See, e.g., Burke Energy Corp. v. Dep't of Energy for the United States, 583 F. Supp. 507, 512 (D. Kan. 1984)* (characterizing the requester's "argument that it is not a competitor" as "totally without merit").

(n48)Footnote 48. *See Heeney, No. 97-5461, 1999 U.S. Dist. LEXIS 23365, *19 (C.D. Cal. Mar. 18, 1999)* (explaining that the "identity of the requester is irrelevant ... because once information has been released -- even to a private, noncompeting individual such as [this particular requester] -- the information has reached the public domain and cannot be withheld from subsequent requesters"). *Cf. Nat'l Archives & Records Admin. v. Favish, 541 U.S. 157, 124 S. Ct. 1570, 1580, 158 L. Ed. 2d 319 (2004)* (re-emphasizing that "[a]s a general rule, if the information is subject to disclosure, it belongs to all").

(n49)Footnote 49. *Seawell, No. 84-241, slip op. at 2 (E.D. Va. July 27, 1984)*.

(n50)Footnote 50. *Trans-Pac. Policing Agreement v. United States Customs Serv., 177 F.3d 1022, 1029 (D.C. Cir. 1999)* (holding that although "[t]here is certainly no doubt" that Exemption 4 was properly applied to a ten-digit customs code, a remand was necessary to determine whether "disclosure of redacted [codes] poses a likelihood of substantial harm"). *See also, e.g., FlightSafety Servs. v. Dep't of Labor, 326 F.3d 607, 613 (5th Cir. 2003)* (per curiam) (adjudicating the requester's contention that the agency "should be required to redact any uniquely identifying private company descriptives, and disclose the remainder of" the requested statistics regarding salary and wage data, and finding, after an "independent review" of the documentation submitted in camera, that "any disclosable information is so inextricably intertwined with the exempt, confidential information that producing it would require substantial agency resources and produce a document of little informational value"); *Public Citizen v. FDA, 185 F.3d 898, 907* (remanding to determine "whether the documents the agency has withheld contain information that can be segregated and disclosed"); *Judicial Watch, Inc. v. United States Dep't of Commerce, 83 F. Supp. 2d 105, 111 (D.D.C. 1999)* (deferring ruling on applicability of Exemption 4, despite finding that the affidavits "appear to support the withholding" of the documents, because they failed to provide enough detail "to permit the Court to conclude that documents withheld in their entirety do not contain any reasonably segregable information").

(n51)Footnote 51. *See, e.g., National Parks, 547 F.2d at 684* ; *Inner City Press/Cmty. on the Move v. Board of Governors of the Fed. Reserve Sys., No. 98-4608, 1998 U.S. Dist. LEXIS 15333, at *14 (S.D.N.Y. Sept. 30, 1998)* ("capital situation, [company's] assets, cash flow, investments, leverage ratios, 'cross-selling strategy,' pre-tax earnings

by product line, dividend capacity, revenues, and rate changes for its insurance operations"), *aff'd*, 182 F.3d 900 (2d Cir. 1999) (unpublished table decision).

(n52)Footnote 52. *See, e.g., Westinghouse Elec. Corp. v. Schlesinger*, 392 F. Supp. 1246, 1249 (E.D. Va. 1974) , *aff'd*, 542 F.2d 1190 (4th Cir. 1976) .

(n53)Footnote 53. *See, e.g., Braintree Electric Light Dep't v. Department of Energy*, , 494 F. Supp. 287, 289 (D.D.C. 1980) . *See also Destileria Serralles, Inc. v. Dep't of the Treasury*, No. 85-0837, slip op. at 9 (D.P.R. Sept. 22, 1988) (purchase records, including prices paid for advertising).

(n54)Footnote 54. *Journal of Commerce, Inc. v. United States Dep't of the Treasury*, No. 86-1075, 1988 U.S. Dist. LEXIS 17610, at *9-10 (D.D.C. Mar. 30, 1988) , *aff'd*, 878 F.2d 1446 (Fed. Cir. 1989) (unpublished table decision).

(n55)Footnote 55. *Lion Raisins Inc. v. USDA*, 354 F.3d 1072, 1081 (9th Cir. 2004) .

(n56)Footnote 56. *See 5 U.S.C.S. § 552(b)(6)*.

(n57)Footnote 57. *See Dep't of the Air Force v. Rose*, 425 U.S. 352, 96 S. Ct. 1592, 48 L. Ed. 2d 11 (1976) (noting that Congress intended a balancing test when applying Exemption 6).

(n58)Footnote 58. *See Benjamin Weiser, When a Life Is in the Cards -- Rolodex Given to SEC Offers a Peek at Enigmatic Dealmaker Oded Aboodi*, Wash. Post. Oct. 21, 1994, at B1, B3.

(n59)Footnote 59. Specifically, FOIA exempts disclosure of documents that are compiled for law enforcement purposes, the release of which a) could reasonably be expected to interfere with law enforcement proceedings; b) would deprive a person of the right to a fair trial or an impartial adjudication; c) could reasonably be expected to constitute an unwarranted invasion of privacy; d) could reasonably be expected to disclose the identity of a confidential source; e) would disclose techniques, procedures, or guidelines for investigations or prosecutions; or f) could reasonably be expected to endanger an individual's life or physical safety. 5 U.S.C.S. § 552(b)(7)(A-F).

(n60)Footnote 60. 5 U.S.C.S. § 552(b)(7)(A).

(n61)Footnote 61. *See NLRB v. Robbins Tire & Rubber Co.*, 437 U.S. 214 (1978) ; *Parker/Hunter, Inc. v. SEC*, 1981 U.S. Dist. LEXIS 14557, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,279, at 91,778-779 (D.D.C. Apr. 26, 1981). *See also Belair, above n.5*, at 19.

(n62)Footnote 62. *See Belair, above n.5*, at 19.

(n63)Footnote 63. *See John Doe Agency v. John Doe Corp.*, 493 U.S. 146 (1989) ; *Crowell & Moring v. Department of Defense*, 703 F. Supp. 1004, 1010 (D.D.C. 1989) .

(n64)Footnote 64. 5 U.S.C.S. § 552(b)(7)(C).

(n65)Footnote 65. *SafeCard Servs., Inc. v. SEC*, 926 F.2d 1197 (D.C. Cir. 1991) .

(n66)Footnote 66. *SafeCard Servs., Inc.*, 926 F.2d at 1205 .

(n67)Footnote 67. *SafeCard Servs., Inc.*, 926 F.2d at 1205 .

(n68)Footnote 68. *Safecard Servs., Inc.*, 926 F.2d at 1205 . The court notes that irreparable harm could be done to one's reputation were such disclosure to be allowed.

(n69)Footnote 69. *SafeCard Servs., Inc.*, 926 F.2d at 1205-1206 .



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CHAPTER 15 DISCOVERY OF INFORMATION FROM THE SECURITIES AND EXCHANGE COMMISSION

1-15 Securities Enforcement: Counseling and Defense § 15.02

AUTHOR: Kenneth B. Winer

§ 15.02 Procedure for Asserting an Exemption from FOIA

The SEC has promulgated regulations implementing FOIA. n1 When producing documents to the SEC that are arguably entitled to confidential treatment for the purpose of the act, the producing person should request confidential treatment for those documents. The regulations provide that the person requesting confidential treatment should take:

... all steps reasonably necessary to ensure, as nearly as practicable, that at the time the information is first received by the Commission (i) it is supplied segregated from information for which confidential treatment is not being requested, (ii) it is appropriately marked as confidential, and (iii) it is accompanied by a written request for confidential treatment which specifies the information as to which confidential treatment is requested. n2

The regulations further provide that:

A person who submits a record to the Commission for which he or she seeks confidential treatment must clearly mark each page or segregable portion of each page with the words "Confidential Treatment Requested by [name]" and an identifying number and code, such as a Bates-stamped number. In his or her written confidential treatment request, the person must refer to the record by identifying number and code. n3

The written request for confidential treatment should be sent to the Staff member receiving the materials in question and to the SEC's FOIA officer. The written request should be clearly and prominently identified on the envelope or other cover and on the top of the first page by the legend "FOIA Confidential Treatment Request," and should contain the name, address, and telephone number of the person requesting confidential treatment. n4 If counsel requests confidential treatment on behalf of the client, the request should identify the client, and provide a telephone number and address for the client or the responsible representative of the client. n5

In addition to submitted documents, the SEC regulations also provide a mechanism for requesting confidential treatment for transcripts of SEC testimony. Specifically, the regulations provide that the witness should inform the Staff member taking the testimony, at the time the information is submitted or as soon thereafter as possible, that he or she is requesting confidential treatment for the information. The witness should then follow up by submitting a written request

for confidential treatment within 30 days of giving the testimony. n6

The SEC does not make a determination regarding the applicability of claimed exemptions when the material is submitted. Only after it receives a FOIA request for the confidential material will the SEC make such a determination. n7

If the documents for which confidential treatment has been requested are requested pursuant to FOIA, and there is no other ground for denying the FOIA request, the SEC will notify the person who requested the confidential treatment and provide an opportunity to submit substantiation in support of the claimed exemptions. One commentator has recommended that a person take the following steps before submitting substantiation to the SEC:

First, he should immediately seek a copy of the FOIA request, as well as the SEC's response to the request. Both the FOIA request and the SEC's initial response are nonexempt, and should be made available... . The SEC customarily requires submitters to file an FOIA request for the FOIA request and response. The SEC, however, will usually make the FOIA request available promptly, sometimes even within one day.

Second, the submitter should insist that the SEC provide him with an identification of every document containing information received from the submitter that the SEC believes to be responsive to the FOIA request. Without such an identification, the submitter runs the risk that his substantiation will fail to address all of the affected documents. The SEC's FOIA staff usually will agree to meet with the submitter or the submitter's counsel in order to identify all responsive records, and discuss the submitter's potential exemption claims.

Third, the submitter should not hesitate to request an extension of time in which to submit the substantiation. Many submitters find that ten calendar days is an inadequate amount of time in which to prepare a substantiation. The SEC customarily will grant extension requests that seek two or three additional weeks. n8

The SEC FOIA officer will then initially determine whether the information is protected by an exemption. If the FOIA officer determines that the information is not protected, the SEC will provide the submitter with written notice of that determination and an explanation of the reasons for its determination. Submitters then have 10 calendar days from the date of the notice to appeal this determination to the general counsel of the SEC. n9

The cost of protecting information from FOIA requests is borne primarily by the person who submitted the information and seeks to protect it. While the SEC theoretically has the burden of sustaining its action when it denies a FOIA request, in practice the SEC relies on the interested private party to appear in court and bear the expense of establishing that an exemption applies. n10

Comment

Documents that an agency has returned to the producing party are not "agency records," and need not be produced pursuant to the act. n11

Because of the risk that sensitive materials produced to the Staff will become available to third parties, it is sometimes appropriate, and the Staff will sometimes agree, to work out an arrangement that will provide the Staff with the information that it believes is necessary while protecting the interests of the company producing the information. For example, if the SEC initially requests the documents reflecting transactions with a company's most valued customers, the Staff might agree to an arrangement in which the documents are made available for inspection at the offices of company's counsel located in the same city as the Staff assigned to the investigation. Thus, the records never come into the possession of the agency, and so never become "agency records" for purposes of FOIA. n12

FOOTNOTES:

(n1)Footnote 1. *See* 17 C.F.R. § 200.83. The procedures are discussed in *Confidential Treatment Procedures Under FOIA, Securities Act Release No. 6241, 1980 SEC LEXIS 718, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,652 (Sept. 12, 1980).*

(n2)Footnote 2. 17 C.F.R. § 200.83(c)(1).

(n3)Footnote 3. 17 C.F.R. § 200.83(c)(2).

(n4)Footnote 4. 17 C.F.R. § 200.83(c)(3).

(n5)Footnote 5. 17 C.F.R. § 200.83(c)(5).

(n6)Footnote 6. 17 C.F.R. § 200.83(c)(4).

(n7)Footnote 7. 17 C.F.R. § 200.83(c)(6).

(n8)Footnote 8. *See* Robert R. Belair, *SEC FOIA Paractice*, 23 Rev. of Sec. and Commodities Reg., at 21 n. 5 (1990).

(n9)Footnote 9. 17 C.F.R. § 200.83(e)(1).

(n10)Footnote 10. *See* James H. Schropp, *Stronger Protection for Business Information Produced in SEC Investigations*, Insights, Jan. 1993, at 27 n. 9.

(n11)Footnote 11. *See Kissinger v. Reporters Comm. For Freedom of the Press, 445 U.S. 136 (1980)* (stating that for purposes of FOIA, an agency cannot withhold records that it does not have in its possession).

(n12)Footnote 12. *See Forsham v. Harris, 445 U.S. 169 (1980)* ("Written data generated, owned, and possessed by a privately controlled organization receiving federal study grants are not 'agency records' within the meaning of the Act when copies of those data have not been obtained by a federal agency subject to the FOIA.").



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CHAPTER 15 DISCOVERY OF INFORMATION FROM THE SECURITIES AND EXCHANGE COMMISSION

1-15 Securities Enforcement: Counseling and Defense § 15.03

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§ 15.03 Discovery Requests Directed to the SEC

Like private litigants, the SEC often challenges discovery requests by asserting that the requested information is privileged. The protections commonly relied on by the SEC in denying discovery requests include the attorney-client privilege, attorney work-product immunity, and the deliberative process privilege. The law enforcement investigatory privilege may also be invoked when defendants seek materials relating to the SEC's investigations.

[1] Deliberative Process Privilege

The SEC often asserts the deliberative process privilege. The privilege has been developed by the courts to protect the confidentiality of the decision-making process of government agencies. n1 In order to gain the protection of the privilege, the material at issue must have been generated before the adoption of the agency policy or decision and it must reflect the give-and-take of the deliberative process. n2 Accordingly, protected documents are limited to predecisional drafts, opinions, recommendations or reports that were prepared in conjunction with an agency's decision-making process. n3

The agency has the burden of demonstrating how the documents fit into the decision-making process in a manner that makes them predecisional, directly related, and thus exempt. n4 Documents that have been expressly adopted by the agency or that in effect are final decisions are not exempt. In addition, the deliberative process is generally inapplicable to purely factual matters, or to factual sections of deliberative memoranda, unless the facts are "inextricably intertwined" with deliberative material. The deliberative process privilege does not apply to post-decisional explanatory documents.

[2] Law Enforcement Investigatory Privilege

The SEC may also assert the law enforcement investigatory privilege in attempting to withhold documents from production in a civil suit. As a threshold matter, the government must properly raise the privilege by complying with three requirements: 1) there must be a formal claim of privilege by the head of the department having control over the requested information; 2) assertion of the privilege must be based on actual personal consideration by that official; and 3) the information for which the privilege is claimed must be specified, with an explanation why it properly falls within the scope of the privilege. n5

Although the privilege is a valid bar to discovery, it is not an absolute bar: public interest in favor of nondisclosure has to be balanced against the litigant's need for access to the privileged information. n6 The process of identifying and weighing the competing interests requires consideration of ten factors, which are: 1) the extent to which disclosure will thwart governmental law enforcement activity; 2) the interest of those who have given information in maintaining confidentiality; 3) the chilling effect disclosure will have on governmental procedures; 4) whether the information sought is factual or evaluative; 5) the identity of the party seeking the discovery (is he or she an actual or potential defendant in proceedings arising from the investigation); 6) the status of the investigation; 7) the possibility that interdepartmental disciplinary proceedings will result from the investigation; 8) whether the requesting party's suit is brought in good faith; 9) the availability of information from other sources; and 10) the importance of the information to the requesting party's case. n7

FOOTNOTES:

(n1)Footnote 1. *See Covington & Burling v. Food & Nutrition Serv. of the U.S. Dep't of Agriculture*, 744 F. Supp 314, 318 (D.D.C. 1990) .

(n2)Footnote 2. *See Covington & Burling v. Food & Nutrition Serv. of the U.S. Dep't of Agriculture*, 744 F. Supp 314, 318-319 (D.D.C. 1990) .

(n3)Footnote 3. *See Covington & Burling v. Food & Nutrition Serv. of the U.S. Dep't of Agriculture*, 744 F. Supp 314, 318-319 (D.D.C. 1990) .

(n4)Footnote 4. *See Covington & Burling v. Food & Nutrition Serv. of the U.S. Dep't of Agriculture*, 744 F. Supp 314, 318-319 (D.D.C. 1990) .

(n5)Footnote 5. *In re Sealed Case*, 856 F.2d 268 (D.C. Cir. 1988) .

(n6)Footnote 6. *In re Sealed Case*, 856 F.2d 268 (D.C. Cir. 1988) . (citing *Friedman v. Bache Halsey Stuart Shields, Inc.*, 738 F.2d 1336, 1341 (D.C. Cir. 1984) .

(n7)Footnote 7. *In re Sealed Case*, 856 F.2d 268 (D.C. Cir. 1988) . (citing *Frankenhauser v. Rizzo*, 59 F.R.D. 339 (E.D. Pa. 1973)) .



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CHAPTER 16 THE SEC WELLS PROCESS

1-16 Securities Enforcement: Counseling and Defense 16.syn

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§ 16.syn Synopsis to Chapter 16: THE SEC WELLS PROCESS

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Securities Enforcement: Counseling and Defense

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CHAPTER 16 THE SEC WELLS PROCESS

1-16 Securities Enforcement: Counseling and Defense § 16.01

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§ 16.01 Introduction

Towards the conclusion of each investigation, the SEC Staff typically makes a preliminary decision regarding whether to recommend that the Commissioners authorize an enforcement action against any individual or entity ("prospective defendant"). Before making such a recommendation, the SEC Staff typically notifies each prospective defendant of the Staff's preliminary decision and offers each prospective defendant an opportunity to file a document commonly referred to as a "Wells Submission," after John A. Wells, who chaired the Advisory Committee on Enforcement Policies and Practices (known as the Wells Committee) in 1972. n1 The Wells Committee recommended that the Commission reflect in a rule or published release the then-existing practice by which experienced SEC defense attorneys conferred with the Staff in order to learn the Staff's view of the facts and the nature of the alleged violations. The Committee recommended that this rule or release detail the practice by which these defense attorneys submitted a written rebuttal to the Staff's position, which the Staff then forwarded to the Commission with the Staff memorandum recommending an enforcement action.

In response to recommendations made by the Wells Committee, the Commission published Securities Act Release No. 5310, *Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*, a copy of which the Staff routinely makes available to all witnesses prior to testimony. n2 In the Release, the Commission expressed its agreement with the objective "to place before the Commission prior to the authorization of an enforcement proceeding, the contentions of both its staff and the adverse party concerning the facts and circumstances which form the basis for the staff recommendation." n3 The Release gave the Staff discretion to advise prospective defendants of the indicated violations and allow the prospective defendants to submit to the Staff a written statement setting forth their "interests and position." As described in the Commission's rules, if the Staff recommends that the Commission authorize an enforcement action, the Staff must forward the submission to the Commission with the Staff's recommendation memorandum:

Persons who become involved in preliminary or formal investigations may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation. Upon request, the Staff, in its discretion, may advise such persons of the general nature of the investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a Staff recommendation to the Commission for the commencement of

an administrative or injunction proceeding. Submissions by interested persons should be forwarded to the appropriate Division Director or Regional Director, with a copy to the staff members conducting the investigation and should be clearly referenced to the specific investigation to which they relate. In the event a recommendation for the commencement of an enforcement proceeding is presented by the Staff, any submissions by interested persons will be forwarded to the Commission in conjunction with the Staff memorandum. n4

In the Wells Submission, the prospective defendant can make factual, legal, and policy arguments as to why it would be inappropriate for the Commission to bring the contemplated enforcement action. The Wells process is often one of the most critical phases in an SEC investigation and provides a valuable opportunity to persuade the Staff or the Commission that the Staff's understanding of the matter is either incorrect or incomplete and that the indicated enforcement action should not be instituted. Even if defense counsel cannot persuade either the Staff or the Commission that no enforcement action should be authorized, defense counsel may persuade the Staff to narrow the charges or seek less severe remedies. This chapter provides an overview of the Wells process and discusses seven steps to effectively represent a prospective defendant in the Wells process.

FOOTNOTES:

(n1)Footnote 1. The other committee members were former SEC Chairman Manuel F. Cohen and former SEC Commissioner Ralph H. Demmler.

(n2)Footnote 2. *38 Fed. Reg. 5457* (Mar. 1, 1973) .

(n3)Footnote 3. Securities Release No. 5310, Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations.

(n4)Footnote 4. Rule 5(c), SEC Rules Relating to Investigations, *17 C.F.R. § 202.5(c)*. The Staff arguably must provide an opportunity to submit a Wells Submission with respect to enforcement actions arising from investigations conducted under either the Investment Company Act or the Investment Advisers Act. The provision of the Investment Company Act of 1940 authorizing the SEC to conduct investigations relating to violations of the act requires the Commission to "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." Section 42(a) of the Investment Company Act of 1940, *15 U.S.C.S. § 80a-41(a)*. Similarly, the provision of the Investment Advisers Act of 1940 authorizing the SEC to investigate violations of the Act provides in part:

[w]henver it shall appear to the Commission, either upon complaint or otherwise, that the provisions [of the Investment Advisers Act] or of any rule or regulation prescribed under the authority thereof, have been or are about to be violated by any person, [the Commission] may in its discretion require, and in any event shall permit, such person to file with it a statement in writing, under oath or otherwise, as to all the facts and circumstances relevant to such violation, and may otherwise investigate all such facts and circumstances.

Section 209(a) of the Investment Advisers Act of 1940, *15 U.S.C.S. § 80b-9(a)*.



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CHAPTER 16 THE SEC WELLS PROCESS

1-16 Securities Enforcement: Counseling and Defense § 16.02

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§ 16.02 Overview

The Wells Submission should be viewed as part of a process that begins when defense counsel first becomes involved in the investigation and continues until the matter is resolved. From the time that defense counsel first becomes involved in the investigation, defense counsel should attempt to monitor the evidence being gathered by the Staff and the Staff's incipient concerns and to develop exculpatory evidence. As the investigation progresses, defense counsel should consider communicating with the Staff in order to address and defuse their concerns and bring exculpatory evidence to their attention. After having received notice of the Staff's tentative decision to recommend an enforcement action, defense counsel should attempt to learn as much as possible about the Staff's concerns and the legal and factual bases for those concerns and should redouble efforts to develop exculpatory evidence.

The Enforcement Manual provides that the Staff is required to obtain the approval of a Deputy Director before issuing a Wells notice. n1 Typically, the Staff members involved in the investigation prepare a memorandum setting forth the Wells notices they believe should be issued and the bases for those notices. The Deputy Director will often, but not always, meet with the Staff members to discuss the proposed Wells notices. The Enforcement Manual provides that in determining whether to issue a Wells notice, the Staff's considerations should include:

- Whether the investigation is substantially complete as to the recipient of the Wells notice (the Staff can issue Wells notices to some persons involved in an investigation while continuing to investigate the potential liability of other persons.)
- Whether immediate enforcement action is necessary for the protection of investors. (For example, the Staff might decide that a Wells notice is inappropriate because emergency action is necessary to freeze assets or stop an ongoing fraud.) n2

In the Wells notice, the Staff typically identifies the specific charges that the Staff is considering recommending to the Commission and offers the recipient of the notice an opportunity to make a submission arguing why the Commission should not bring the contemplated action. n3

Comment

While the Staff usually provides Wells Notices to potential defendants, there are circumstances in which the Staff might exercise its discretion to not provide such notices. The Staff is especially likely not to provide such notice where the Staff plans to seek emergency relief or where criminal prosecutors are conducting a criminal investigation.

The Staff can provide the notice by telephone call or letter or (most often) a telephone call promptly followed by a letter. This notification is commonly referred to as a "Wells Call." The letter will typically state that the prospective defendant will be given an opportunity to make a written or videotaped submission setting forth the position and arguments of the individual or entity. n4 It is the policy of the SEC Staff to provide written notice of the Wells Call, although the Staff often provides oral notice of the Wells Call in advance of the written notice.

If, after reviewing the Wells Submission, the Staff decides to recommend an enforcement action, then the Staff's memorandum, along with the prospective defendant's Wells Submission, is distributed to the Commission and senior officers of any other offices and divisions of the SEC that are involved in the matter. If the Staff's proposal is to be addressed in the ordinary course of business, the Commission will meet to act on the recommendation within several weeks of docketing of the matter. The Commission considers the recommendation of the Staff at a closed meeting, which the Staff, but neither the prospective defendant nor defense counsel, can attend.

Nevertheless, the Staff's unwillingness and the sheer press of time may limit counsel's ability to plumb the depths of the Staff's concerns and the evidence on which the Staff is relying and thus hinder their ability to prepare an extensive rebuttal. It is not unusual for the Staff to inform defense counsel that he or she has only 14-30 days or less from the date of the initial Wells Call to file the Wells Submission. Often the Staff will grant limited extensions if warranted by the circumstances; n5 however, the Staff is under considerable pressure by management to conclude the Wells process without delay. Accordingly, it is often prudent to begin work on a Wells Submission before receipt of the Wells Notice.

FOOTNOTES:

(n1)Footnote 1. Enforcement Manual 2.4, at p. 23.

(n2)Footnote 2. *Enforcement Manual 2.4* at 23.

(n3)Footnote 3. *Enforcement Manual 2.4* at 23.

(n4)Footnote 4. The letter typically states that a written submission should not exceed forty pages and that a videotape submission should not exceed twelve minutes. The Commission does not specify whether the written submissions must be double spaced, but prospective defendants often submit written submissions that are single spaced.

(n5)Footnote 5. *See Enforcement Manual* § 24, p. 25 ("Requests for extensions of time should be made in writing, clearly state the basis for the request, and be directed to the appropriate Assistant Director."). It is, however, fairly common for defense counsel to seek, and the Staff to grant, extensions orally.



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CHAPTER 16 THE SEC WELLS PROCESS

1-16 Securities Enforcement: Counseling and Defense § 16.03

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§ 16.03 Steps to Preparing an Effective Wells Submission

Set forth below are seven steps to preparing an effective Wells Statement if the matter is not part of the pilot program described by Chairman Cox.

[1] Anticipate Impact of Possible Wells Call

The receipt of a Wells Call can have a substantial adverse impact on an individual or company. For example, FINRA requires that a person associated with a securities firm that is a member of FINRA update his/her Form U-4 upon, among other things, written notification that he or she is the subject of an SEC investigation that could result in an adverse finding against the person. n1 In light of the significant adverse ramifications that such an amendment can have on a securities professional, SEC Staff members will sometimes agree to notify defense counsel in advance of a Wells Call that the Staff has serious concerns which could ultimately lead to the initiation of the Wells process. Defense counsel can at this earlier stage attempt to persuade the Staff that an enforcement action is inappropriate. A certified public accountant might be required to notify the state accountancy board if the accountant receives a Wells Call. For example, California Board of Accountancy Regulation 5063(b)(4) provides: "Any licensee shall report to the board in writing the occurrence of any of the following events occurring on or after January 1, 2003, within 30 days of the date the licensee has knowledge of the events. ... (4) Any notice from the Securities and Exchange Commission to a licensee requesting a Wells Submission."

[2] Consider Engaging in Written or Oral Advocacy in Order to Avoid the Wells Call

In order to reduce the risk of receiving a Wells Call, defense counsel should consider seeking an opportunity to make an oral or written presentation to the Staff in advance of a Wells Call. Although a Wells Call represents only a tentative decision by the Staff to recommend that the Commission authorize an enforcement action, many defense counsel believe that the process of obtaining authority to make a Wells Call is likely to make Staff members feel more committed toward recommending an enforcement action. In addition, the receipt of a Wells Call can have negative consequences. An employer might decide to terminate or suspend the employment of an individual who has received a Wells Call. A professional might decide that he or she has to disclose the receipt of the Wells Call to existing or potential clients. A company might decide that it has to make public disclosure of a Wells Call received by an officer or by the company even though such disclosure can have an adverse impact on the individual's career and on the stock

price and operations of a company.

There are many approaches to seeking such an opportunity. Defense counsel can mention that they have studied the available evidence, have made significant observations regarding that evidence, and would like an opportunity to present those observations. Sometimes, it is appropriate for defense counsel to communicate the observations in passing while discussing with the Staff other aspects of the investigation. Defense counsel can ask the Staff members to contact defense counsel before making a Wells Call if the Staff is seriously considering making a Wells Call.

[3] Evaluate Conflicts of Interest

In many instances, it is both ethical and appropriate for one counsel to represent both the company and a number of company employees who testify during the information-gathering phase of the investigation. Representation of multiple witnesses during the fact-finding process can often provide a number of benefits both to the company and to the individual employees. Upon receiving a Wells Call, counsel should promptly evaluate whether it remains both ethical and appropriate to continue representing multiple clients. ⁿ² It often will be appropriate for separate counsel to be retained to represent one or more of the prospective defendants. For example, it is difficult for counsel representing two company employees to provide impartial advice to one client on the wisdom of making an argument that might be detrimental to the other client. Thus, it is not uncommon for defense counsel to spin off individual clients upon receipt of a Wells Call identifying those individuals as prospective defendants.

Even if counsel and the clients initially determine that separate representation remains neither necessary nor appropriate, counsel should periodically reevaluate this determination as additional information is gathered. In addition, counsel should consider updating the disclosure to the clients regarding possible conflicts and the impact of those conflicts.

[4] Obtain as Much Information as Possible Regarding the Staff's Case

When seeking authority from the Commission to institute an enforcement action, the Staff submits to the Commissioners a memorandum recommending the institution of an enforcement action. ⁿ³ Because the Staff's recommendation memorandum is a confidential document and will not be made available to defense counsel, it is important to elicit from the Staff as much detail as possible regarding the bases for its proposed recommendation.

As indicated above, throughout the information-gathering phase of the investigation, counsel should endeavor to identify the Staff's concerns and potential arguments. Usually, counsel can ascertain many of the Staff's concerns and potential arguments by becoming familiar with the priorities and management realities which drive the SEC's enforcement program, conferring with other defense counsel, and reviewing documents and testimony. ⁿ⁴ Counsel also can learn valuable information by engaging in an ongoing dialogue with the Staff throughout the information-gathering phase of the investigation.

Upon receiving a Wells Call, defense counsel should attempt to supplement this information. In the initial Wells Call and letter, the Staff will typically provide a cursory outline of the charge that the Staff has tentatively decided to recommend. For example, the letter might do little more than identify the statutory provisions allegedly violated and the nature of the relief the Staff has tentatively decided to seek (e.g., an injunction, civil penalties, a cease-and-desist order, a bar from association with a broker-dealer).

Comment

It is often appropriate for defense counsel to have a second lawyer present during the Wells Call in order to take detailed notes.

Upon receiving a Wells call, defense counsel should attempt to engage in a detailed discussion with the Staff. These discussions often involve the investigators who conducted the investigation and the branch chief supervising the investigation. It is sometimes desirable for these discussions to take place in a meeting, which is sometimes also attended by the Assistant Director (or Assistant Regional Administrator) responsible for the investigation, especially if counsel to the prospective defendant is new to the matter.

There is a significant range of practices regarding the extent to which the Staff will provide details regarding the theories and evidence underlying its tentative decision. The Enforcement Manual provides that it is within the Staff's discretion to allow a recipient of the notice an opportunity to review "the non-privileged portions of the investigative file, including documents that the recipient likely would receive during discovery if the Commission was to file a recommended action or proceeding." n5 There are several reasons why the SEC Staff should disclose their concerns and potential arguments to defense counsel. Full disclosure improves the ability of the Senior Staff and the Commission to evaluate the Staff's recommendation after having been tested by a well-informed Wells Submission that carefully addresses the Staff's concerns and arguments. It is in no one's interest for the SEC to institute an enforcement action based on a mistaken view of the evidence or the law. In addition, the more information they provide to defense counsel, the more likely it is that the Staff can persuade defense counsel that prompt settlement is in the best interests of counsel's client. For these reasons, among others, the Staff typically is willing to share information in some detail as they set forth their perception of the evidence and the law during the Wells process.

Comment

If the prospective defendant/respondent testified during the investigation and the Staff members are nevertheless unwilling to provide detailed information, counsel should consider involving a more senior member of the SEC Staff.

While a limited amount of defense advocacy is sometimes appropriate at this stage, defense counsel's primary goal is usually to obtain as much information as possible regarding the Staff's view of the evidence and the law. In general, the Staff is likely to be more forthcoming with information if defense counsel is open about the defense view of the evidence and the law. The Staff is also more likely to be forthcoming if defense counsel avoids putting the Staff on the defensive. Defense counsel should strive to keep the discussion civil and pleasant; it is rarely productive to debate the facts with the Staff at this stage.

It will sometimes be appropriate to have more than one meeting with the Staff prior to filing the Wells Submission. In general, the Staff is particularly likely to agree to multiple meetings if defense counsel has only limited information regarding the matter, because, for example, defense counsel was not retained until the Staff issued the Wells call. In addition, the Staff will sometimes respond to factual and legal questions in follow-up telephone calls. The Staff will sometimes provide access to relevant transcripts and exhibits. In most cases, defense counsel will obtain sufficient information to prepare an effective Wells Submission. If unable to obtain sufficient information, defense counsel should consider speaking with the more senior members of the Staff who are assigned to the investigation.

Comment

Some Staff members take the position that the Privacy Act and other confidentiality requirements bar the Staff from providing defense counsel with access to specific testimony from witnesses other than their clients or to documents supplied by persons other than their clients.

Often, it will also be important to gather information possessed by other witnesses. Counsel should consider contacting counsel for other individuals and entities believed to be prospective defendants, individuals believed to have provided testimony to the Staff, and individuals and entities believed to have provided documents to the Staff. In addition, defense counsel should contact other individuals and entities who might be able to provide exculpatory evidence.

Comment

Often, the Staff will provide relatively little information where the prospective defendant declined to testify based on the *Fifth Amendment* right against self-incrimination.

[5] Decide Whether to File a Wells Submission

A Wells Submission serves a number of purposes. Ideally, it might persuade either the Staff or the Commission that an enforcement action is not appropriate. Alternatively, the statement might persuade either the Staff or the Commission to narrow the scope or change the form of the proposed enforcement action. In addition, the Wells process often serves as a vehicle for arriving at a more favorable settlement than might otherwise be the case.

In deciding whether to file a Wells Submission, consideration should be given to the possibility that (1) the Enforcement Staff may at trial attempt to introduce into evidence factual statements in the Submission or use the factual statements to impeach the prospective defendant/respondent; (2) the Wells Submission may be made available to criminal prosecutors or other law enforcement or regulatory agencies; (3) private plaintiffs may obtain the Wells Submission through discovery; and (4) the media or other members of the public may obtain the Wells Submission pursuant to FOIA or otherwise.

In some cases, it will be clear whether the prospective defendant should file a Wells Submission. In many other cases, the decision whether to file a Wells Submission will be a judgment call based on a number of factors. These factors include:

- Counsel's judgment regarding the likelihood that either the Staff or the Commission can be persuaded not to proceed with an enforcement action. A Wells Submission is especially likely to be effective where the prospective defendant is peripheral to the alleged violation, the Staff appears to be proceeding on a mistaken interpretation of the law, or the Staff appears to be proceeding on an understanding of the facts that is not supported by the record. Even if the SEC Staff members appear to be unmovable, a Wells Submission might persuade either senior members of the SEC Staff or the Commissioners that the proposed action should not be pursued.
- Counsel's judgment regarding the likelihood that the Wells Submission might persuade either the Staff or the Commission to agree to a settlement that would be acceptable to the prospective defendant. By highlighting evidence that favors the prospective defendant and by identifying the weaknesses in the Staff's position, the Wells Submission might persuade either the Staff or the Commission to agree to a settlement that would be acceptable to the prospective defendant. For example, where the Staff's position expressed in the Wells Call involved a fraud charge and a penalty, the Staff might be persuaded through the Wells process to recommend a settlement involving a charge of negligence and no penalty.
- The extent to which the filing of an SEC action would have a devastating impact on the career of the prospective defendant/respondent even if the prospective defendant/respondent were ultimately to prevail in the enforcement action. For many individuals who are senior executives of publicly owned companies, are employed by public accounting firms, or who are employed by regulated entities (e.g., broker-dealer firms, investment companies, investment advisors), the very filing of an SEC enforcement action can have severe adverse consequences. Accordingly, it will often be appropriate to file a Wells Submission on behalf of such individuals even though, in the judgment of counsel, the Wells Submission is unlikely to avoid an enforcement action and might, for the reasons set forth below, reduce the strategic advantage possessed by the prospective defendant in ensuing litigation.

There are a number of factors that sometimes indicate that the prospective defendant should not file a Wells

Submission. The filing of a Wells Submission is usually unnecessary if the Staff and the prospective defendant or respondent have reached a settlement in principle before the Wells Submission is filed. In addition, there are other factors that sometimes indicate that the filing of a Wells Submission would be inappropriate:

- It appears likely that an acceptable settlement can be negotiated without incurring the effort and expense entailed in preparing an effective Wells Submission.
- There is little likelihood that the Wells Submission will dissuade the Staff from recommending the proposed action and the Commission from authorizing the action. In these circumstances, the prospective defendant might be better advised to conserve for litigation resources that would be expended in the Wells process. By revealing the strategies and positions of the prospective defendant, a Wells Submission may impair the ability of the defendant to mount an effective defense against the enforcement action. On the other hand, even in this circumstance, a Wells Submission may be effective in persuading the Staff or the Commission to drop aspects of the proposed enforcement proceeding.
- There is a significant possibility that the person against whom the Staff wishes to proceed will become a target of a parallel civil or criminal investigation or criminal prosecution. Given that the Wells Submission might be admissible in these matters and often discloses the defense's arguments and strategies, a Wells Submission is often inappropriate in matters involving a substantial risk of a criminal prosecution unless counsel forms the judgment that the Wells Submission will likely reduce the possibility of a criminal prosecution or the consequences of an SEC enforcement action would be devastating to the prospective defendant. The risk can also be addressed by filing a Wells Submission that makes general arguments without a detailed presentation of the key facts.
- There are serious deficiencies in the Staff's case that the Staff could cure with relative ease once they are identified in the Submission. In drafting the Wells Submission, counsel should be aware that the SEC Staff might respond to the Submission by conducting additional discovery to obtain the evidence that was otherwise missing from the record or by modifying the theory of the case in a manner that will make it harder for the prospective defendant/respondent to prevail in litigation.
- The danger that the Wells Submission will lock the defendant into a litigation position before the defense counsel can learn all of the evidence.

[6] Consider Whether to Initiate Settlement Discussions

In connection with the Wells process, defense counsel must consider whether to initiate settlement discussions. The vast majority of SEC enforcement actions are resolved through settlements. Often these settlements arise from discussions that defense counsel initiates during the Wells process.

The Staff often responds favorably to settlement discussions initiated by defense counsel. The initiation of settlement discussions often is appropriate if defense counsel believes that the Staff is highly likely to recommend, and the Commission is highly likely to authorize, an enforcement action. Many defense counsel believe that the Staff is more flexible in fashioning settlements during the Wells process than after the Commission has authorized an enforcement action. Indeed, some defense counsel believe that the Staff is more likely to be flexible early in the Wells process, before Staff positions have hardened, than near the conclusion of the Wells process. This danger of hardened Staff positions is especially significant if defense counsel does not initiate settlement discussion until after the Commission has authorized the action. On the other hand, the initiation of settlement discussions arguably reduces the likelihood that the Staff will be persuaded not to recommend any enforcement action or that the Commission will be persuaded not to authorize an enforcement action. n7

As discussed *infra* at §17.05[6], in April 2007, Chairman Cox announced a pilot program under which the Enforcement Staff would be required to obtain Commission approval before engaging in settlement discussions with respect to cases in which a penalty against an issuer might be involved. n8 This pilot program represents a significant change from prior practice under which the Staff typically engaged in settlement discussions before presenting the case to the Commission. These discussions often resulted in an agreement between prospective defendants/respondents and the Staff regarding the terms of a settlement that the defendants/respondents would offer and the Staff would recommend to the Commission. Although these agreements were not binding on the Commission, the prospective defendants/respondents often decided not to submit Wells Statements to the Commission.

Comment

Counsel should also consider submitting a video Wells instead of, or in addition to, the written submission. The usual practice is not to submit video Wells submissions. Video Wells submissions are, however, appropriate to drive home certain issues (e.g., character issues) or to put a human face on a sympathetic potential defendant.

[7] Draft the Wells Submission

Many Wells Submissions begin with an executive summary, then set forth a detailed statement of the facts, and conclude by presenting the defense's factual, legal and policy arguments. In addition, defense counsel sometimes includes in the Wells Submission an argument that even if the Commission authorizes an enforcement action, the Commission should not seek the sanctions sought by the Staff.

In drafting the Wells Submission, defense counsel should bear in mind that the Submission is likely to be reviewed by a number of Commission personnel including:

- the Staff members who conducted the investigation;
- their supervisors, usually including senior members of the Staff; n9
- the Commissioners or their personal legal assistants;
- the SEC Office of the General Counsel; and
- personnel from other relevant divisions or offices (e.g., Division of Market Regulation in a case involving broker-dealers, trading practices, or market structure, the Office of the Chief Accountant in a case involving accounting or auditing issues). The Enforcement Staff will consult with the other interested divisions and offices who also will have input into the position of the Commission.

The executive summary should be targeted to the senior members of the Staff, the Commissioners, and the legal assistants to the Commissioners. These people are extremely busy, and the primary purpose of the executive summary is to persuade them that they should scrutinize the Staff's recommendation and carefully consider the more detailed arguments set forth in the body of the Submission.

In Securities Act Release No. 5310, n10 the SEC advises that Wells Submissions are most useful in connection with questions of policy and law, and that disagreements regarding factual matters can rarely be resolved through the Wells process. Defense counsel should largely disregard this advice. If the Staff's recommendation is based on an inaccurate or incomplete factual predicate, counsel should seriously consider including in the Wells Submission evidence demonstrating that the predicate is inaccurate. This evidence can be drawn from the record assembled by the Staff during the investigation or from other sources. For example, in an insider trading investigation, it may be appropriate to

submit newspaper articles showing that the allegedly nonpublic information was in the public domain; trading records showing that the trades by an alleged tippee were typical of trades previously made by him or her; and an affidavit from the person (e.g., a stockbroker) who, based on publicly available information, recommended the trade to the alleged tippee. Similarly, in an accounting case, it may be appropriate to submit affidavits from experts explaining why the company's accounting was thought to be in accordance with generally accepted accounting principles ("GAAP"). The Staff sometimes includes in its recommendation memoranda claims based on aggressive interpretations of the federal securities laws. In such instances, counsel should set forth the reasons why the Staff's interpretation is wrong as a matter of both law and policy. If the Staff or the Commission is persuaded that the legal premise is in doubt, they might modify their position in order to avoid the controversial legal theory.

The Wells Submission should set forth the facts that are central to the defense. To the extent possible, the Wells Submission should address and defuse evidence on which the Staff places substantial reliance. While legal and policy arguments are often important, in most instances the facts will be decisive. Even if defense counsel does not dispute the facts relied upon by the Staff, there frequently are other mitigating facts that defense counsel should bring to the attention of both the Staff and the Commission. For example, in drafting the detailed statement of the facts in a matter where the Staff alleges that the issuer had prematurely recognized revenue, defense counsel should consider whether effective arguments can be made that:

- the disclosure was consistent with GAAP;
- the disclosure was not materially false or misleading in light of the mix of information available to investors;
- the prospective defendant acted in good faith;
- the company had reasonable procedures;
- the conduct at issue complied with industry practice, especially if the SEC has known of the practice and not objected to it (e.g., in broker-dealer matters);
- once the disclosure issue was identified, the prospective defendant acted promptly to remedy the situation and prevent a recurrence;
- the disclosure issue was an isolated incident in the client's otherwise unblemished record;
- the client fully disclosed the relevant facts to a professional and relied on advice from the professional;
- the client was the individual who ultimately forced the corrective disclosure;
- new management has come in and the alleged malefactors are no longer associated with the company;
- the alleged defendant cooperated with the Staff investigation; and
- the conduct at issue was not egregious.

The Wells Submission should set forth the most powerful arguments available to the defense. Sometimes, the arguments will center on whether certain conduct, undisputed for the purpose of the Wells Submission, warrants an enforcement action. Sometimes, the arguments will center on whether the record supports the Staff's view of the facts.

Comment

In preparing a Wells Submission, defense counsel should consider retaining an expert to assist in the articulation of technical arguments or to submit a supporting affidavit.

In advance of arguing for the appropriate sanction, defense counsel should review recent settlements to determine whether the enforcement remedy that the Staff has tentatively decided to recommend is consistent with the remedies in recent prior settlements based on similar allegations. The SEC and the Staff believe that similarly situated defendants should be treated similarly. Accordingly, the Commission and the Staff might well be persuaded by an argument that the tentatively recommended remedy is not consistent with remedies in recent settlements involving comparable facts.

If the proposed defendant-respondent is a public company and the Staff has indicated that it intends to recommend the imposition of monetary penalties, counsel should consider including a discussion of whether monetary penalties are appropriate under the Commission's Statement on Corporate Penalties. n11 Similarly, if the corporation is willing to agree to a settlement including the imposition of a monetary penalty but believes that the amount of penalty sought by the Staff is excessive, counsel should consider including a discussion based on the Seaboard § 21(a) Report. n12

If the Staff has assembled sufficient evidence that a violation has occurred, it might be appropriate to draft a Wells Submission that focuses on the proposed remedy. For example, a company might argue that even if prior management violated the securities law, the proposed remedy is excessively harsh given that new management has taken over, internal controls have been enhanced, and previously issued representations have been corrected or clarified.

The Wells Submission should set forth the available policy arguments. If applicable, the Wells Submission should include arguments that the proposed enforcement proceeding is contrary to public policy. If the enforcement action represents a substantial expansion of the law, the Wells Submission can argue that an enforcement proceeding is an inappropriate vehicle for implementing such an expansion.

Comment

Often, defense counsel prepares a Wells Submission using a format similar to the typical format of a brief, with a cover page, a table of contents, a summary of the facts, and argument.

Many matters do not pose novel legal issues. If the matter involves only legal issues that the Commission has repeatedly addressed, there often is little benefit to attacking an established legal position. Legal argument is often appropriate, however, if the legal issues are novel.

There is a danger that the Wells Submission might be discoverable and might be admissible in litigation. n13 In order to strengthen the argument that a Wells Submission is settlement material inadmissible at trial under *Federal Rule of Evidence 408*, n14 it is often advisable to include in the Wells Submission a footnote indicating that the Submission is being filed for the purpose of resolving the matter without litigation. Defense counsel should nevertheless be aware of the danger that the Commission (or other litigants, such as plaintiff shareholders) will attempt to introduce the Wells Submission into evidence. Indeed, the SEC Staff routinely informs defense counsel in the Wells Call that the Staff may use the Wells Submission as an admission in any enforcement proceeding.

The appropriate length of the Wells Submission varies according to the complexity of the case. In most instances, a serious effort should be made to limit the Submission to no more than 40 pages. In light of its considerable docket, the Commission may not be prepared to plough through more lengthy documents.

Comment

One common practice when the Staff gives a Wells Notice to both a company and company employees is for the company to submit the primary Wells Submission and for the employees to submit separate Wells Submission that make the points that are of special significance to the individual employees.

Accordingly, it often is important for counsel for the company to coordinate with counsel for company personnel and other potential defendants.

[8] Follow-Up with the Staff After Submitting a Wells Submission

The Wells process does not end with the filing of the Wells Submission. Defense counsel should contact the Staff after filing the Wells Submission. There are a number of reasons for making such contact.

It is important for defense counsel to ascertain whether the Staff's position has shifted in response to the Wells Submission. The Staff sometimes changes the theory underlying its recommendation for enforcement action in response to the arguments set forth in the Wells Submission. While defense counsel can include in the Wells Submission a request that the Staff notify counsel if it materially changes its position after receipt of the Submission, the Staff does not always notify defense counsel of such changes.

In appropriate circumstances, after filing the Wells Submission, defense counsel should attempt to meet again with the Staff to discuss the issues raised in the Submission. Such a meeting will help counsel ensure that the Staff understands the defense theory and its implications and identify and address any changes in the Staff's position and any lingering concerns. Similarly, the Staff might articulate its position in a manner that provides new insights into the Staff's view of the case. If counsel gains new insights into the Staff's view of the case or learns that the Staff has altered its theory, it might well be appropriate for defense counsel to consider preparing a supplemental Wells Submission.

In addition, a post-filing meeting provides an opportunity for oral advocacy. While senior members of the Staff review the Wells Submissions, they only have a limited amount of time to devote to most Wells Submissions. A meeting that includes members of the Senior Staff (e.g., the Director, Deputy Director, Regional Administrator, Associate Directors, Associate Regional Administrator, the Chief Counsel of the Division of Enforcement, the Chief Enforcement Accountant) provides a valuable opportunity to focus the Senior Staff on defense arguments unfiltered by junior staff. Similarly, a post-filing meeting provides an opportunity to ensure that representatives of other interested Divisions (Division of Market Regulation, Division of Corporation Finance, Office of the General Counsel, etc.) focus on the potential defenses.

Comment

The Director and Deputy Director have very demanding schedules. Defense counsel should exercise discretion in asking for very senior members of the Division to attend the meeting. Asking that a Director or Deputy Director attend a meeting involving a relatively minor matter can impair the credibility of defense counsel and annoy the Staff and thereby prove counter-productive.

Defense counsel can also attempt to influence who will attend the meeting. If the matter presents significant legal issues, then defense counsel might suggest that the meeting be attended by a representative of the Office of General Counsel. If the matter presents technical issues, it is appropriate to ask whether a representative of another relevant division will attend. For example, if the matter involves GAAS and GAAP issues, it might be appropriate to ask whether representatives of the Office of Chief Accountant plan to attend the meeting. If the presentation will focus on the evidentiary weakness of the case, defense counsel can suggest that a member of the trial unit attend the meeting. Prior to attending the meeting, defense counsel should attempt to learn (1) the Staff's reactions to the Wells Submission and (2) the identity of the SEC personnel who are expected to attend the meeting. This information can assist defense counsel in determining the appropriate focus and emphasis for his presentation.

The issue of whether to meet with other divisions or offices is highly sensitive. For example, it is appropriate to ask for the Office of General Counsel to participate in a meeting only if the matter involves a significant unsettled legal issue. If defense counsel wants to involve another office or division, defense counsel should seek that meeting through the Enforcement Staff.

Defense counsel can take various approaches to this meeting. Sometimes, defense counsel will simply ask whether the Staff has any questions and whether the Staff's position has evolved in response to the Wells Submission. More often, defense counsel will use this meeting as an opportunity to advance his client's position through further articulation of the theory of the defense. Accordingly, defense counsel should consider preparing a detailed presentation of the defense, including visual aids, designed to engage and hold the interest of the attendees. Sometimes, however, defense counsel should simply prepare talking points similar to the presentation that an advocate would make in an oral argument. Counsel should take extreme care to ensure there is adequate evidence to support each factual point and to base the theory of the defense on a factual background as similar as possible to that described by the Staff as the basis for their preliminary determination. By so doing, defense counsel will minimize clashes with the Staff not needed to advance his client's interests.

Comment

Defense counsel should prepare thoroughly for this meeting. Defense counsel should master the record and prepare responses to articulated questions.

As a result of the post-filing meeting and other communications, defense counsel may detect a shift in the Staff's position or gain greater insight into their reasoning. If appropriate, these can be addressed in a supplemental or superseding Wells Submission.

In August 2010, as part of the Dodd-Frank Act, Congress provided that not later than 180 days after the date on which the Commission Staff provide a written Wells notification to any person, the Commission shall either file an action against such person or provide notice to the Enforcement Director of its intent not to file an action.¹⁵ This provision was intended to address the situations where a lengthy period of time elapsed between provision of the Wells Notice and the conclusion of the investigation. Although the Dodd-Frank Act provides a mechanism for extending this 180-day period, this provision is likely to increase the pressure on the Enforcement Division to conclude the Wells process sufficiently within the 180-day period set forth in the Dodd-Frank Act to allow for the resolution of the matter within the 180-day period.

FOOTNOTES:

(n1)Footnote 1. See FINRA Form U-4, Item 22I & Explanation of Terms.

(n2)Footnote 2. A discussion of multiple representation can be found in Chapter 11.

(n3)Footnote 3. The Staff's memorandum usually sets forth the key evidence and legal theories on which the Staff has based their conclusion that the federal securities laws have been or are about to be violated and that an enforcement action should be brought. The line investigators usually bear primary responsibility for preparing the first draft of the memorandum. The branch chief to whom the line investigators report and the assistant director, or assistant regional administrator or assistant district director to whom that branch chief reports also typically provide substantial input in the drafting of the memorandum. The preparation of the memorandum can consume weeks or even months as it winds its way through the various layers of supervisory review and is amended to respond to factual or legal arguments set forth in a Wells Submission.

(n4)Footnote 4. The SEC Staff will typically permit a witness to purchase the transcript of his or her testimony. While the SEC will typically not share with one witness the transcripts of the testimony of other witnesses, counsel often can obtain from the other witnesses or their counsel information regarding the substance of the testimony of those

other witnesses.

(n5)Footnote 5. Enforcement Manual 2.4.

(n6)Footnote 6. A Wells Submission is arguably a "statement made in compromise negotiations" for the purpose of *Federal Rule of Evidence 408*. The Enforcement Staff takes the position, however, that a Wells Submission is not a settlement document for the purpose of *Federal Rule of Evidence 408* and will sometimes return to counsel a Wells Submission that contains a claim that the rule does apply. While courts do sometimes hold that Wells Submission are discoverable, at least one Court of Appeals has held "any communications made in furtherance of settlement are privileged" and therefore protected from third party discovery. *The Goodyear Tire & Rubber Co. v. Chiles Power Supply, Inc.*, 332 F.3d 976, 983 (6th Cir. 2003) .

(n7)Footnote 7. If the client is an issuer and has not previously disclosed the existence of the SEC investigation, the client should also consider whether disclosure is appropriate in light of the Wells Call.

(n8)Footnote 8. Chairman Christopher Cox, "Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference," (Wash., D.C., Apr. 13, 2007) (*Available at*: <http://www.sec.gov/news/speech/2007/spch041207cc.htm>).

(n9)Footnote 9. A Wells Submission responding to an investigation conducted by a regional office will be reviewed by the Enforcement Staff in the regional office, but also by Office of the Chief Counsel in the Division of Enforcement in Washington. The Office of the Chief Counsel typically will review each enforcement recommendation and accompanying Wells Submission for consistency with the policy objectives of the division and treatment of prospective defendants or respondents relative to other cases and soundness on the merits and legal theory.

(n10)Footnote 10. *Securities Act Release No. 5310, 1972 SEC LEXIS 238*, [1972 -1973 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 79,010* (Sept. 27, 1972).

(n11)Footnote 11. The Statement is discussed in Chapter 17, "Settlement Discussions."

(n12)Footnote 12. A discussion of the Seaboard § 21(a) Report is included in Chapter 17, "Settlement Discussions."

(n13)Footnote 13. *In re Steinhardt Partners*, 9 F.3d 230 (2d Cir. 1993) (a document that a prospective defendant submitted to the staff before a Wells Submission is discoverable in private litigation). In addition, once the investigation has been concluded, members of the press and others might be able to obtain copies of the Wells Submissions from the SEC through Freedom of Information Act requests.

(n14)Footnote 14. *See In re Allied Stores Corp., Administrative Proceeding File No. 3-6869, 1998 SEC LEXIS 5247, 52 SEC Docket (CCH) 451* (Mar. 21, 1988) (decision of administrative law judge excluding Wells Submission on grounds that admitting the statement would impair settlement negotiations).

(n15)Footnote 15. Dodd-Frank Act § 929U.



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CHAPTER 16 THE SEC WELLS PROCESS

1-16 Securities Enforcement: Counseling and Defense § 16.04

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§ 16.04 Conclusion

The Wells process provides a prospective defendant with an important opportunity to persuade the Staff and the Commission that an enforcement action would be inappropriate. The Wells process often constitutes a prospective defendant's last best chance of avoiding a crippling SEC enforcement action. In order to represent a prospective defendant effectively, defense counsel must learn as much of the relevant evidence as possible, gain insight into the Staff's view of the matter, and engage in effective written and oral advocacy.



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CHAPTER 17 SETTLEMENT DISCUSSIONS

1-17 Securities Enforcement: Counseling and Defense 17.syn

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§ 17.syn Synopsis to Chapter 17: SETTLEMENT DISCUSSIONS

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§ 17.02 Settlement Considerations

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CHAPTER 17 SETTLEMENT DISCUSSIONS

1-17 Securities Enforcement: Counseling and Defense § 17.01

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§ 17.01 Introduction

The Securities and Exchange Commission (SEC) enforcement program is largely driven by settled cases. The overwhelming majority of enforcement actions have historically settled before they are filed, and many more settle after filing, but before trial. The SEC Staff is implicitly authorized to discuss settlement at any point in the proceedings, and is often expressly authorized to discuss settlement at the time that the Commission authorizes the action. The Staff may discuss settlement, but cannot bind the Commission absent extraordinary circumstances, such as a judicial order requiring the Commission to delegate settlement authority. Settlement discussions can thus take place at any time during the process, including during the information-gathering phase of the investigation, during the Wells process, before filing, and after commencement of a contested action.

The SEC generally expects settlements to be on terms *at least* as favorable as those that the Commission is likely to obtain in litigation. Many settlements sought by the Staff are driven not by the likely litigated outcome, but by what the Commission and the Staff view as programmatic imperatives. In short, the Commission is willing to expend considerable litigation resources, and to risk uncertain outcomes, in order to preserve the Commission's settlement posture in its other cases.

A clear understanding of the current priorities of the Commission's enforcement program is essential to having a constructive settlement dialogue with the Staff. Equally important is an understanding of the realistic strengths and weaknesses of the facts and the law, and the potential cost to the Staff, in terms of resource commitments and legal risk, of a contested proceeding. Finally, any settlement negotiation with the SEC will hinge on the perceived good faith of the settling party and may turn on the Staff's perception of the sufficiency of remedial actions already undertaken by the settling party.



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CHAPTER 17 SETTLEMENT DISCUSSIONS

1-17 Securities Enforcement: Counseling and Defense § 17.02

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§ 17.02 Settlement Considerations

There are numerous reasons, aside from the strength or weakness of any particular case, why parties settle with the SEC. An ongoing investigation or litigation with the SEC will consume substantial time, energy and resources, and will expose a defendant or respondent not only to the initial bad press associated with the announcement of an enforcement proceeding but also repeated negative public reports throughout the litigation. Institutional defendants, such as issuers or broker-dealers, may suffer adverse consequences from pending enforcement litigation when dealing with other SEC divisions on pending registration statements, no-action letters, or other SEC enforcement matters. In short, for some parties, it is quite possible that continued investigation is worse than any reasonable settlement.

Moreover, the cost of an adverse finding at the conclusion of a contested proceeding can be high. Findings from a litigated court action are likely to be binding on the defendants in a suit brought by disgruntled shareholders. The historical rule that collateral estoppel applied only when there was "mutuality" of parties (the parties in the action in which collateral estoppel was being asserted had also been parties in the action in which judgment had been rendered), has been eroded. In *Parklane Hosiery Co. v. Shore*,ⁿ¹ the United States Supreme Court held that private plaintiffs could offensively use the doctrine of collateral estoppel in seeking to use a contested injunctive judgment obtained by the SEC to preclude relitigation in the private action of the issues necessarily decided in the SEC action, except where the use of collateral estoppel would be unfair to the defendant. While *Parklane* involved an SEC injunctive action that had been litigated in court, collateral estoppel effect might also be given to the decision of an administrative law judge,ⁿ² although a strong argument can be made that an ALJ's decision should rarely be given collateral estoppel effect, because a respondent in an administrative proceeding is not entitled to take pre-hearing discovery, the rules of evidence do not apply in an SEC administrative hearing, and final *de novo* review is by the Commissioners--not a judge.

In contrast, settled enforcement actions are not given collateral estoppel effect in civil actions.ⁿ³ The Commission will ordinarily agree to a settlement in which the defendant/respondent neither admits nor denies the allegations (or in the case of an administrative proceeding, the findings) of wrongdoing but does admit jurisdiction and the adequacy of service of process.

It should, however, be noted that the SEC may insist in some cases on curative disclosures. Arguably, even though the company settles without admitting or denying any allegations, disclosures made by the company pursuant to settlement

are admissible against the company in certain instances. Moreover, a restatement of the company's financial statements is arguably an admission that the previously issued financial statements were in error. Accordingly, a restatement of financial statements can seriously impair the ability of a company to defend itself in private securities litigation, especially if the litigation includes a claim under Section 11 of the Securities Act or some other provision that does not include a scienter element.

The threat of criminal prosecution or other pending law enforcement action can drive settlements. Given the current working relationship between the Department of Justice (DOJ) and the SEC, it may be difficult for criminal targets in securities law prosecutions to be able to settle with the DOJ without also resolving a parallel proceeding with the SEC. Moreover, criminal prosecutors might be less likely to pursue a matter if the potential defendant has accepted responsibility by agreeing to a settlement with the SEC. In addition, if the presence of the criminal investigation prompts the prospective defendant to assert the *Fifth Amendment* right against self-incrimination, any defense of an SEC enforcement action is severely compromised for an individual defendant. On the other hand, if not stayed, the SEC enforcement action might enable the prospective defendant to obtain discovery that will be useful in defending the criminal prosecution. n4

While most parties settle SEC enforcement actions before they are brought, in appropriate circumstances companies and individuals should be prepared to litigate with the SEC. The SEC has taken aggressive positions in, and consequently has lost, a number of the enforcement matters that it was forced to litigate, especially matters that were litigated in federal court, as opposed to an administrative tribunal. In light of the aggressive positions being taken by the Commission and the Enforcement Staff, it is quite possible to obtain a more favorable outcome through litigation than through settlement.

FOOTNOTES:

(n1)Footnote 1. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979) .

(n2)Footnote 2. *Univ. of Tennessee v. Elliott*, 478 U.S. 788, 797-799 (1986) .

(n3)Footnote 3. Note, however, that in 2003 the SEC stated its intention to assume that the allegations in prior settlements are true, even where the respondent entered into the settlement without admitting or denying the allegations, in considering whether subsequent administrative sanctions are in the public interest as to registered securities industry entities and associated persons *In re Marshall Melton and Asset MgmT. & Research*, SEC Admin. Proc. File No. 3-9865, 2003 SEC LEXIS 1767 (July 25, 2003) .

(n4)Footnote 4. Stays of SEC enforcement actions pending a criminal prosecution are discussed in Chapter 23.



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CHAPTER 17 SETTLEMENT DISCUSSIONS

1-17 Securities Enforcement: Counseling and Defense § 17.03

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§ 17.03 Settlement Discussions

[1] Role of the Enforcement Staff

Settlement rarely occurs without extensive discussions with the Enforcement Staff. n1 As a practical matter, the Commission rarely accepts an offer of settlement that is opposed by the Staff. Accordingly, it is usually necessary to negotiate terms that the Staff is prepared to recommend that the Commission accept.

For investigations conducted by the home office, settlement negotiations usually involve supervisors who are directly involved with the matter, typically the branch chief or assistant director, and occasionally the associate director. Settlement discussions for investigations conducted by a regional or district office are usually conducted with the Staff of that office, although the home office may become involved. Under the Division's enforcement management plan, either a Deputy Director or the Director must be involved in the Staff's "settlement posture." n2 On significant or unusual matters, it is not unusual to involve the director or a deputy director of the Enforcement Division in settlement discussions. Even if defense counsel reaches a tentative agreement with the Enforcement Staff regarding the terms of the agreement, there is some risk that another interested division or the Commission will disagree with the proposed settlement or that the Commission will not accept the proposed settlement. n3

[2] Timing

As set forth above, counsel can initiate settlement discussions when the Staff has made the Wells call or even earlier. n4 Even if an early settlement is not realistic counsel may defend an investigation differently depending on the client's view of settlement. Accordingly, throughout the investigation, counsel should be exploring the client's view on settlement, and should assess whether it is appropriate to broach the topic of settlement with the Staff.

The SEC Rules of Procedure provide that any person who is notified that the Commission may institute a proceeding against that person may, at any time, propose in writing an offer of settlement. n5 The Rules provide that "[t]he interested division shall present the offer of settlement to the Commission with its recommendation, except that, if the division's recommendation is unfavorable, the offer shall not be presented to the Commission unless the person making the offer so requests." n6 Since the Commission is unlikely to accept an offer of settlement over the unfavorable recommendation of the Staff, it is rare for defense counsel to request that an offer of settlement be presented to the

Commission over the unfavorable recommendation of the Staff. n7

As all SEC investigations are costly and disruptive, clients often push defense counsel to initiate settlement discussions early in the process. Yet premature settlement discussions can be counterproductive and dangerous. Counsel should understand that an effective enforcement program is an opportunistic enforcement program, and that early settlement discussions may be viewed as signs of weakness, and, therefore, as an opportunity for the Staff. Early settlement discussions may embolden the Staff and encourage it to invest greater resources in any investigation than it otherwise might, either based on the merits or because of other demands for limited enforcement resources.

Even if some potential defendants reach an early settlement with the SEC, the settlement is unlikely to resolve the investigation if other potential defendants do not also reach early settlements. For example, even if the issuer settles, the Staff is likely to continue to investigate potential claims against former and current company personnel. Similarly, if the issuer and relevant company personnel settle, the Staff might continue to investigate third parties, such as auditors or lawyers.

Despite the obvious dangers of early settlement talks, it sometimes makes sense to initiate settlement discussions even prior to receiving a Wells call. In some circumstances, early settlement talks, especially if combined with a credible presentation of the relevant facts, can inform and narrow the scope of the Staff's investigation. Moreover, approaching the Staff prior to a Wells call can result in an earlier resolution of the matter, either by accelerating the settlement process or prompting the Staff to conduct its investigation more expeditiously. In addition, the Staff might view an early settlement offer as a factor supporting a less severe sanction than might otherwise be appropriate.

Settlement discussions often occur after receipt of a Wells Call. Potential defendants/respondents often responded to a Wells Call by attempting to negotiate a settlement in the expectation that a settlement might avoid the need to prepare and file a Wells Submission and that the negotiation process would provide an adequate opportunity for presenting the position of the prospective defendant/respondent.

Traditionally, absent unusual circumstances, once the Commission had authorized an enforcement action, the Staff would explore settlement possibilities with the expected defendants/respondents. Accordingly, if a potential defendant/respondent was unable to negotiate a satisfactory settlement at this point, the potential defendant/respondent might file a Wells Submission with the Commission in the hopes of persuading the SEC to refuse to authorize at least some of the relief sought by the Staff, expecting to have another opportunity to negotiate settlement if the Commission authorized an enforcement action.

In 2010, however, the SEC reportedly filed an enforcement action against Goldman Sachs without giving Goldman Sachs any opportunity to settle after the Commission authorized an enforcement action. n8 The Staff has indicated that defense counsel can mitigate the risk of the Staff filing an enforcement action without further opportunity for settlement discussions by representing that the prospective defendant/respondent is interested in exploring settlement in the event that the Commission authorizes an enforcement action.

Comment

An attempt to achieve early settlement is likely to backfire, however, if the Staff discovers that the company's factual presentation was not forthcoming and accurate.

FOOTNOTES:

(n1)Footnote 1. There is a risk that documents relating to settlement discussions with the SEC could be deemed discoverable in related private litigation. *See, e.g., In re Subpoena Issued to Commodities Futures Trading Comm'n, 2005 U.S. Dist. LEXIS 7403* (D.D.C. Apr. 28, 2005) (holding that documents relating to settlement discussions with CFTC were not privileged from discovery).

(n2)Footnote 2. See SEC Press Release 2008-103, "SEC Announces Walter Ricciardi to Retire as Deputy Director of Enforcement Division," (Jun 2, 2008), www.sec.gov/news/press/2008/2008-103.htm.

(n3)Footnote 3. In an unusual development in 2005, the Commissioners rejected a recommended settlement of a previously filed SEC enforcement action, and ordered the Staff to seek dismissal of the action with prejudice.

(n4)Footnote 4. The Wells process is discussed in Chapter 16.

(n5)Footnote 5. SEC Rule of Practice 240, *17 C.F.R. § 201.240*.

(n6)Footnote 6. SEC Rule of Practice 240, *17 C.F.R. § 201.240(c)(3)*.

(n7)Footnote 7. There may be tactical reasons to offer a settlement involving administrative sanctions directly to the Commission, even if the Commission is unlikely to accept the offer. Because the Commission may be an adjudicator of such claims, it cannot discuss possible administrative sanctions *ex parte*, absent a waiver of so-called prejudgment by the party. In the absence of such direction by the Commission, however, the Staff must conduct settlement discussions based on what it perceives the Commission will expect. A well-timed settlement offer, with the required prejudgment waiver, will allow, indeed require, the Staff to discuss possible administrative sanctions with the Commission, and thus may add clarity to the discussion of what the Commission would accept as to a particular settling defendant.

(n8)Footnote 8. S. Pulliam and S. Craig, "Goldman Talks Settlement with SEC (WSJ May 7, 2010), available at <http://online.wsj.com/article/SB10001424052748704370704575228232487804548.html> ("The SEC filed the suit without giving the company a chance to settle.").



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CHAPTER 17 SETTLEMENT DISCUSSIONS

1-17 Securities Enforcement: Counseling and Defense § 17.04

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§ 17.04 Internal Investigations and Credit for Cooperation

An effective internal investigation can facilitate early settlement negotiations. Absent a thorough internal investigation, it is difficult, early in an SEC investigation, to determine the scope of the issues under investigation. In addition, an internal investigation can assist defense counsel in ascertaining the extent to which exonerating evidence is available. Furthermore, the Staff is reluctant to discuss settlement at the outset of an investigation unless it can assure the Commission that additional misconduct has not occurred. Failing to obtain that assurance, usually after an investigation, may leave the Staff vulnerable to criticism if additional violations are uncovered at a later date. Early overtures of settlement, therefore, may be greeted by the Staff with skepticism and concern that the full extent of misconduct has not been uncovered.

Companies under investigation often launch internal investigations to ascertain the underlying facts. Often, the audit committee of the company's board of directors, rather than management, directs the independent investigation. In an effort to obtain credit for cooperation, some companies waive the attorney-client and work product protections that otherwise apply to the investigation and provide the results of the investigations (including an oral or written report, interview memoranda, and document compilations) to the SEC. The provision of these materials may allay the Staff's concerns about agreeing to a settlement without knowing the full scope of the conduct at issue, as well as to assure the Staff that the company is not settling because it fears that the investigation will uncover additional misconduct. To be credible with the Staff, the company must have conducted a thoroughgoing internal investigation, including witness interviews and document review. That kind of cooperation may benefit the client, but will come at considerable cost and may jeopardize the attorney-client privilege and attorney work product protection.

For several years, the Commission has focused on the cooperation provided by entities subject to investigation. In October 2001, the SEC issued a report of investigation (Seaboard § 21(a) Report) encouraging companies to institute internal investigations upon learning of possible violations of the federal securities laws and to report to the SEC the results of the investigation. The facts in Seaboard § 21(a) Report are straightforward. A controller at a subsidiary caused Seaboard Corporation's periodic reports to be misstated. On discovering the misconduct, Seaboard Corporation's internal auditors conducted an immediate inquiry and advised management, who promptly notified the audit committee. The audit committee promptly conducted an investigation through outside counsel, the controller and two other employees were fired, and the company issued a prompt public announcement of an anticipated restatement. Seaboard

Corporation also cooperated with the Staff by providing "all information relevant to the underlying violations" and instituting meaningful remedial measures.

The Commission issued a cease-and-desist order against the controller n3 but did not bring any action against Seaboard Corporation. In the Seaboard § 21(a) Report the Commission explained its decision not to bring an enforcement action against the company. The Commission stated that among the reasons why there was no enforcement action brought against Seaboard Corporation were that Seaboard Corporation conducted internal reviews performed by outside professionals unfettered by limitations or interference from interested persons, took corrective action, and voluntarily reported the results of its internal investigation to the Staff.

In the Seaboard § 21(a) Report, the SEC identified thirteen non-exclusive factors as "the criteria we will consider in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation--from the extraordinary step of taking no enforcement action to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents we use to announce and resolve enforcement actions:" n4

1. The nature of the misconduct involved. The factor includes whether the conduct resulted from inadvertence, honest mistake, simple negligence, reckless or deliberate indifference to indicia of wrongful conduct, willful misconduct or unadorned venality and whether the company's auditors misled?
2. The company's compliance culture. This factor includes how did the misconduct arose, including whether the conduct resulted from the result of pressure placed on employees to achieve specific results or a tone of lawlessness set by those in control of the company. This factor also includes consideration of what compliance procedures were in place to prevent the misconduct now uncovered and why did those procedures fail to stop or inhibit the wrongful conduct.
3. The level of the wrongdoer in the organization. The SEC factor includes the seniority of the wrongdoer(s), whether senior personnel participate in, or turn a blind eye toward, obvious indicia of misconduct, whether the misconduct was "isolated" or whether it was "systemic" and "symptomatic of the way the entity does business."
4. The duration of the misconduct. In addition to the duration of the conduct, this factor includes consideration of whether the misconduct occurred before the company went public and whether it facilitated the company's ability to go public.
5. The amount of harm inflicted upon investors and other corporate constituencies. This factor includes consideration of whether "the share price of the company's stock drop significantly upon its discovery and disclosure."
6. The detection of the misconduct. Presumably, the SEC is more likely to exercise its discretion to seek a less severe sanction if company personnel detected the misconduct than it a law enforcement agency such as the SEC discovers the misconduct.
7. Response upon discovering the misconduct. This factor includes consideration of how long it took for the company to implement an effective response. It appears to be encompassed by the eighth factor, but emphasizes the priority the Staff places on the speed of the effective response.
8. The steps the company took upon learning of the misconduct. This factor considers whether the company immediately stopped the misconduct and whether the persons responsible for any misconduct remain with the company in the same positions. This factor also includes whether the company promptly, completely and effectively disclosed the existence of the misconduct to the public, to regulators and to

self-regulators? Did the company cooperate completely with appropriate regulatory and law enforcement bodies? Did the company identify what additional related misconduct is likely to have occurred? Did the company take steps to identify the extent of damage to investors and other corporate constituencies? Did the company appropriately recompense those adversely affected by the conduct?

9. The processes the company followed to resolve many of these issues and ferret out necessary information. This factor also appears to be encompassed by the eighth factor, but emphasizes corporate governance factors such as whether and when the Audit Committee and the Board of Directors were fully informed.

10. Thoroughness of the internal investigation. This factor also appears to be encompassed by the eighth factor but emphasizes issues related to the internal investigation, including whether "the company commit to learn the truth, fully and expeditiously," whether the company performed "a thorough review of the nature, extent, origins and consequences of the conduct and related behavior," whether the review was overseen by the Board or committees consisting solely of outside directors, whether company employees or outside persons perform the review (and if outside persons, had they done other work for the company), and whether (and why) scope limitations placed on the review.

11. Disclosure to the Commission. This factor also appears to be encompassed by the eighth factor but emphasizes the extent of the company's cooperation with the Enforcement Division including whether "the company promptly ma[d]e available to [SEC] staff the results of its review and provide sufficient documentation reflecting its response to the situation," whether the company "identify[ed] possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law," whether the company produce[d] a thorough and probing written report detailing the findings of its review," whether "the company voluntarily disclose[d] information our staff did not directly request and otherwise might not have uncovered," and whether "the company ask[ed] its employees to cooperate with our staff and make all reasonable efforts to secure such cooperation."

12. Assurances are there that the conduct is unlikely to recur. This factor also appears to be encompassed by the eighth factor and emphasizes whether "the company adopt[ed] and ensure[d] enforcement of new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct" and whether "the company provide[d] [SEC] staff with sufficient information for it to evaluate the company's measures to correct the situation and ensure that the conduct does not recur."

13. Identity of the company. This factor considers whether the company is the same company in which the misconduct occurred, or has changed through a merger or bankruptcy reorganization.

The Seaboard § 21(a) Report provides only limited comfort to issuers that seek to obtain credit for cooperation by instituting an internal investigation and reporting to the SEC the results of the internal investigation. The Commission and the Staff have emphasized that even if an issuer takes prompt and effective corrective action and cooperates with the Staff, the Commission might bring an enforcement action against the issuer where the conduct was more egregious or the harm to the investing public more substantial. Many SEC defense counsel suspect that the benefits suggested by the Seaboard § 21(a) Report are largely illusory. In addition, Enforcement Staff have in the past stated that the benefits of the Seaboard § 21(a) Report may be unavailable to companies that decline to provide to the Staff materials otherwise protected by the attorney-client privilege and the work-product doctrine. While the SEC will enter into so-called "confidentiality agreements" whereby it agrees that production of otherwise privileged materials will not constitute a subject matter waiver, and indeed may even make this argument in court, the success of this argument is uncertain at best. Accordingly, a party may receive some benefits from cooperating with the SEC, but is unlikely to receive the full benefits of the Seaboard § 21(a) Report unless the party is prepared to waive attorney-client privilege and the work-product doctrine.

In 2007, in the wake of the debate regarding whether the McNulty Memo n6 had gone far enough, SEC Enforcement Director Linda Chatman Thomsen provided the following overview of the SEC's approach to cooperation and the waiver of attorney-client privilege:

Do we discuss waiver issues with counsel? Of course. Do we raise the topic? Sometimes, but more often than not it is the company or individual or their counsel who raise the issue. Why is that? A variety of reasons. First, advice of counsel is often used as a defense. Second, especially for companies with serious issues, they want to do whatever they can to distinguish the company from its employees who have engaged in serious law breaking. I have heard one defense counsel say that, when confronted with a big problem, he, his colleagues and his client, stay up nights trying to think of ways to cooperate.

So what do we do when we initiate the conversations? We have a process, which I will describe, but first two important notes. First, we do not - indeed we cannot - require waiver of the attorney/client privilege. Second, waiver of a privilege or protection is not a pre-requisite to obtaining credit in a Commission investigation. The credit given is based on, among other things, the factual information given, the timeliness of the provision of information and the usefulness of the information. Waivers may be, and often are, a means to that end but are not an end in and of themselves.

On to our process. It is, to coin a phrase from another current discussion in the securities world, principles based. First and foremost, we respect the legitimate assertions of the attorney client privilege and the attorney work product protection. Second, we think about alternatives for obtaining the information we seek. Third, we distinguish between facts and core attorney-client communications and opinion work product. It is the former we are interested in. We also recognize the difference between work associated with an internal investigation and work done at the time of the events at issue. It is the factual information from the former we are most interested in. As to the latter, we often get it but not at our request but rather as a result of someone advancing an advice of counsel defense or argument. Fourth, recognizing the importance of this issue, if we initiate these conversations, we do so at the Assistant Director level or higher. Finally, we are candid about the existing state of the law and let people know that while we will do our best to protect the confidentiality of information provided to us, the state of the law may not support maintaining confidentiality after information has been shared with us. n7

Thomsen's explanation that the Enforcement Staff are not to seek waiver of privilege is reflected in the SEC *Enforcement Manual* published in October of 2008:

The staff should not ask a party to waive the attorney-client privilege or work-product privileges and is directed not to do so. All decisions regarding a potential waiver of privilege are to be reviewed with the Assistant supervising the matter and that review may involve more senior members of management as deemed necessary. The Enforcement Division's central concern is whether the party has disclosed all relevant facts within the party's knowledge that are responsive to the staff's information requests, and not whether a party has elected to assert or waive a privilege. As discussed below, if a party seeks cooperation credit for timely disclosure of relevant facts, the party must disclose all such facts within the party's knowledge. On request, and to the extent possible, the staff should continue to work with parties to explore alternative means of obtaining factual information when it appears that disclosure of responsive documents or other evidence may otherwise result in waiver of applicable privileges. n8

FOOTNOTES:

(n1)Footnote 1. The term "internal investigation" has several different meanings. In some contexts, it is limited to a fact-finding exercise directed by senior management or a committee of the company's board of directors to uncover wrongdoing. In this chapter, it is used to mean the efforts by defense counsel to investigate the factual and legal issues

relating to an SEC investigation.

(n2)Footnote 2. *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decision Exchange Act Release No. 44969, AAER No. 1470, 2001 SEC LEXIS 2210* (Oct. 23, 2001) (the "Seaboard § 21(a) Report"). A copy of the Seaboard § 21(a) Report is set forth in Appendix A, Forms, Reports & Memoranda.

(n3)Footnote 3. *In re Gisela de Leon-Meredith, Exchange Act Release No. 44969, 2001 SEC LEXIS 2210* (October 23, 2001) .

(n4)Footnote 4. *In re Gisela de Leon-Meredith, Exchange Act Release No. 44969, 2001 SEC LEXIS 2210* (October 23, 2001) .

(n5)Footnote 5. This privilege issue is discussed in Chapter 12.

(n6)Footnote 6. *See* Chapter 23, for discussion of the McNulty Memo.

(n7)Footnote 7. L. Thomsen, "Remarks Before the 27th Annual Ray Garrett, Jr. Corporate and Securities Law Institute 2007" (May 4, 2007) (*available at* <http://www.sec.gov/news/speech/2007/spch050407lct.htm>).

(n8)Footnote 8. *Enforcement Manual* § 4.3, p. 99.



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CHAPTER 17 SETTLEMENT DISCUSSIONS

1-17 Securities Enforcement: Counseling and Defense § 17.05

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§ 17.05 Factors in Negotiations

Before initiating settlement discussions, the company and its counsel should thoroughly understand the company's priorities. Counsel should further understand that the SEC is administering a far-reaching law enforcement program, and that many items that might otherwise be subject to negotiation cannot be considered because of the effect on the program as a whole. Certain things are simply non-negotiable, such as the requirement that any settlement be public, and involve a court or administrative order constraining future conduct. Within these constraints, there are a number of factors to be considered in negotiating a settlement such as the form of the relief sought by the Commission, the violations charged, and the language of the charging document.

[1] Form of Relief

There are three basic forms of settlement with the SEC. The SEC remedy of choice has historically been a court order enjoining the defendant from future violations of specified provisions of the federal securities laws. The SEC also has authority to obtain a number of remedies through the administrative process. n1 Finally, in rare instances, the SEC may resolve a matter by issuing a report pursuant to Section 21(a) of the Exchange Act.

The selection of the relief can have a significant impact on the client. For example, an injunction can impose disclosure obligations on an issuer that are not necessarily triggered by an administrative remedy. Similarly, a court order enjoining a person (including a broker-dealer) from violations of § 10(b) and *Rule 10b-5* thereunder can render that person ineligible to act as an investment adviser or underwriter for an investment company. n2 Companies, attorneys, accountants and securities professionals should also consider the potential collateral consequences under state law.

To some extent, the form of the relief may be perceived as indicative of the seriousness of the alleged misconduct. For example, the SEC has taken the position that a person can be a cause of a violation for the purpose of a cease-and-desist order if the person's conduct was merely negligent, or short of the knowing or reckless standard required for fraud charges in federal court. Accordingly, many negotiations involve an effort by defense counsel to persuade the Staff that the settled action should be an administrative proceeding rather than an injunctive action. Settlement discussions less frequently focus on whether the Staff should agree to resolve the matter with a Section 21(a) report.

In settled administrative proceedings, the Commission issues an order that simultaneously institutes the proceedings, makes findings, and imposes remedial sanctions. Under the exception to the hearsay rules for government reports, the findings in a settled administrative proceeding may be admissible in other litigation, including related securities class actions and derivative claims. n3

In July 2002, the SEC entered into a settlement on innovative terms involving a springing cease-and-desist order. The settlement partially resolved a cease-and-desist proceeding that the SEC had instituted in December 1998, against Philip J. Ryan III and six other individuals who worked for W.R. Grace or a subsidiary of W.R. Grace. In instituting the proceedings, the SEC had alleged that Ryan had caused violations of the books and records provisions and reporting provisions of the Exchange Act. In July 2002, the SEC dismissed the proceedings as to Ryan pursuant to a settlement under which Ryan publicly agreed that the Commission enter an Order reinstating proceedings against Ryan and making the findings and imposing remedies on Ryan if, as a result of conduct in which Ryan engaged before July 15, 2005, other than that alleged in the initial Order Instituting, one or more of the following four triggering events occurred before July 15, 2007: (1) Ryan is found by any court, agency or SRO to have violated any federal or state securities laws; (2) Ryan settles any claim by any agency or SRO involving any violation of the securities laws; (3) Ryan is disciplined by any accounting regulatory body; and (4) Ryan is subject to a final order under Rule 102(e) of the SEC Rules of Practice. n4 It appears, however, that the Ryan settlement will not serve as a precedent for future settlements.

In insider trading cases, the Commission historically insists on injunctive relief. In matters involving accountants practicing before the Commission, regulated entities, and persons associated with regulated entities, the Commission is likely to insist on administrative remedies. In many other matters, the Staff may have more flexibility to consider alternative remedies.

In 2010, the Enforcement Division amended its Manual to set forth two remedies that are analogous to remedies that federal prosecutors had been using extensively for the past decade: deferred prosecution agreements and non-prosecution agreements. The SEC can enter into deferred prosecution agreements and non-prosecution agreements only with the approval of the Commission.

The Enforcement Manual provides that a deferred prosecution agreement is a written agreement between the Commission and a potential cooperating individual or company in which the Commission agrees to forego an enforcement action against the individual or company if the individual or company agrees to, among other things: 1) cooperate truthfully and fully in the Commission's investigation and related enforcement actions; 2) enter into a long-term tolling agreement; 3) comply with express prohibitions and/or undertakings during a period of deferred prosecution; and 4) under certain circumstances, agree either to admit or not to contest underlying facts that the Commission could assert to establish a violation of the federal securities laws. n4.1 Under the terms of the agreement, if the agreement is violated during the period of deferred prosecution, the Staff may recommend to the Commission--and the Commission may authorize--an enforcement action against the individual or company for the original misconduct as well as any additional misconduct. Furthermore, if the Commission authorizes the enforcement action, the Staff may use any factual admissions made by the cooperating individual or company to file a motion for summary judgment, while retaining the ability to bring an enforcement action for any additional misconduct at a later date. Deferred prosecution agreements must be approved by the Commission.

Like deferred-prosecution agreements, non-prosecution agreements are agreements in which the Commission agrees not to pursue an enforcement action against the company or individual and the company or individual agrees to cooperate fully with the SEC and makes certain other undertakings (e.g., payment of disgorgement or civil penalties) and the Staff retains the ability to recommend--and the Commission retains the authority to authorize--an enforcement action if the company or individual violates the agreement. Unlike deferred prosecution agreements, non-prosecution agreements typically do not include an agreement to admit (or not contest) certain facts and does not include a tolling agreement.

[2] Violations Charged

The violations charged often reflect the Staff's view of the seriousness of the conduct. In addition, the legal collateral consequences of an SEC enforcement action depend, in part, on the statutory and regulatory provisions identified as having been violated. For example, a company can lose the benefit of the safe-harbor for forward looking statements if it is the subject of a judicial or administrative order or decree that requires the company to "cease and desist from violating the antifraud provisions of the securities laws." n5 Similarly, the defendant might have an obligation to continue disclosing orders involving violations of the anti-fraud or reporting provisions, but not violations of the internal controls and books and records provisions, in such documents as registration statements and proxy statements. Many public companies have licenses, lending arrangements, joint venture agreements, and government contracting issues that could be affected by an SEC settlement. In developing settlement priorities, companies, attorneys, accountants, and securities professionals should thoroughly consider the collateral consequences under state, as well as federal, law.

Enforcement actions alleging fraud are viewed as more serious than those alleging violations of the reporting, internal controls, and books and records provisions of the Exchange Act. n6 Although more subtle, a violation of § 17(a)(1) of the Securities Act, which requires scienter, is viewed as more serious than violations of §§ 17(a)(2) and (3) of the Securities Act, which have no scienter requirement. n7 Nevertheless, the SEC will often refer to even non-scienter violations of §§ 17(a)(2) and (3) as fraud violations.

The statutory provisions alleged to have been violated are also important because they tend to influence the form of remedy that the SEC and its Staff will accept in settlement. For example, the SEC is likely to insist on barring from the securities industry any securities professional charged with violating an anti-fraud provision of the federal securities laws. In addition, allegations in support of fraud charges can fuel private securities litigation against the client. For example, in cases involving misleading filings, a settlement based on Exchange Act § 10(b) n8 is more likely to trigger private litigation than a settlement based on Exchange Act § 13(a) n9 because a § 13(a) settlement may be interpreted by the plaintiff securities bar as indicating that the SEC had not obtained evidence sufficient to establish a violation of the anti-fraud provisions of the federal securities laws. In addition, if the settlement includes a fraud charge, the possibility that a judge might permit the settlement to be introduced in private litigation might significantly embolden plaintiffs in such litigation.

Another area of contention is whether entities such as broker-dealers, investment advisers, and accounting firms should be charged with fraud whenever their personnel engaged in fraud. n10 Discussions on this topic tend to focus on factors such as the gravity, pervasiveness and duration of the alleged misconduct, the role of senior management in the alleged misconduct, the compliance culture and procedures of the entity, whether the entity self-reported the misconduct, whether the entity engaged in appropriate remediation, and whether the entity cooperated with law enforcement agencies.

Comment

In negotiating a settlement, defense counsel should consider collateral consequences. These consequences could include legal consequences arising from the federal securities, state securities laws, other state and federal laws, and the company's operations. n11

[3] Subjects of the Enforcement Proceeding

The SEC will bring charges against not only corporations, but also senior executives and other company personnel. The inclusion of individual managers as defendants in the enforcement action will often result in a costly diversion of management resources from the business of the company to responding to the SEC's proposed charges. For these reasons, the company may want to consider settling in return for the Staff's commitment to refrain from naming certain individuals. Discussions along these lines rarely take place explicitly, and, if they do, are likely to prompt a response

that the SEC will not consider not charging a culpable person in exchange for the settlement of another party.

The SEC rarely accepts a proposed settlement against a company that does not include an officer or employee of the company. Moreover, the Commission may be unwilling to accept a settlement of fraud charges against such individuals without their consent to officer and director bars.

[4] Language in the Settlement Papers

The language in the settled complaint or order is important. On the day of filing, the SEC usually releases copies of the pleadings and a news release to the press. In addition, if the charging document is a complaint, the Commission issues a litigation release that describes the settlement and summarizes the allegations of the complaint. n12 For major matters, the SEC may also issue a press release. Thus, the language in the settlement papers can dramatically affect the nature and extent of the publicity generated by the enforcement action. Moreover, when a party settles an injunctive or administrative proceeding with the Commission, the complaint or order might be admitted as evidence in a subsequent proceeding. In addition, for an individual, the language of the complaint is important because it will likely be reviewed by prospective employers and, if the individual is an attorney, accountant or securities professional, by the state officials who regulate the individual's profession. Similarly, for a company, the language of the settlement papers might affect the extent to which other companies or government entities hesitate to conduct business with the company. Furthermore, the language of the charging document along with the violations charged and the relief sought can influence the extent to which state regulators (e.g., bar associations, state accountancy boards) and criminal prosecutors seek to impose additional sanctions.

The Staff's initial draft of the charging document is likely to be a one-sided presentation of the facts favorable to the Staff's case. The Staff ordinarily will engage in only limited negotiations with counsel over the language in the charging document to be issued in connection with the settlement. While the Staff often endeavors to confine these negotiations to adjustments needed to correct factual errors in the draft complaint or order, defense counsel should press to make the charging document more balanced. Defense counsel can seek deletion of certain information on the ground that the evidence is weak or the facts are peripheral to the charges. Negotiations over the language of the charging document can be time-consuming, but fruitful. While the Staff's hands may be tied by the Commission's programmatic concerns in terms of the charges and the relief sought, the Staff has considerable discretion in how it chooses to characterize the facts underlying the charges, particularly in federal court proceedings.

Defense counsel can attempt to persuade the Staff to delete or tone down inflammatory statements or characterizations. In addition, counsel can seek to have certain mitigating information added. Inclusion of mitigating facts and subsequent remedial measures may be essential to a fair presentation of the underlying facts. In addition, inclusion of such references may enhance the message sent by the settlement and increase its deterrent value. For example, counsel representing a company in a settlement involving control person liability for insider trading might consider arguing to the Staff that it should include in the settlement papers references to the company's having:

- notified employees annually regarding the prohibitions of the insider trading laws,
- obtained written commitments from employees that they would not violate the federal securities laws, and
- informed officers that they should only trade in the securities of the issuer during specified time periods.

Counsel should consider seeking written clarification of the characterization of the client's conduct if the charges require that the conduct be "willful," as, for example, is required in administrative proceedings against securities industry professionals under Section 15(b)(6). The term "willful" suggests serious misconduct, but, as defined by the SEC,

encompasses conduct that might not even constitute negligence. n13 Such clarifying language might be admissible into evidence in a private action, might prevent the SEC sanction from triggering certain collateral consequences (e.g., action by a state board of accountancy), and might affect public perception of the significance of the enforcement action.

The caption on the pleadings may also be significant. In an action involving multiple defendants, the first name on the caption tend to receive more publicity than the other names on the caption. Counsel can, for instance, argue that it would be unfair to list a client first, if that client is arguably less culpable than another defendant in the same action.

The language of the press release usually conforms to the language of the underlying complaint or administrative order. Counsel will always have an opportunity to review the complaint or order instituting proceedings in connection with the settlement, and should press for an opportunity to review for inaccuracies the press release that the SEC plans to release in connection with the filing of the complaint. Even if the Staff provides defense counsel with an advance copy of the release, the Staff often will resist negotiating the language of the press release. Counsel should, nevertheless, negotiate for language that fairly and accurately describes the allegation in the charging documents.

[5] Disgorgement

Disgorgement amounts can be a major issue in settlement discussions involving companies. The SEC has required companies to pay tens of millions of dollars in disgorgement in order to settle enforcement actions. For example, as part of the settlement of charges relating to late trading and market timing, Bank of America agreed to pay \$250,000,000 in disgorgement. n14 In a settlement with Richard Strong of charges relating to undisclosed frequent trading in funds advised by Strong Capital Management, the SEC required Strong to disgorge \$30,000,000 (in addition to penalties of \$30,000,000) even though Strong's gross and net profits from his personal undisclosed frequent trading in the funds totaled \$4,100,000 and \$1,600,000, respectively. n15

The SEC Staff often starts the settlement discussions with an aggressive calculation of disgorgement. The principle behind disgorgement is that a wrongdoer should surrender the profit gained or loss avoided by the misconduct at issue. Because the SEC views itself as a principle litigant, the discussions regarding disgorgement amounts usually need to focus more on the facts of the case and the relevant law than on the pragmatic need for compromise. There are a number of issues that can be negotiated, including the conduct that should be treated as unlawful, the extent to which the proposed defendant should be deemed liable for the profits gained or losses avoided by others, the extent to which the profits gained or losses avoided are attributable to the conduct at issue, and the extent to which offsets should be applied.

Comment

The Sarbanes-Oxley Act of 2002 contains a provision making judgments for violations of the federal securities laws not dischargeable in bankruptcy. Sarbanes-Oxley Act § 803, amending *11 U.S.C.S. 523(a)(19)*.

[6] Penalties

Penalties have become a major issue in many settlement discussions in the 2000's. The SEC has required substantial penalties in settling fraud charges against public companies. In April 2002, the SEC required a \$10,000,000 penalty as part of a settlement of fraud charges against Xerox. n16 In July 2003, a federal court approved the largest civil penalty imposed in Commission history--a \$2.25 billion penalty against WorldCom, to be satisfied, post-bankruptcy, by the company's payment of \$500 million in cash, and common stock in the reorganized company valued at \$250 million. n17 In December 2003, the SEC required a \$50 million penalty as part of a settlement of financial fraud charges against Vivendi. In May 2004, the SEC required a \$25,000,000 penalty from Lucent Technologies Inc. as part of the settlement

of fraud charges. n18 In June 2004, the SEC required multi-million penalties as part of the settlement of fraud charges against three public companies: Symbol Technologies--\$37,000,000; i2 Corporation--\$10,000,000; and Gemstar--TV Guide--\$10,000,000. n19 In July and August 2004, the SEC announced a \$150 million settlement against Bristol Myers-Squibb, of which \$50 million was neither disgorgement nor penalty. n20 In March 2005, Time Warner agreed to a \$300,000,000 penalty. n21 In April 2005, Adelphia settled with the SEC and the Attorney's Office for the Southern District of New York for a \$715 million penalty. n22 In February 2006, the SEC obtained a \$800,000,000 settlement from AIG. n23

The SEC has also required substantial penalties in actions involving allegations that financial services firms aided and abetted public companies in issuing materially false or misleading financial disclosures. For example, between March and December of 2003, the Commission brought enforcement actions against four financial services firms for allegedly aiding and abetting or causing Enron's accounting fraud. These four firms--Merrill Lynch, J.P. Morgan Chase, Citigroup, and CIBC--agreed to pay a total of \$197.5 million in civil penalties, ranging from \$37.5 million to \$65 million each, in addition to making substantial disgorgement payments. n24

The SEC has also required substantial penalties in actions against regulated entities. For example, in 2003, the SEC, as part of the settlement of the global research analyst matter, required penalties of \$150 million against Citigroup and \$75 million against Credit Suisse First Boston. With respect to the mutual fund industry, the SEC has required penalties of \$125,000,000 against Bank of America, \$70,000,000 against FleetBoston, \$50,000,000 against Pilgrim Baxter & Associates, \$40,000,000 against Banc One Investment Advisors, \$40,000,000 against Strong Capital Management, \$50,000,000 against Putnam Investment Management LLC and \$50,000,000 against Massachusetts Financial Services Company. n25

In an April 2004 speech, the then Director of the Division of Enforcement, Stephen M. Cutler, provided an overview of the factors considered by the Commission in assessing penalties:

I think we start from the presumption that any serious violation of the federal securities laws should be penalized with a monetary sanction. Indeed, Congress's willingness to extend the Commission's penalty authority to reach all categories of violations suggests lawmakers agreed that no violation should be inherently exempt from a penalty. We recognize, however, that in particular cases, there may be factors present which justify departing from this penalty presumption. Unfortunately, the number and variety of factors that may be relevant in the broad range of cases we pursue precludes our developing--or my spelling out for you--a precise, formulaic approach to arrive at a penalty amount. Indeed, if you tried to do so, you would no doubt quickly conclude that the combinations of facts and factors are nearly infinite. Nevertheless, as the staff examines the equities in each case, there are certain core factors, which are always relevant to our analysis. Supplementing these core considerations are a number of other factors which, if relevant in a particular case, may also influence our penalty recommendation. I'll discuss first the core factors--those factors which are consistently part of our analysis.

Perhaps the most basic factor we consider is the type of violation committed. Specifically, whether it involved fraud, and if so, the degree of scienter, if any, that was present. In short, there is fraud, and then there is fraud. Conversely, while the absence of fraud is a factor that may mitigate the need for a penalty, I would caution against thinking of fraud as the bright line separating penalty cases from non-penalty cases. The Commission has frequently imposed penalties for violations of the non-fraud provisions of the securities laws. In other words, although it is always relevant, this factor may be swamped by the presence or absence of the other core factors.

The second core factor is the degree of harm resulting from the violations. Significant harm will very often lead to a significant penalty. In the case of public company violators, we are likely to look to

the losses to investors from the misconduct as reflected in the company's change in market capitalization.

In cases involving regulated entities, the enforcement staff is likely to assess harm from a slightly different perspective. Because of the unique, gatekeeper role these entities play in the operation of our markets, instead of simply weighing investor losses, we may also assess the harm that their misconduct caused to public confidence and trust in the markets. Examples of violators that scored high in this regard include the Wall Street firms that were part of the global research analyst settlement and the investment advisory firms that recently have reached agreements with the Commission or its staff to settle actions involving late trading and/or market timing. In this category are Massachusetts Financial Services and Putnam, which have consented to orders to pay penalties of \$50 million each, and Bank of America and FleetBoston, which have agreed in principle to pay penalties of \$125 million and \$70 million, respectively.

The third core factor, which will often prove decisive in our analysis, is the extent of a violator's cooperation, as measured by the standards set forth in the Commission's [Seaboard] 21(a) Report. If, for example, an entity--whether public company, accounting firm, or regulated entity--or its counsel is recalcitrant during an investigation, misleads the staff, or fails unreasonably to comply with Commission processes, the staff is very likely to seek a penalty in settlement. The penalty is likely to be particularly substantial if the violator's underlying conduct has also resulted in significant investor harm.

As you would expect, the provision of extraordinary cooperation, on the other hand, including self reporting a violation, being forthcoming during the investigation, and implementing appropriate remedial measures (including, in the case of an entity, appropriate disciplinary action against culpable individuals), can contribute significantly to a conclusion by the staff that a penalty recommendation should be more moderate in size or reduced to zero. For example, in two recent actions involving Reliant Resources and Consec, Inc., the Commission declined to impose civil penalties on either public-company respondent. The Commission's order against Reliant notes that the company voluntarily undertook an internal inquiry to determine whether it had engaged in illegal round trip trades, and that when the internal inquiry revealed that it had, the company promptly reported the facts to the Commission and publicly disclosed those facts in a press release. The Commission's order against Consec stated that in accepting a settlement, which did not include charges of fraud or a penalty, "the Commission considered certain remedial acts promptly undertaken by Consec, and Consec's cooperation with the Commission's staff."

Supplementing the three core considerations--the type of violation, the degree of harm, and the extent of cooperation--are several other factors, which may, if present, incrementally influence the staff's penalty recommendation. For example, if the wrongdoer is a recidivist, that will weigh in favor of a (larger) penalty. If the staff is recommending charges against a sophisticated party who violated a clear legal standard and should have known better than to commit a violation--an officer, director, lawyer, or regulated person, for instance--the staff is more likely to seek a (higher) penalty. A person or entity that was enriched by its own wrongdoing, too, may be subject to a stiffer penalty. Larger penalties are necessary in such cases to deter misconduct that otherwise would be perceived as particularly lucrative. We will also consider the duration of the misconduct and the seniority of the employees involved in it when determining an appropriate penalty against an entity.

It is also important that a penalty be of sufficient size for the wrongdoer to feel some sting. While we don't take the approach they use in Finland--where traffic fines are mathematically proportionate to the offender's income, sometimes resulting in speeding tickets upward of \$100,000--we may take into account, in a macro sense, the size of an entity or the net worth of an individual in determining the appropriate amount of a penalty recommendation. Finally, in assessing all of the various factors, the staff also seeks to fairly reflect in the penalty amounts the relative culpability of violators involved in the

same or a similar scheme. n26

On January 4, 2006, the SEC issued, Statement of the Securities and Exchange Commission Concerning Corporate Penalties (the "Statement"). The Statement details the framework for the Commission's penalty determinations with respect to two public companies. In the first case, the Commission agreed to a settlement with McAfee, Inc. that included imposition of a \$50 million penalty. In the second case, the Commission agreed to a settlement with Applix that did not involve the imposition of any penalty.

The Commission's stated purpose in issuing the Statement, was "to provide the maximum possible degree of clarity, consistency, and predictability in explaining the way that its corporate penalty authority will be exercised." The five Commissioners unanimously adopted the Statement. According to Chairman Cox, the Statement was the result of extensive discussions among the Commissioners over the course of several closed meetings. Each Commissioner devoted at least 40 hours to the effort. The Statement's framework appears to reflect an approach to assessing whether a penalty should be imposed, rather the amount of the penalty to be imposed.

On its face, the Statement differs significantly from previous guidance. The Commission stated that its "view of the appropriateness of a penalty on the corporation in a particular case, is distinct from the individuals who commit a securities law violation, turns principally on two considerations:

- *The presence or absence of a direct benefit to the corporation as a result of the violation.* The fact that a corporation itself has received a direct and material benefit from the offense, for example through reduced expenses or increased revenues, weighs in support of the imposition of a corporate penalty. If the corporation is in any other way unjustly enriched, this similarly weighs in support of the imposition of a corporate penalty. Within this parameter, the strongest case for the imposition of a corporate penalty is one in which the shareholders of the corporation have received an improper benefit as a result of the violation; the weakest case is one in which the current shareholders of the corporation are the principal victims of the securities law violation.

- *The degree to which the penalty will recompense or further harm the injured shareholders.* Because the protection of innocent investors is a principal objective of the securities laws, the imposition of a penalty on the corporation itself carries with it the risk that shareholders who are innocent of the violation will nonetheless bear the burden of the penalty. In some cases, however, the penalty itself may be used as a source of funds to recompense the injury suffered by victims of the securities law violations. The presence of an opportunity to use the penalty as a meaningful source of compensation to injured shareholders is a factor in support of its imposition. The likelihood a corporate penalty will unfairly injure investors, the corporation, or third parties weighs against its use as a sanction.

The Commission stated that, in addition to these two principal considerations, there are "six" secondary factors that are properly considered in determining whether to impose a penalty on the corporation:

1. *The need to deter the particular type of offense.* The likelihood that a corporate penalty will serve as a strong deterrent to others similarly situated weighs in favor of the imposition of a corporate penalty. Conversely, the prevalence of unique circumstances that render the particular offense unlikely to be repeated in other contexts is a factor weighing against the need for a penalty on the corporation rather than on the responsible individuals.
2. *The extent of the injury to innocent parties.* The egregiousness of the harm done, the number of investors injured, and the extent of societal harm if the corporation's infliction of such injury on innocent parties goes unpunished, are significant determinants of the propriety of a corporate penalty.

3. *Whether complicity in the violation is widespread throughout the corporation.* The more pervasive the participation in the offense by responsible persons within the corporation, the more appropriate is the use of a corporate penalty. Conversely, within this parameter, isolated conduct by only a few individuals would tend not to support the imposition of a corporate penalty. Whether the corporation has replaced those persons responsible for the violation will also be considered in weighing this factor.

4. *The level of intent on the part of the perpetrators.* Within this parameter, the imposition of a corporate penalty is most appropriate in egregious circumstances, where the culpability and fraudulent intent of the perpetrators are manifest. A corporate penalty is less likely to be imposed if the violation is not the result of deliberate, intentionally fraudulent conduct.

5. *The degree of difficulty in detecting the particular type of offense.* Because offenses that are particularly difficult to detect call for an especially high level of deterrence, this factor weighs in support of the impositions of a corporate penalty.

6. *Presence or lack of remedial steps by the corporation.* Because the aim of the securities laws is to protect investors, the prevention of future harm, as well as the punishment of past offenses, is a high priority. The Commission's decisions in particular cases are intended to encourage the management of corporations accused of securities law violations to do everything within their power to take remedial steps, from the first moment that the violation is brought to their attention. Exemplary conduct by management in this respect weighs against the use of a corporate penalty; failure of management to take remedial steps is a factor supporting the imposition of a corporate penalty.

7. *Extent of cooperation with the Commission and other law enforcement.* Effective compliance with the securities laws depends upon vigilant supervision, monitoring, and reporting of violations. When securities law violations are discovered, it is incumbent upon management to report them to the Commission and to other appropriate law enforcement authorities. The degree to which a corporation has self reported an offense, or otherwise cooperated with the investigation and remediation of the offense, is a factor that the Commission will consider in determining the propriety of a corporate penalty.

(Numbers supplied.)

As a result of the Statement, a company seeking to settle with the SEC will typically negotiate with the Staff a framework for settlement that the Staff believes it can recommend to the Commission. This framework will typically include the charges to be pled, the basic factual bases for the charges, and the proposed remedies other than monetary penalties. Pursuant to the Statement, the Staff will then seek guidance from the Commission as to whether a penalty is appropriate and, if so, the amount of the penalty. In this connection, the company can submit to the Staff a letter addressing the factors set forth in the Statement.

Penalties are also a major issue in many settlements involving individuals. The SEC has also increased the penalties sought from individuals. For example, the SEC required Richard Strong of Strong Capital Management to pay \$30,000,000 in penalties in connection with a settlement of charges relating to undisclosed frequent trading in funds advised by Strong Capital Management.

Traditionally, in insider trading cases, the SEC has sought the remedies of disgorgement, a civil money penalty equal to the amount of disgorgement, and pre-judgment interest on the amount disgorged. Several recent settlements indicate that the SEC is beginning to vary the penalty based on the facts and circumstances. In May 2002, the SEC settled insider trading charges against a lawyer and former stock broker who allegedly purchased stock after learning of an impending merger from a client. n27 The Commission imposed a penalty of two times the amount of his illegal profit. The SEC noted that his conduct was "especially egregious particularly considering the defendant's breach of his

professional obligations." n28 The SEC also required a number of defendants to pay one-and-a-half-time penalties in order to settle insider trading cases. n29 On the other hand, in August 2002, the SEC insisted on a penalty equal to only half the disgorgement. n30

On April 2007, Chairman Cox announced the launch of a pilot program which will implement recently adopted guidelines applicable to cases that might involve a monetary penalty against a company. Specifically, the SEC Staff would be required to obtain prior Commission approval before engaging in settlement discussions. n31 This program could have a significant impact on the Wells and Settlement processes. As of May 2007, however, the details of the program have not been worked out and it is not yet apparent what that impact will be.

Comment

The SEC's departure from its traditional settlement formula of imposing a penalty equal to the amount of disgorgement has complicated the settlement process by reducing predictability of outcomes, but may represent an opportunity for some clients.

In negotiating penalties in cases other than insider trading, it may be useful to refer to other, recently resolved comparable matters, though it can be difficult to ascertain a pattern from prior matters. Counsel can also attempt to reduce the amount of the monetary penalty by pointing to the company's cooperation, the mitigating facts, remedial measures taken, and costs (including amounts paid in related private litigation) already incurred by the company as a result of the conduct in question. n32 In cases other than insider trading cases, the Staff has considerable discretion in recommending penalty amounts.

[7] Duration and Scope of Any Bar or Suspension

The Commission has the ability to bar or suspend professionals in a variety of capacities. Professionals appearing before the Commission, typically accountants and attorneys are subject to Rule 102(e) of the SEC's Rules of Practice. Broker-dealers, investment advisers and municipal securities dealers can be suspended or have their licenses revoked with a right to apply for reinstatement in a specific period of time. In certain circumstances the Commission can obtain relief barring an individual from serving as an officer or director of a publicly held company. Many orders specify that a person who has been barred may apply to have the bar lifted, in whole or in part, after a specific period of time and, sometimes, under specified conditions. Counsel should explore with the Staff limiting the duration of any suspension--stating the time period after which an application to lift the bar can be filed, the scope of activities covered by the suspension or bar, and the specifics relating to the right to apply for reinstatement. Counsel should note that a suspension (up to twelve months) of an associated person pursuant to Section 15(b)(6) of the Exchange Act. expires on its own, while a bar (greater than twelve months) always requires the Commission to approve an application for re-association.

[8] Statutory Disqualifications

Certain remedies trigger statutory disqualification provisions that can have severe consequences. Chapter 20 discusses collateral consequences set forth in the federal securities laws. Defense counsel should also consider collateral consequences, if any, arising from other federal law, state and local law, and non-U.S. law. For example, Regulation D, the most important exemption from the securities registration requirements, is unavailable to issuers that have been enjoined within the past five years from engaging in conduct or practices in connection with the purchase or sale of any security, involving the making of a false filing with the SEC, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser, unless, upon a showing of good cause, the Commission determines that it is not necessary under the circumstances that the exemption be denied. Thus, a company that syndicates securities in private offerings might, as part of a settlement involving an injunction, seek an order from the SEC that the exemption not be denied.

The entry of an injunction can have significant collateral consequences for individuals and entities in the area of regulation of investment companies and investment advisers. Section 9(a) of the Investment Company Act prohibits any person who is enjoined by a court from engaging in conduct in connection with a purchase or sale of a security from serving as an employee, officer, director, investment adviser, or depositor of any registered investment company or as a principal underwriter for any registered open-end company, registered unit investment trust, or registered face-amount certificate company. n33 Further, any company affiliated with the ineligible person is equally barred from serving in the capacity described in § 9(a). Section 2(a)(3) of the Investment Company Act defines affiliated person to include, among others, any person directly or indirectly controlling, controlled by, or under common control with the ineligible person. The SEC will often give complete or partial relief to these affiliates from the disqualifying effect of an injunction.

Once a broker or dealer has been enjoined by a court in an SEC enforcement proceeding from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities dealer, transfer agent, or in a number of other activities or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security, the Commission may proceed against the broker or dealer under § 15(b)(4)(C) of the Exchange Act. n34 Under that provision, the SEC may, after notice and hearing, "censure, plac[e] limitations on the activities, functions or operations of, suspen[d] for a period not exceeding 12 months, or revok[e] the registration of any broker or dealer" so enjoined, if such censure or limitation is in the public interest. Under Section 15(b)(6) of the Exchange Act, the Commission may bar an individual from association with a broker or dealer or otherwise sanction that person upon a finding that he or she

- engaged in certain willful misconduct as described in Section 15(b)(4)(A), (D), and (E);
- was convicted of certain crimes enumerated in § 15(b)(4)(C) within the last 10 years; or
- was enjoined from engaging in any conduct in connection with the purchase or sale of a security.

Counsel should address with the Staff the extent, if any, to which such additional sanctions will be imposed. If defense counsel negotiates a settlement that can trigger collateral consequences under the control of the SEC, defense counsel should address these consequences with the Staff. If the Staff states that it does not intend to ask the Commission to initiate a collateral proceeding, defense counsel should confirm this statement in a letter to the Staff. If the Staff is not willing to disclaim an intention of initiating the collateral proceeding, defense counsel should seriously consider negotiating a settlement of the collateral proceeding. Similarly, if the SEC has the power to grant an exemption from a collateral consequence that would otherwise be triggered by the settlement, defense counsel should seek to make the exemption part of the settlement. Defense counsel should also consider seeking exemption from consequences triggered by the underlying conduct. For example, the SEC sanctioned Fifth Third Bank on the grounds that a municipal finance professional employed by Fifth Third Bank had made a political contribution to candidates or incumbents for elective office in Ohio who were responsible for, or had authority to appoint persons who were responsible for, the hiring of brokers, dealers, or municipal securities brokers by certain governmental entities in Ohio in violation of MSRB Rule G-37. n35 On the same day, the Commission issued an order pursuant to Section 15B(a)(4) of the Exchange Act that exempted Fifth Third Bank from the ban on participating in certain municipal securities finance business that otherwise would have been automatically triggered by the political contributions. n36

Comment

There can be significant delays between the date on which the settlement is finalized and the date on which the Commission issues the order charging the respondent. An order that suspends the respondent from certain activities for a period of time does not become effective until it is issued. Accordingly, a delay in the issuance can prejudice the respondent. In these cases, defense counsel should remain in touch with the Enforcement Staff in order to monitor the progress of the settlement and to urge speedy

action.

[9] Enhancements to the Company's Internal Accounting Controls or Supervisory Procedures and Independent Consultants

The Commission often requires that a settling company agree to enhance its internal controls or supervisory procedures. For example, in cases involving financial reporting issues, the SEC might require enhancements in the system of internal accounting controls, the appointment of a corporate compliance officer, and compliance training. Similarly, in broker-dealer sales practice cases, the SEC might require enhanced supervisory procedures by that person's employer. The Staff has taken at least three approaches. In some instances, the Staff has insisted that the respondent implement additional procedures and controls without specifying a mechanism for evaluating whether they are appropriate. In others, the company instituted the enhancements prior to the settlement, but the settled order required those procedures to be maintained, and provide some mechanism for modifying the procedures and controls. Under a third approach, the settlement has required the company to implement appropriate procedures, controls and disclosures and has specified a mechanism, such as a report by an independent consultant, for determining whether the procedures are appropriate.

A prospective defendant is well served by developing and implementing its own additional procedures and controls. This approach reduces the Staff's incentive for crafting its own changes, which may be more intrusive than those proposed by the prospective defendant's own management or board of directors. In addition, while the Staff tends to give little credit for changes instituted after the SEC began its investigation, it can be harshly critical of a company that fails to change its internal controls after the alleged problems surfaced.

The SEC also requires independent examiners or consultants for other purposes. In connection with settlements, companies have agreed to engage an independent examiner to determine whether the company's historical accounting for certain transactions was in conformity with GAAP; n37 agreed to retain an independent consultant to review the company's FCPA compliance and procedures; n38 agreed to retain a consultant to examine and assess extent to which entity complied with undertakings that entity made in settlement; n39 and agreed to retain an independent consultant to make binding recommendations regarding the company's internal controls to prevent a recurrence of the alleged misconduct. n40 In general, a settlement calling on an independent consultant to review the company's prior conduct is likely to be very burdensome.

Once the matter has been settled and a monitor has been appointed, the company should consider asking for the consultant's work plan. If the work plan calls on the consultant to review an extensive number of emails and interview numerous witnesses, the company should consider questioning the work plan.

[10] Tax Treatment and Insurance Coverage

Historically, settlement discussions with the SEC have not addressed whether amounts paid in connection with the settlement should be tax-deductible. They also have not addressed whether the putative defendant/respondent will be indemnified by an insurance company or other person. Often, settling defendants were indemnified for amounts paid in settlement. n41

In April, 2003, Senator Grassley complained publicly that amounts to be paid by the investment banks in the then anticipated global settlement of a number of SEC/NASD/NYSE actions relating to analysts might be tax-deductible or covered by insurance. The SEC responded by requiring each settling defendant to include in the document consenting to the entry of an injunction a paragraph providing that it will treat the civil penalty "as a penalty paid to the government for all purposes, including tax purposes, and "shall not claim, assert, or apply for a tax deduction or tax credit with regard to any federal, state or local tax for any penalty amounts," that it will not seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to any insurance policy, with regards to any penalty amounts" paid by the defendant. n42 Similar provisions have been required in subsequent settlements. n43

FOOTNOTES:

(n1)Footnote 1. These remedies and the collateral consequences associated with these remedies are discussed in Chapter 18 and Chapter 20, respectively.

(n2)Footnote 2. Investment Company Act § 9(c). Investment Advisers Act § 203(e)(4).

(n3)Footnote 3. The admissibility of SEC charging documents is discussed at Chapter 19.

(n4)Footnote 4. *In re Jean-Paul Boldue, Securities Exchange Act Release No. 46206, 2002 SEC LEXIS 1811* (July 15, 2002) .

(n5)Footnote 4.1. SEC Enforcement Manual § 6.2.3 at 129.

(n6)Footnote 5. Exchange Act § 21E, *15 U.S.C.S. § 78u-5(b)(1)(A)(ii)(II)*.

(n7)Footnote 6. Section 302 of the Sarbanes Oxley Act of 2002 requires CEOs and CFOs to certify, *inter alia*, that they have designed internal controls to ensure that material information relating to the issuer is made known to them. In light of this requirement, companies may demonstrate increased resistance to settlements that include a charge that a company's internal controls were deficient.

(n8)Footnote 7. *15 U.S.C.S. § 77a*.

(n9)Footnote 8. *15 U.S.C.S. § 78j(b)*.

(n10)Footnote 9. *15 U.S.C.S. § 78m(a)*.

(n11)Footnote 10. Stephen M. Cutler, *Remarks Before the American Institute of Certified Public Accountants* (Dec. 12, 2002) (*available at* www.sec.gov/news/speech/speecharchive/2002speech.shtml).

(n12)Footnote 11. *See* Chapter 20 for more on collateral consequences.

(n13)Footnote 12. Occasionally, the Staff will conduct a press conference to discuss unique or high profile settlements.

(n14)Footnote 13. The SEC takes the position that "willfulness means 'no more than that the person charged with the duty knew what he was doing. It does not mean that, in addition, he must suppose that he is breaking the law.'" *See, e.g., In re Feeley & Willcox Asset MgmT. Corp.*, Exchange Act Release No. 48162 (July 10, 2003), quoting *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) .

(n15)Footnote 14. "SEC Reaches Agreement in Principle to Settle Charges Against Bank of America for Market Timing and Late Trading," *News Release 2004-51, 2004 SEC NEWS LEXIS 572* (March 16, 2004).

(n16)Footnote 15. "Strong Capital Management and Founder Richard Strong Agree to Pay \$140 Million to Settle Fraud Charges Concerning Mutual Fund Trading," *News Release 2004-8, 2004 SEC NEWS LEXIS 1131* (May 20, 2004).

(n17)Footnote 16. "Xerox Settles SEC Enforcement Action Charging Company with Fraud Agrees to Pay \$10 Million Fine, Restate its Financial Results and Conduct Special Review of its Accounting Controls," *Litig. Rel. No. 17465, 2002 SEC LEXIS 896* (Apr. 11, 2002) .

(n18)Footnote 17. "The Honorable Jed Rakoff Approves Settlement of the SEC's Claim for a Civil Penalty Against WorldCom," *Litig. Rel. No. 18219, 2003 SEC LEXIS 1590* (July 7, 2003) .

(n19)Footnote 18. "SEC Files Settled Civil Fraud Action Against Vivendi Universal S.A., Its Former CEO, Jean-Marie Messier, and Its Former CFO, Guillaume Hannezo," *Litig. Rel. No. 18523, 2003 SEC LEXIS 3054* (Dec. 24, 2003).

(n20)Footnote 19. "Symbol Technologies Agrees to Settle SEC Enforcement Action Charging the Company with Accounting Fraud," *News Release 2004-74, 2004 SEC NEWS LEXIS 1204* (June 3, 2004); "i2 Technologies, Inc. Settles Fraud Charges Involving Misstatement of Approximately \$1 Billion in Revenues," *News Release 2004-81, 2004 SEC NEWS LEXIS 1268* (June 9, 2004); "Gemstar-TV Guide International Agrees to Settle SEC Enforcement Action Charging the Company with Overstating Its Revenues," *News Release 2004-86, 2004 SEC NEWS LEXIS 1356* (June 23, 2004).

(n21)Footnote 20. R. McTague, "Bristol-Myers to Pay \$15 Million to Settle SEC Charges of Accounting Fraud," 2 Corporate Accountability Report 831 (BNA August 6, 2004).

(n22)Footnote 21. "SEC Charges Time Warner with Fraud Aiding and Abetting Fraud by Others, and Violating a Prior Cease-and-Desist Order," *SEC. Ex. Act. Release No. 34-51400, 2005 SEC LEXIS 649* (March 21, 2005).

(n23)Footnote 22. "SEC and U.S. Attorney Settle Massive Financial Fraud Case Against Adelphia and Rigas Family for \$715 Million," *News Release 2005-63, 2005 SEC NEWS LEXIS 920* (April 25, 2005).

(n24)Footnote 23. "SEC Charges AIG with Securities Fraud," *Litig. Rel. No. 19560, 2006 SEC LEXIS 277, 2006 SEC NEWS LEXIS 289* (Feb. 9, 2006) *available at* www.sec.gov/litigation/litreleases/r19500. Of the \$800 million, the SEC characterized \$700 million as disgorgement and \$100 million as monetary penalty. The charging documents do not, however, indicate any basis for disgorgement. It is therefore possible that the entire \$800 million should be viewed as a penalty.

(n25)Footnote 24. "SEC Charges Merrill Lynch, Four Merrill Lynch Executives with Aiding and Abetting Enron Accounting Fraud," *News Release No. 2003-32, 2003 SEC NEWS LEXIS 590* (Mar. 17, 2003); "SEC Settles Enforcement Proceedings Against J.P. Morgan Chase and Citigroup," *News Release No. 2003-87, 2003 SEC NEWS LEXIS 1700* (July 28, 2003); "SEC Announces Agreement with Canadian Imperial Bank of Commerce and Two Executives to Settle Charges of Aiding and Abetting Enron Accounting Fraud," *News Release No. 2003-180, 2003 SEC NEWS LEXIS 2989* (Dec. 22, 2003).

(n26)Footnote 25. "SEC Reaches Agreement in Principle to Settle Charges Against Bank of America for Market Timing and Late Trading," *News Release No. 2004-51, 2004 SEC NEWS LEXIS 572* (Mar. 16, 2004); "SEC's Division of Enforcement Announces Agreement to Settle Civil Fraud Charges Against Fleet's Columbia Mutual Fund Adviser and Distributor for Undisclosed Market Timing," *News Release No. 2004-34, 2004 SEC NEWS LEXIS 573* (Mar. 16, 2004); "Harold Baxter and Gary Pilgrim Agree to Pay a Total of \$160 Million to Settle Fraud Charges Concerning Undisclosed Market Timing," *News Release No. 2004-157, 2004 SEC NEWS LEXIS 2541 & 2004 SEC NEWS LEXIS 2542* (Nov. 17, 2004); "Banc One Investment Advisors Corporation Agrees to Pay \$50 Million To Settle SEC Fraud Charges For Market-Timing Abuses," *News Release No. 2004-90, 2004 SEC NEWS LEXIS 1407* (June 29, 2004); "Massachusetts Financial Services Co. Will Pay \$225 Million and Make Significant Governance and Compliance Reforms To Settle SEC Fraud Charges Concerning Mutual Fund Market Timing; MFS's Two Top Executives Prohibited From Serving as Officers or Directors of Any Investment Adviser for Three Years; Entire Amount Paid To Be Returned to Investors Harmed by Market Timing," *2004 SEC NEWS LEXIS 248* (Feb. 5, 2004); "Putnam Agrees to Pay \$55 Million to Resolve SEC Enforcement Action Related to Market Timing by Portfolio Managers," *News Release No. 2004-49, 2004 SEC NEWS LEXIS 793* (Apr. 8, 2004).

(n27)Footnote 26. Stephen M. Cutler, "Speech to 24th Annual Ray Garrett Jr. Corporate and Securities Law Institute," at 4-6 (April 29, 2004) *available at* www.sec.gov/speech/spch042904smc.htm (footnotes omitted).

(n28)Footnote 27. *SEC v. Goldberg, 02 Civ. 3488 (JES) (S.D.N.Y.)*, *Litig. Rel. No. 17505, 2002 SEC LEXIS 1213*

(May 7, 2002) .

(n29)Footnote 28. *SEC v. Goldberg*, 02 Civ. 3488 (JES) (S.D.N.Y.), *Litig. Rel. No. 17505*, 2002 SEC LEXIS 1213 (May 7, 2002) .

(n30)Footnote 29. *SEC v. Bucknum*, Civil Action No. 06-10065 PBS (filed D. Mass. Jan. 12, 2006) *Litig. Rel. No. 19528*, 2006 SEC LEXIS 46 (Jan. 12, 2006) ; *SEC v. Villa Manzo*, Civil Action No. 02CV 1766 (S.D.N.Y.) (filed March 6, 2002), *Litig. Rel. No. 17395*, 2002 SEC LEXIS 510 (March 6, 2002) (chairman of public company and broker-dealer firm traded on tip about upcoming merger); *SEC v. Kramer*, Civil-2-690 (MLC) (D. N.J.), *Litig. Rel. No. 17364*, 2002 SEC LEXIS 389 (Feb. 19, 2002) (bank employee traded and tipped others after learning of bank customer's planned acquisitions); *SEC v. Harbottle*, Case No. CIV 02- 0491 PHX PGR (D. Ariz.), *Litig. Rel. No. 17424*, 2002 SEC LEXIS 695 (March 20, 2002) (officer of public company purchased stock issued by his employer after attending board meeting where merger plans were discussed).

(n31)Footnote 30. *SEC Charges Former Genentech Employee With Insider Trading*, *Litig. Rel. No. 17684*, 2002 SEC LEXIS 2119 (August 15, 2002) .

(n32)Footnote 31. Chairman Christopher Cox, "Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference," (April 13, 2007) (*available at* <http://www.sec.gov/news/speech/2007/spch041207cc.htm>).

(n33)Footnote 32. For example, in reaching a settlement with the former CEO of Sunbeam Corp. that included a monetary penalty of \$500,000, the SEC stated that the \$15 million previously paid by the former CEO in settlement of a related securities class action weighed heavily. *Sunbeam Settlement Reached: A Record SEC Fine for Ex-CEO Dunlap*, The Washington Post, September 5, 2002, at E1.

(n34)Footnote 33. For example, a securities fraud injunction can impair the ability of the enjoined defendant to act as a fiduciary, for an ERISA plan subject to regulation by the Department of Labor.

(n35)Footnote 34. 15 U.S.C.S. § 78o(b)(4)(C).

(n36)Footnote 35. *In re Fifth Third Sec., Inc.*, Exchange Act Release No. 46087, 2002 SEC LEXIS 1573 (June 18, 2002) .

(n37)Footnote 36. *In re Fifth Third Sec., Inc.*, Exchange Act Release No. 46088, 2002 SEC LEXIS 1565 (June 18, 2002) .

(n38)Footnote 37. *SEC v. Time Warner Inc.*, Civ Action No. 1:05CV00578 (GK) (D.D.C.), *Litig. Rel. No. 34-51400*, 2005 SEC LEXIS 649 (Mar. 21, 2005) , *available at* www.sec.gov/litigation/litreleases/lr19147.htm.

(n39)Footnote 38. "SEC Sues The Titan Corporation For Payments to Election Campaign of Benin President," *Litig. Rel. No. 19107*, 2005 SEC LEXIS 444 (Mar. 1, 2005) , *available at* www.sec.gov/litigation/litreleases/lr19107.htm.

(n40)Footnote 39. "KPMG Pays \$22 Million to Settle SEC Litigation Relating to Xerox Audits," Press Release No. 2005-59, 2005 SEC NEWS LEXIS 860 (April 20, 2005), *available at* www.sec.gov/news/press/2005-59.htm.

(n41)Footnote 40. "SEC Charges American International Group and Others in Brightpoint Securities Fraud," Press Release No. 2003-11, 2003 SEC NEWS LEXIS 2100 (Sept. 11, 2003), *available at* www.sec.gov/news/press/2003-111.htm.

(n42)Footnote 41. In June 2003, Xerox announced that it would pay \$19 million of the \$22 million that six former Xerox executives agreed to pay in settling SEC fraud charges. D. Solomon, *SEC Consider Stronger Sanctions*, The Wall Street Journal, June 16, 2003, at A2, column 3.

(n43)Footnote 42. *See, e.g., Consent of Defendant Bear Stearns & Co., Inc., SEC v. Bear, Sterns & Co., Inc., 03 CV 2937 (WHP) (S.D.N.Y.), Litig. Rel. No. 18109, 2003 SEC LEXIS 1011 (April 28, 2003) .*

(n44)Footnote 43. *See, e.g., Consent and Undertaking of Defendant Worldcom, Inc., SEC v. Worldcom, Inc., Civ. No. 02-CV-4963 (JSR) (S.D.N.Y.), Litig. Rel. No. 18147, 2003 SEC LEXIS 1208 (May 19, 2003) .*



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CHAPTER 17 SETTLEMENT DISCUSSIONS

1-17 Securities Enforcement: Counseling and Defense § 17.06

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§ 17.06 Interpretation and Modification of a Settlement

In *SEC v. Levine*, the Second Circuit held: "A consent judgment, though it is a judicial decree, is principally an agreement between the parties. Such judgments 'should be construed basically as contracts, without reference to the legislation the Government originally sought to enforce but never proved applicable through litigation.'" n1 Thus consent judgments should be interpreted in a way that gives effect to what the parties have agreed to, as reflected in the judgment itself or in documents incorporated to it by reference. The Second Circuit further stated that "[e]xtrinsic documents ... may generally be considered only if the terms of the judgment, or of documents incorporated in it, are ambiguous." n2 The terms of a consent decree, however, cannot be altered by the parties without the consent of the court, and the court is not required to enforce terms that it has not approved. In *Levine*, the Second Circuit stated that the defendants did not have the right to compel specific allocations of the funds they disgorged because "they did not negotiate inclusion of such an agreement by the Commission in the consent judgments entered by the Courts." n3

FOOTNOTES:

(n1)Footnote 1. *SEC v. Levine*, 881 F.2d 1165, 1178 (2d Cir. 1998) .

(n2)Footnote 2. 881 F.2d at 1179 .

(n3)Footnote 3. 881 F.2d at 1183 .



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CHAPTER 17 SETTLEMENT DISCUSSIONS

1-17 Securities Enforcement: Counseling and Defense § 17.07

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§ 17.07 SEC Position on Settling Parties Denying Alleged Facts

The SEC will insist that the settlement papers specifically provide that if, after settling with the SEC, the settling defendant denies the allegations in the complaint, the SEC can move to vacate the settlement and commence litigation. The SEC Rules of Practice describes this policy as follows:

The Commission has adopted the policy that in any civil lawsuit brought by it or in any administrative proceeding of an accusatory nature pending before it, it is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact, occur. Accordingly, it hereby announces its policy not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings. In this regard, the Commission believes that a refusal to admit the allegations is equivalent to a denial, unless the defendant or respondent states that he neither admits nor denies the allegations. n1

In at least two instances, the SEC has filed motions to vacate a judgment after the settling defendant made statements to the public that the SEC construed as denials. n2 In both instances, the SEC withdrew its motion to vacate after the settling defendant publicly stated that he withdrew any statement made on his behalf that was inconsistent with the terms of the settlement. In connection with the global settlement of analyst cases, the Chairman of the SEC publicly rebuked the CEO of a brokerage firm stating that he did not see anything in the settlement that will concern the retail investor about the firm. The Chairman of the SEC responded by sending a highly publicized letter rebuking the CEO. n3

FOOTNOTES:

(n1)Footnote 1. SEC Rule of Practice 202.5(e), *17 C.F.R. § 202.5(e)*.

(n2)Footnote 2. *See, SEC v. Angelos, Litig. Rel. No. 14886, 1996 SEC LEXIS 1172 (April 22, 1996) ; SEC v. Tyson, Litig. Rel. No. 15115, 1996 SEC LEXIS 2856 (October 9, 1996) .*

(n3)Footnote 3. D. Solomon, 'New SEC Chief's Top Priority: Rebuilding Trust in Watchdog, The Wall Street Journal, June 6, 2003, p.1, 8 Col. 3-4.



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CHAPTER 17 SETTLEMENT DISCUSSIONS

1-17 Securities Enforcement: Counseling and Defense § 17.08

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§ 17.08 Judicial Approval

Settlements involving court orders require judicial approval. Usually, courts grant this approval readily. In a case involving settlement of an SEC enforcement action, the Ninth Circuit reviewed the refusal of a district court to approve a settlement and held:

Unless a consent decree is unfair, inadequate, or unreasonable, it ought to be approved. Also, the courts should pay deference to the judgment of the government agency which has negotiated and submitted the proposed judgment. n1

The Second Circuit described the role of the district court as follows:

Before entering a consent judgment, the district court must be certain that the decree (1) springs from and serves to resolve a dispute within the court's subject matter jurisdiction, (2) comes within the general scope of the case made by the pleadings, and (3) furthers the objectives of the law upon which the complaint was based. n2

The First Circuit provided the following description:

[T]he district must refrain from second-guessing the Executive Branch... . The relevant standard, after all, is not whether the settlement is one which the court itself might have fashioned, or considers as ideal, but whether the proposed decree is fair, reasonable, and faithful to the objectives of the governing statute... . While the district court should not mechanically rubberstamp the agency's suggestions, neither should it approach the merits of the contemplated settlement *de novo*. n3

FOOTNOTES:

(n1)Footnote 1. *SEC v. Randolph*, 736 F.2d 525, 529 (9th Cir. 1984) (citations omitted).

(n2)Footnote 2. *Kozlowski v. Coughlin*, 871 F.2d 241, 244 (2d Cir. 1989) .

(n3)Footnote 3. *United States v. Cannon's Eng'g Corp.*, 899 F.2d 79, 84 (1st Cir. 1990) .



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense 18.syn

AUTHOR: Kenneth B. Winer

§ 18.syn Synopsis to Chapter 18: REMEDIES

§ 18.01 Introduction

§ 18.02 Overview

§ 18.03 Federal Court Proceedings

[1] Injunctive and Other Equitable Relief

[a] Permanent Injunctions

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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.01

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§ 18.01 Introduction

The Securities and Exchange Commission has available to it a wide array of enforcement remedies. Depending on the nature of the remedy being sought and the nature of the respondent/defendant, the enforcement proceeding must be brought either in federal court or in the Commission's administrative forum. The remedies available to the SEC vary with the alleged wrong it seeks to redress and the identity of the purported wrongdoer. This chapter begins with a brief overview of the distinctions between the Commission's administrative proceedings and those conducted in federal court. The chapter then discusses the remedies available in either federal court or via an administrative proceeding. It concludes with discussions of various issues related to both court and administrative proceedings.



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.02

AUTHOR: Kenneth B. Winer

§ 18.02 Overview

If litigation rather than settlement is the likely course of action, individuals and companies often prefer, for a number of reasons, that the enforcement proceeding be brought before federal court rather than in an administrative proceeding. The Federal Rules of Civil Procedure often afford defendants in SEC enforcement proceedings greater protection, including a vehicle for more extensive discovery than they would find in the administration forum. Moreover, in a civil proceeding where the SEC is seeking an order imposing money penalties, the litigating individual or entity has a right to a jury trial. Furthermore, courts are more receptive than administrative law judges to motions to dismiss and motions for summary judgment. In addition, historically there has been a perception that a federal court judge is likely to provide a more impartial hearing than an administrative law judge ("ALJ"), who is housed with and interacts regularly with the SEC Staff and whose decisions are reviewed by the Commission.

On the other hand, the current administrative law judges, unlike certain of their predecessors, are not former members of the SEC Staff and several of the administrative law judges have demonstrated a willingness to review critically the legal and factual positions asserted by the Staff. Moreover, the limited discovery available in administrative proceedings can benefit respondents who lack the financial resources to conduct, and respond to, the more extensive discovery available in federal court.

In the settlement context, individuals and companies often prefer that the settled enforcement proceeding be administrative rather than a court proceeding. First, injunctive proceedings have historically been the SEC's remedy of choice for egregious misconduct. Second, the collateral consequences arising from the entry of a court injunction often are harsher than the consequences arising from an administrative proceeding. Third, if the SEC is filing an injunctive proceeding against a regulated entity or individual affiliated with a regulated entity, the Commission will often insist on the filing of a concomitant administrative proceeding. n1

Comment

The Commission will rarely authorize an enforcement proceeding against a company without also authorizing an action against at least one individual.

FOOTNOTES:

(n1)Footnote 1. *See Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099 (D.C. Cir. 1988) (holding that the SEC did not violate due process when it initiated administrative proceedings against a broker-dealer after it had obtained substantial relief in a civil enforcement action brought in district court).



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.03

AUTHOR: Kenneth B. Winer

§ 18.03 Federal Court Proceedings

Before Congress enacted the Sarbanes-Oxley Act of 2002, the federal securities laws expressly authorized the SEC to seek in a civil action:

- a court order enjoining persons from violating these laws;
- monetary penalties for certain violations of these laws, in an amount up to the greater of the amount of illegal gain or \$100,000 for natural persons or \$500,000 for any "other persons" or, for a violation of the insider trading laws, an amount that is treble the profit gained or loss avoided; and
- for a violation of certain anti-fraud provisions of these laws, a bar against future service as an officer or director of a publicly held company.

In addition, the courts have interpreted the statutory provisions authorizing injunctive relief as also authorizing other equitable relief, including disgorgement of ill-gotten gains, accountings, and the appointment of a receiver. The Sarbanes-Oxley Act of 2002 amended the Exchange Act to authorize the SEC to seek additional remedies:

- a temporary order freezing the assets of a public company that the SEC believes is likely to make extraordinary payments to its directors, officers, partners, controlling persons, agents or employees
- an order prohibiting certain persons from participating in the offering of a penny stock
- "any equitable relief" that may be appropriate or necessary for the benefit of investors

[1] Injunctive and Other Equitable Relief

[a] Permanent Injunctions

Injunctive relief has been the SEC's principal enforcement remedy and has traditionally been regarded as its remedy of

choice. n1 Under Securities Act § 22(a), the SEC may file an injunctive action in the district where the defendant is found, is an inhabitant, or transacts business, or in the district where the offer or sale of securities in question took place, provided the defendant participated in the offer or sale. Under Exchange Act § 27, the SEC may file the injunctive action in any district in which any act or transaction constituting the violation occurred, or in the district in which the defendant is found, is an inhabitant, or transacts business. Both the Investment Company Act of 1940 and the Investment Advisers Act of 1940 allow an injunctive action to be brought in "any such district or in the district wherein the defendant is an inhabitant or transacts business." n2 Enforcement actions brought by the SEC are subject to transfer pursuant to 28 U.S.C. § 1404 for the convenience of the parties and witnesses or in the interest of justice. n3

While once viewed as a "mild prophylactic," n4 an SEC injunction, in the view of an increasing number of courts, is "a drastic remedy ... and should not be obtained against one acting in good faith." n5 In *SEC v. American Board of Trade*, n6 the Second Circuit stated:

We think it appropriate to begin our discussion by emphasizing the gravity of an injunction against violation of the securities laws. The phrase "mild prophylactic," used by Judge Clark ... may have been appropriate in that case where the injunction was read as requiring only limited disclosure by the defendant. However, the phrase is quite inappropriate as applied to an injunction of the extraordinary breadth of that here issued, which, in addition to the violations of the registration provisions of the 1933 Act and the ICA and the antifraud provisions of the 1933 and 1934 Acts with which defendants were charged, included every section of the three statutes, and, indeed, for good measure, of any other federal securities laws, however, unrelated to the acts charged... .

Each of the statutes under which the SEC operates authorizes it to seek injunctions against persons who are violating or are about to violate the relevant act or rules or regulations thereunder. n7 For example, Exchange Act § 21(d) authorizes the SEC to bring an action in federal district court "[w]henver it shall appear ... that any person is engaged or is about to engage in acts or practices constituting a violation of [the Exchange Act or] the rules or regulations thereunder." Investment Advisers Act § 209 and Investment Company Act § 42(d) expressly authorize the SEC to seek, and the court to order, an injunction if a defendant has engaged in a violation of the corresponding act. The SEC has typically viewed an injunctive proceeding as a more severe remedy than an administrative proceeding seeking a cease-and-desist order. n7.1

[i] Required Showing

In order to obtain an injunction, the SEC must do more than establish that the defendant violated the federal securities laws. n8 Courts have articulated a variety of standards regarding the additional burden that the SEC must meet. Some courts have stated that an injunction is appropriate only when the SEC has established a past violation and made a proper showing that "a reasonable likelihood" exists that a future violation would occur absent an injunction. n9 An alternative standard was enunciated by the Sixth Circuit in *SEC v. Youmans*, n10 requiring that the SEC show a "reasonable and substantial" likelihood that future violations will occur. In *SEC v. Cavanagh*, n11 the Second Circuit stated "The SEC must demonstrate that there is a substantial likelihood of future violations" Other courts have stated that the Commission must show "a cognizable risk of future violation, something 'more than the mere possibility which serves to keep the case alive.'" n12 A strong argument can be made that an injunction against a corporation is not warranted if the personnel who were involved in the past violation are no longer with the corporation. "A substantial body of SEC injunction law has been careful to identify the distinction between the management of the corporation and the corporate entity itself, when the circumstances of the corporation's continued existence have changed." n13

Comment

Because injunctions are designed to deter rather than to punish, courts have discretion to deny injunctions based on equitable considerations, even where the SEC has made a proper showing of a

reasonable likelihood of future violations. n14

It has been held that the SEC, unlike private plaintiffs, need not prove reliance on alleged misrepresentations in order to enjoin future violations of § 10(b) of the Exchange Act and *Rule 10b-5* promulgated thereunder. n15 Moreover, the Second Circuit has held that the SEC need not demonstrate an irreparable injury or an inadequate legal remedy to obtain an injunction. n16

Courts weigh a number of factors in assessing the likelihood of a future violation. These factors include:

- the egregiousness of the violations;
- the isolated or repeated nature of the violations;
- the degree of scienter involved;
- the sincerity of the defendant's assurances, if any, against future violations;
- the defendant's recognition of the wrongful nature of his or her conduct; n17
- the likelihood that the defendant's occupation will present opportunities (or lack thereof) for future violations; and
- the defendant's age and health. n18

Courts also consider the gravity of the offense committed and the time elapsed since the violation, n19 the "severe economic and professional consequences" that an injunction can have on a defendant, n20 and whether the defendants were acting in good faith and in reliance on counsel. n21 As the District of Columbia Circuit has explained, "[i]njunctive relief is reserved for willful lawbreakers or those whose operations are so extremely or persistently sloppy as to pose a continuing danger to the investing public." n22

Federal courts have the authority to fashion injunctive relief more narrowly tailored than the Staff might request. At least one court has issued an injunction that was limited to a specific anti-fraud regulation and was of limited duration. n23 In litigation and settlement discussions, the Staff has not shown much inclination to pare back the scope of the broad injunctive relief it seeks.

[ii] Ability of the SEC to Obtain Injunctions

The SEC obtains injunctive relief in a substantial majority of the contested proceedings in which it seeks such relief. Viewing the SEC's charges from the broad context of a court of general jurisdiction, however, some courts have refused to issue injunctions after finding violations because they did not view the violations as egregious. For example, in *SEC v. Pros International, Inc.*, n24 the appeals court affirmed the district court's refusal to issue an injunction against an accountant based on findings that:

- at worst, the defendant's conduct was reckless;
- the defendant did not intend to defraud investors;
- the violation was isolated in nature;
- the defendant had discontinued preparing audit reports for public companies and agreed to limit his

practice to tax return work; and

- the defendant had recognized the wrongful nature of his conduct and assured the district court that this situation would not occur again. n25

Similarly, in *SEC v. Park Florida Associates, Ltd.*, n26 the district court refused to issue an injunction against a brokerage firm after finding that the firm had violated SEC rules by selling units in a limited partnership after the cutoff date for such sales and by failing to disclose the sales commission that the firm was to receive in connection with the offering. The court explained that "egregiousness does not come to mind when characterizing [the defendant's] violations. While they are not fairly called technical violations, neither are they extraordinary" and that the failure to disclose commissions "is certainly not so flagrant that it suggests that [defendant] will likely commit future violations." n27 In *SEC v. Sargent*, the First Circuit affirmed the denial of an injunction against an individual who was found to have tipped his dentist in violation of *Rule 10b-5*. The court relied on this being a first time offense, the fact that his violation was not egregious and the fact that his position did not put him in a position where future violations were likely. n28 In *SEC v. Blatt*, n29 the Fifth Circuit reversed the issuance of an injunction against a lawyer on the grounds that the lawyer's violation was "minor" and could not "fairly be termed egregious." n30

In 2010, a court found that Charles Conaway, the former chairman and CEO of Kmart Corp., had committed securities fraud, but declined to impose either an injunction or an officer-and-director bar. n30.1 The U.S. Securities and Exchange Commission sued Mr. Conaway in 2005, accusing him of deceiving investors in the management discussion and analysis ("MD&A") portion of a Kmart quarterly report and in the earnings call relating to that quarterly report, but not informing investors that Kmart had (1) faced a cash liquidity crisis caused, in large part, by Kmart's having made a large inventory purchase above plan and (2) addressed the crisis by delaying payments to vendors. A jury found Mr. Conaway liable on all of the SEC's claims. The court decided not to issue either an injunction or an officer-and-director bar against Mr. Conaway, even though the court found Mr. Conaway's violation to be "serious and clearly wrong," and to involve "deliberate indifference to the securities laws of this country" and that Mr. Conaway testified falsely at trial. In deciding not to issue an injunction or an officer-and-director's bar, the court gave substantial weight to the damage that Mr. Conaway's reputation had incurred as a result of the SEC enforcement action and the jury's findings, the likelihood that if the Court of Appeals upheld the jury's verdict, the court's sanctions, and the likelihood that Mr. Conaway will realize that what he did was wrong, the hardships to him and his family, and the disgorgement and penalties ordered by the court are affirmed on appeal. n30.2 The court's decision might trigger a trend of courts recognizing that civil penalties served a substantial deterrence function and that a court should issue an injunction and officer-and-director bar only if the SEC has actually met its burden of showing "a reasonable and substantial likelihood that [the defendant], if not enjoined, would violate the securities laws in the future." n30.3

The SEC has also encountered difficulties in proving that the defendant violated the securities laws. In *SEC v. Price Waterhouse*, n31 the district court, finding that auditors had not acted with scienter, explained that it was highly improbable that an accounting firm would risk a valuable reputation for honesty and careful work merely to receive increased fees. n32 In *SEC v. Wellshire Securities*, n33 the court refused to issue an injunction against a brokerage firm on the grounds that the firm's conduct, far from being reckless as charged by the SEC, was "prudent, prompt, and business-like." n34 The court criticized the SEC for "Monday morning quarterbacking" and alleging "fraud by hindsight." n35

Some courts have denied permanent injunctions where the violations were isolated or have not suggested significant likelihood of recurrence. n36 For example, the court in *SEC v. Brethen* n37 denied an injunction where it found that the defendant, a 66-year-old former executive of a public company, had engaged in insider trading in the securities of that company in violation of § 610(b) on information only marginally material. In reaching this decision, the court considered the fact that the defendant was unlikely to work for a public company in the future, either as an executive officer or director. n38

Similarly, in *SEC v. Ingram*,ⁿ³⁹ the court found that the defendant had violated the securities laws, but refused to issue an injunction because there was no reasonable likelihood of future violations. Several factors contributed to this determination. The court noted that this was the defendant's first violation during 19 years as a broker, the evidence of scienter was "not overwhelming," his financial gain was small, and he appeared to be contrite and repentant.ⁿ⁴⁰

As set forth in Chapter 20, an injunction can have a number of severe collateral consequences. In addition, the entry of an injunction by a court can assure the SEC of the ability to bring a civil enforcement action in that court's jurisdiction even if that court would lack jurisdiction absent the injunction.ⁿ⁴¹ The Eleventh Circuit issued an opinion raising questions regarding the enforceability of the standard SEC injunction, which tracks the statutory provision that the defendant allegedly violated.ⁿ⁴² The Court of Appeals explained:

This Circuit has held repeatedly that "obey the law" injunctions are unenforceable. *See, e.g., Burton v. City of Belle Glade*, 178 F.3d 1175, 1200 (11th Cir. 1999) (holding that injunction which prohibited municipally from discriminating on the basis of race in its annexation decisions "would do no more than instruct the City to 'obey the law,' " and therefore was invalid); *Payne v. Travenol Labs., Inc.*, 565 F.2d 895, 899 (5th Cir. 1978) (invalidating injunction that prohibited defendant from violating Title VII in its employment decisions). The specificity requirement of Rule 65(d) is no more technicality; "[t]he command of specificity is a reflection of the seriousness of the consequences which may flow from a violation of an injunctive order." *Payne*, 565 F.2d at 897. An injunction must be framed so that those enjoined know exactly what conduct the court has prohibited and what steps they must take to conform their conduct to the law. *See Meyer v. Brown & Root Constr. Co.*, 661 F.2d 369, 373 (5th Cir. 1981) (citing *International Longshoremen's Assoc. v. Philadelphia Marine Trade Assoc.*, 389 U.S. 64, 76, 88 S. Ct. 201, 208, 19 L. Ed. 2d 236 (1967)).ⁿ⁴³

[b] Preliminary Injunctions

In *SEC v. American Board of Trade, Inc.*ⁿ⁴⁴ the Second Circuit noted that the district court had stated "quite correctly" that to obtain a preliminary injunction, the SEC must demonstrate "(a) a *prima facie* case that a violation of the securities laws has occurred, and (b) a strong likelihood that a violation will occur again in the future."ⁿ⁴⁵ In *SEC v. Cavanaugh*,ⁿ⁴⁶ the Second Circuit articulated a different standard:

A preliminary injunction enjoining violations of the securities laws is appropriate if the SEC makes a substantial showing of likelihood of success as to both a current violation and the risk of repetition.

In *SEC v. Unifund SAL*,ⁿ⁴⁷ the same appeals court set forth a detailed history of its opinions regarding SEC requests for preliminary injunctions:

We find this history an insubstantial basis for concluding that the Commission's burden on the merits in obtaining a preliminary injunction is any greater than the traditional "likelihood of success" standard we have regularly applied to private litigants, and we see little virtue in enshrining the phrase "strong *prima facie* case" to serve along with the traditional standard.ⁿ⁴⁸

Comment

Private litigants can typically obtain a preliminary injunction by showing irreparable injury plus both sufficiently serious questions going to the merits of the case and a balance of hardships tipping decidedly to the party requesting preliminary relief. The Second Circuit has indicated, however, that the SEC must show that it is likely to prevail in order to obtain the relief and need not show either irreparable injury or a balance of the hardships.ⁿ⁴⁹

In offering and insider trading cases where there is a likelihood that funds will leave the jurisdiction of the United States

courts, courts have shown a willingness to issue temporary restraining orders that freeze those funds for a limited period of time and provide for expedited discovery. In *Unifund*, the Second Circuit indicated that the degree to which the SEC must show likelihood of success will be reduced where the interim relief sought is not especially onerous. n50 In this case, the court held that a showing of likely success insufficient to support a preliminary injunction against future violations of the federal securities laws was sufficient to support a limited and temporary freeze of the defendants' assets. n51 In freezing a defendant's assets, some courts have limited the ability of defendants to pay counsel from assets traceable to the fraud, even if they demonstrate that they cannot pay for an attorney from exempted assets. n52

The SEC has taken the position that in connection with an ongoing receivership proceeding pursuant to *Federal Rule of Civil Procedure 66*, courts have the power to freeze assets of a non-party against whom no wrongdoing is alleged. The Second Circuit has held, "Federal courts may order equitable relief against a person who is not accused of wrongdoing in a securities enforcement action where that person: (1) has received ill-gotten funds; and (2) does not have a legitimate claim to those funds." n53 In *SEC v. Black*, 163 F.3d 188 (3rd Cir. 1998), the Third Circuit rejected this position.

[c] Temporary Freeze Authority

In the Sarbanes-Oxley Act of 2002, Congress gave the Commission authority to seek a temporary order against extraordinary payments by an issuer to any officers, directors, agents or employees of any issuer under investigation for the violation of the federal securities laws. n54 The Ninth Circuit described the statutory grant of authority as follows:

Sarbanes-Oxley Act § 1103 authorized the SEC to petition a federal court for an order freezing for up to forty-five (45) days any payments by an issuer to the issuer's officers, directors, controlling persons, partners, agents or employees, if the SEC is conducting an investigation into possible violations of the federal securities laws by the issuer or such persons and it appears to the Commission that the issuer will make "extraordinary" payments to any such person. n55 Such an order can be secured only with notice and after a hearing, unless "impracticable or contrary to the public interest." The statute does not identify what burden, if any, the Commission must meet in order to obtain this relief. In addition, the statute authorizes the SEC to obtain a 45-day extension of the freeze on a showing of good cause and provides that if the SEC charges the officer, director, partner, agent, or employee with a securities law violation by commencing an action, the freeze will remain in effect, subject to court approval, until the conclusion of such proceeding. Litigation relating to the application of this provision to "Restructuring Payments" to two former officers of Gemstar-TV Guide focused on defining the term "extraordinary payments." n56 In that case, a district court froze certain payments to the former CEO and the former CFO of Gemstar, a panel of the Ninth Circuit reversed the district court, holding that the "Restructuring Payments" were not "extraordinary," and an en banc panel of the Ninth Circuit affirmed the district court, holding that the district court was correct in finding that the "Restructuring Payments" were extraordinary. In assessing the district court finding, the en banc panel applied a flexible standard which considered a number of factors including that the termination payments were made pursuant to termination agreements entered the same day the payments were to be disbursed, the "Restructuring Payments" were five to six times the base salary of the former CEO and former CFO, the former CEO asserted the *Fifth Amendment* right against self-incrimination when questioned regarding the payments, the Restructuring Payments differed substantially from the payments to which the former CEO and former CFO would have been entitled pursuant to their prior termination agreements, and the "restructuring payments were based in part on financial statements that had been restated." n57 The court stated that "bonuses are clearly the type of extraordinary payment encompassed by Section 1103." n58

[d] Other Ancillary Equitable Relief

Even before enactment of the Sarbanes-Oxley Act of 2002, federal courts exercised a broad equitable power to grant ancillary relief to the SEC. n59 In *SEC v. Manor Nursing Centers*, n60 the Second Circuit held that "[o]nce the equity

jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy." n61 Any relief granted ancillary to an injunction, however, must be remedial and not punitive in nature. n62

The Sarbanes-Oxley Act of 2002 amended the Exchange Act to provide expressly that in any action or proceeding instituted by the SEC under any provision of the securities laws, the SEC "may seek, and any federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors." n63

[i] Disgorgement of Unjust Enrichment

Pursuant to this power to grant equitable relief, courts have the power to order a defendant to disgorge any profit obtained as a result of the violation. n64 Disgorgement is a particularly common remedy in proceedings involving insider trading or stock manipulation. n65 The SEC sometimes seeks disgorgement of bonuses, other incentive compensation and stock profits attributable to inflated financial statements. The SEC sometimes also seeks disgorgement of compensation paid to employees and of fees paid to professional or investment banking firms. The SEC sometimes also seeks disgorgement of proceeds of offerings raised through the use of fraudulent offering materials. The SEC has obtained disgorgement orders in matters in which it has not been able to obtain an injunction. n66

A court has held a defendant violated the strict liability provisions of § 5(a) and (c) of the Securities Act and the antifraud provisions of the Securities Act and Exchange Act. In that case, the two defendants were held jointly and severally liable because they had "close relationships in engaging in illegal conduct," even though the second defendant was more culpable than the first. n67

[ii] Disclosure

In a number of proceedings the SEC has obtained a court order directing an issuer to make curative disclosures. n68 This remedy can have substantial collateral consequences. For example, the SEC sometimes obtains as part of a settlement a court order directing the issuer to correct previously issued financial statements that the SEC has alleged to be materially misstated. Even though the defendant has consented to entry of the order without admitting or denying any allegations, the act of restating financial statements arguably constitutes an admission that the previously issued financial statements were in error and that the restated financial statements are fairly stated.

Comment

It is unclear what protection, if any, a company and its officers have if a court orders them to make certain disclosures and it is later found that the compelled disclosures were materially false or misleading and the company's officers and directors knew, or were reckless in not knowing, that they were materially false or misleading.

Under § 304 of the Sarbanes-Oxley Act of 2002, if a court orders an issuer to restate its financial statements, the CEO and the CFO of the issuer might be required to reimburse the issuer for certain incentive-based and equity-based, compensation and certain stock profits.

[iii] Receivership and Voting Trusts

Even before enactment of the Sarbanes Oxley Act of 2002, courts appointed receivers to take control of a corporation's, partnership's or individual's assets. Relying on the court's broad discretion in granting ancillary relief, the Ninth Circuit in *Los Angeles Trust Deed & Mortgage Exchange v. SEC* n69 held that the district court may appoint a receiver to protect the interests of investors. n70 The Second Circuit also recognized the power of the SEC to appoint a receiver, holding that such action was warranted where necessary to protect the public interest. n71

The district court in *SEC v. Drexel Burnham Lambert Inc.* n72 imposed what it termed a milder remedy than receivership. This case involved two individuals, Victor Posner and his son Steven Posner, who were found to have violated the federal securities laws while serving as officers and directors of companies in which they held substantial stock. In addition to barring the Posners from serving as officers and directors of a public company, the court ordered them to place in a voting trust their stock in any public company that they controlled. In the court's view, the only way to effectuate the officer and director bar was to force the Posners to relinquish control. n73 The voting trust requirement in this case applied to shares of any company controlled by the Posners, either currently or in the future. n74 In addition, SEC can seek an order holding the defendant liable for the receiver's costs and fees. n75

[e] Order to Preserve Documents and Assets

In June 2002, a United States district court judge, based on a joint agreement between the Commission and defendant WorldCom, Inc., ordered WorldCom to preserve documents relating to its financial reporting and public disclosure obligations. n76 WorldCom had declared bankruptcy and was under SEC investigation for accounting improprieties. The judge also ordered the appointment of a Corporate Monitor to oversee all compensation paid by WorldCom. The Corporate Monitor had the responsibility to prevent unjust enrichment and to ensure that the company's assets were not dissipated by payments not necessary to the operation of the business. The judge directed WorldCom to cooperate with the Corporate Monitor and to make its corporate books and records available to the Monitor.

[2] Other Civil Remedies

[a] Civil Penalties

[i] The Insider Trading Sanctions Act of 1984 ("ITSA") and the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA")

Prior to 1990, the SEC had only limited authority to seek fines or penalties. The most significant of the statutes conferring fining authority on the courts prior to 1990 was the ITSA, as amended by the ITSFEA. n77 Section 21A of the ITSA authorizes the SEC to seek, and the courts to impose, fines up to the greater of \$1,000,000 or three times the profit gained or loss avoided as a result of the violations. These fines are imposed against persons who violate the Exchange Act by purchasing or selling security while in possession of material, nonpublic information, or by communicating such information, or, with respect to controlling persons of issuers, acting with reckless disregard of the risk of insider trading in the issuer's securities.

There is not much authority indicating which facts and circumstances should be considered by a court in determining the amount of the penalty under ITSFEA. Courts have focused on a number of factors in determining the appropriate penalty to be imposed: the egregiousness of the Defendant's violations; the isolated or repeated nature of the violations; and the degree of scienter involved; the deterrent effect given the defendant's financial worth; and other penalties arising from the conduct; whether the defendant concealed his trading; and whether the defendant is employed in the securities industry. n78 Review of these factors is considered helpful in assisting the court in assessing "both the severity of the violations and a defendant's culpability, thus indicating the degree of punishment warranted and the extent to which future violations must be deterred." n79 The court in *SEC v. Brethen* n80 noted that the factors to consider when contemplating a civil penalty are similar to those germane to the granting of an injunction, as both serve similar goals of punishment and deterrence. n81

The SEC has not always been able to obtain penalties in cases in which it has established that a person violated the insider trading laws. For example, in *SEC v. Ingoldsbey*, n82 the court merely ordered disgorgement even though it found that the defendant had committed insider trading in violation of the anti-fraud provisions of the federal securities laws. Although the SEC had requested an injunction, disgorgement, pre-judgment interest on amounts disgorged, and a civil penalty of three times the amounts disgorged, the court relied on several factors in denying the imposition of a penalty

and simply ordering disgorgement. In its decision, the court noted that the profits to be disgorged were merely paper profits, the defendant actually sustained losses on the trades, and the defendant's business collapsed after the filing of the SEC enforcement action. n83

[ii] The Securities Enforcement Remedies and Penny Stock Reform Act of 1990

In 1990, Congress enacted the Remedies Act, n84 which amended the Securities Act, the Exchange Act, the Investment Company Act and the Investment Advisers Act in order, *inter alia*, to authorize courts to impose penalties for violations of any of the provisions of the federal securities laws upon a proper showing by the SEC. n85 The legislative history indicates that the primary purpose of the monetary penalties was deterrence. n86 The amendments to the Securities Act and the Exchange Act exempt from the civil penalty provisions of the Remedies Act insider trading violations that are subject to penalties pursuant to § 21A of the Exchange Act.

The Remedies Act provides a three-tier structure for setting the amount of the penalty. Each of the three tiers provides that for each violation, the penalty shall not exceed the greater of a stated dollar amount or the gross pecuniary gain to the defendant as a result of the violation(s). n87 The tiers are based on the malefactor's level of culpability and the magnitude of the harm caused or threatened by the malefactor's misconduct. The stated dollar amount is a function of three factors: (1) the tier; (2) whether the defendant is a natural person; and (3) when the violative conduct occurred. n88

The first tier addresses violations which do not involve "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." The second tier addresses violations that involve "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," but do not result directly or indirectly in, or create a significant risk of, substantial losses to other persons. The third tier addresses violations that involve "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" *and* result directly or indirectly in, or create a significant risk of, substantial losses to other persons. n89

Neither the statute nor the legislative history defines the terms "substantial loss" or "significant risk." Nor does the statute define "pecuniary gain." The legislative history suggests that "pecuniary gain" means "the amount by which the defendant was unjustly enriched." n90

The legislative history of the Remedies Act indicated that the SEC should exercise restraint in exercising its power to seek penalties, especially against companies that are publicly owned. The Report of the House Committee on Energy and Commerce stated:

The Committee believes that the civil money penalty provisions should be applicable to corporate issuers, and the legislation permits penalties against issuers. However, because the costs of such penalties may be passed on to shareholders, the Committee intends that a penalty be sought when the violation results in an improper benefit to shareholders. In cases in which the shareholders are the principal victims of the violations, the committee expects that the SEC, when appropriate, will seek penalties from the individual offenders acting for the corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations. The court also may consider the extent to which the passage of time has resulted in shareholder turnover. n91

Similarly, the Report of the Senate Committee on Banking and Currency stated:

The Committee contemplates that the Commission would not impose a civil money penalty in every case. When a failure to comply with Commission requirements involves isolated or unintentional

conduct, the implementation of new procedures or a similar remedial measure may be the most appropriate resolution of the case. At the other end of the spectrum, when a defendant in a Commission action is also the subject of a criminal prosecution, the imposition of a civil money penalty in the Commission's action may, in some cases, be unnecessary to achieve deterrence.

The Committee also expects that the SEC will not ordinarily seek penalties against registered investment companies. Generally, an investment company is a managed portfolio of liquid assets, with all expenses being passed onto the shareholders. While the legislation permits civil penalties based on violations of the Investment Company Act, the penalties generally would be assessed against the responsible individuals. n92

Courts often impose a penalty equal to the pecuniary gain to the defendants. n93 In *SEC v. Ferrero*, n94 the Commission argued that the court should impose the maximum penalty on three defendants because they repeatedly lied to the SEC, forcing it to spend considerable time and resources to disprove their fabrications. The court nevertheless imposed a one-time penalty on two of the defendants. n95 As for the third defendant, the court imposed a penalty of three times the profits gained and losses avoided, explaining that it was guided by the defendant's culpability, the total amount that he and others were to gain and avoid losing as a result of his unlawful acts, the evidence of prior unlawful trading by the defendant, the need to impose a penalty (beyond disgorgement, prejudgment interest, and an injunction) to deter that defendant from violating the securities laws, and the defendant's testimony during trial regarding his net worth. n96 Courts take different approaches in determining what multiplier, if any, to apply to the money penalty. Some do not appear to apply a multiplier. n97

In a 2004 speech, then SEC Enforcement Director Steve Cutler expressed the view that the SEC "start(s) from the presumption that any serious violation of the federal securities laws should be penalized with a monetary sanction." n98 Mr. Cutler's speech provided precious--albeit limited--insight into the Staff's approach to considering the appropriateness of specific monetary penalties. Mr. Cutler identified "three core considerations--the type of violation, the degree of harm, and the extent of cooperation." n99 He also identified factors that may incrementally influence the Staff's penalty recommendations; the Staff may recommend a larger penalty if (1) "the wrongdoer is a recidivist;" (2) the wrongdoer "is a sophisticated party who violated a clear legal standard;" (3) the wrongdoer was enriched by its own misconduct; (4) the size and relative net worth of the wrongdoer; (5) the duration of the misconduct; (6) the seniority of the violators involved; n100 and (7) the relative culpability of violators involved in the same or a similar scheme. n101

[iii] Right to a Jury Trial

The defendant in an action in which the SEC seeks penalties has a right to a jury trial. n102 The Supreme Court distinguishes between an action for disgorgement and one for penalties and reasons that the penalty action is legal relief giving rise to the right of a jury trial. n103

[b] Orders Barring Service as an Officer or Director of a Public Company

Under § 20(e) of the Securities Act and § 21(d)(2) of the Exchange Act, a court in an SEC enforcement action may bar a defendant from serving as an officer or director of a public company where it finds that:

- the defendant has violated either § 17(a)(1) of the Securities Act or § 10(b) of the Exchange Act, and
- the defendant's "conduct demonstrates unfitness to serve as an officer or director." n104

In *SEC v. Posner*, n105 the Second Circuit held that prior to the Remedies Act, courts had the power to impose officer and director bars pursuant to their general equitable power. n106

The SEC obtained explicit statutory authority to obtain court orders barring individuals from serving as officers and directors of any public company with the enactment of the Remedies Act. In testifying on behalf of the bar authority, then-SEC Chairman Richard Breeden told Congress that the Commission would seek the remedy "only in those cases ... that involve egregious fraudulent conduct." n107 At that time, the Commission could obtain an officer and director bar only if the defendant's conduct demonstrated "substantial unfitness" to serve as an officer or director. The statutes did not define "substantial unfitness," and the legislative history does not reveal the intent of Congress. In *SEC v. Patel*, n108 the SEC brought enforcement proceedings against an officer of Par Pharmaceutical, who had violated insider trading provisions of the federal securities laws. Ratilal Patel appealed a district court order barring him from service as an officer or director of any public company. In deciding to impose the bar, the district court had considered factors identified by Professor Jayne W. Barnard in a law review article: n109

- the "egregiousness" of the underlying securities law violation,
- the defendant's "repeat offender" status,
- the defendant's "role" or position when he engaged in the fraud,
- the defendant's degree of scienter,
- the defendant's economic stake in the violation, and
- the likelihood that misconduct will recur. n110

Applying these factors, the district court had found that:

- the conduct was not especially egregious,
- Patel had no prior violations,
- Patel had abused his position as Par's founder and officer,
- There was some evidence of scienter in Patel's action,
- Patel received the full economic benefit of his actions, and
- There was sufficient likelihood of future violations due to Patel's abuse of his position. n111

Based on these findings, the district court imposed a permanent bar on Patel. n112

In considering whether an officer should be barred under these provisions, the Second Circuit in *Patel* made several important points. First, the court held that the district court's finding of a likelihood of future violations was not adequately supported given "[t]he loss of livelihood and the stigma attached to the permanent exclusion from the executive suite." n113 Second, while noting that other factors might also be appropriate, the court expressed approval of the six factors identified by Professor Barnard. n114 Third, the court held that it was appropriate for the district court to have considered misconduct that was not directly related to the federal securities laws, but that set in motion the scheme culminating in insider trading. n115 Fourth, it held that "before imposing a permanent bar, the court should consider whether a conditional bar (e.g., a bar limited to a particular industry) and/or a bar limited in time (e.g., a bar for five years) might be sufficient, especially where there is no prior history of unfitness." n116 Finally, the court stated that in considering the nature of the bar to be imposed, it would be appropriate to "take into account any prior punishment that may have been imposed in a criminal proceeding." n117

Strikingly, in a separate opinion, the same district court declined to issue a bar against an officer of a related company, even though the findings as to that officer were quite similar to those relating to Patel. n118 In *SEC v. Shah*, n119 a former president, Dilip Shah, of a Par subsidiary had engaged in insider trading and had been convicted of making illegal payments to government officials on behalf of the corporation. Nevertheless, the court concluded that a bar was not appropriate because:

- the \$121,340 loss unlawfully averted was relatively small;
- Shah had never before been involved in any other violations of the securities laws;
- Shah had been an officer of a subsidiary of the public company;
- while Shah had conceded scienter, there was no evidence that he had engaged in clandestine trading;
- Shah had received the entire economic benefits of the trade; and
- given that Shah had been convicted of making illegal payments on behalf of the corporation, the likelihood of future misconduct was relatively slight.

In *SEC v. Drexel Burnham Lambert Inc.*, n120 the SEC, pursuant to the Remedies Act, was seeking to bar the Posners from acting as officers or directors of public companies:

Because prior injunctions had failed to prevent them from engaging in further like violations and because the Posners have used and abused public companies, of which they are (or were) officers and directors, as vehicles to engage in rapacious and violative conduct repeatedly, and to unjustly enrich themselves unconscionably at the expense of the public shareholders, the SEC therefore here seeks an injunction barring them in the future from further serving in the capacities of officers and directors of public companies registered with the SEC. n121

In determining that the Posners should be barred, the court considered five factors, some of which were different from those applied in the *Patel* case. Specifically, in holding that a bar was appropriate, the court found that:

- the violations were egregious,
- the Posners were recidivists (having twice before been enjoined from violating various anti-fraud and reporting provisions of the federal securities laws),
- the Posners engaged in fraudulent activities in their corporate capacities,
- the other shareholders lacked sufficient control to remove the Posners from office, and
- the Posners made a mockery of the public policy underlying the various reporting and anti-fraud provisions that they violated and thereby served to "undermine the integrity of the markets." n122

In some of the cases involving an officer or director bar, the courts appeared to place substantial weight on the individual's having engaged in conduct intended to obstruct justice or otherwise cover up the securities violation. For example, in *SEC v. Sprecher*, n123 the court barred the defendant from serving as an officer or director of a publicly owned company based in large part on conduct for which the defendant had been convicted of obstruction of justice.

Comment

Experience has shown that the SEC may well seek a bar against individuals who engage in insider trading based on information that they obtained as an officer or director of a public company. n124

Courts can issue a limited officer and director bar. For example, in one case the defendant was permanently barred from holding an officer/director position with any banking or financial institutions. Even though the defendant had been criminally convicted of securities fraud, the court found that a permanent officer and director bar was not appropriate. n125

In 2002, SEC enforcement officials publicly complained about the reluctance of courts to bar individuals from serving as officers and directors of public companies. n126 In apparent response to these complaints, the Sarbanes-Oxley Act of 2002 amended the Exchange Act and Securities Act to change the statutory standard from "substantial unfitness" to "unfitness." n127 The SEC argues that this amendment was intended to lower the threshold for barring individuals from serving as officers and directors of public companies. Indeed, the Commission sought four times as many officer and director bars in fiscal 2003 than in fiscal 2000. n128 In light of Sarbanes Oxley, the SEC has been more aggressive in seeking officer and director bars from officers and directors alleged to have committed scienter-based securities fraud.

[c] Penny Stock Bars

Section 21(d) of the Exchange Act n129 and Section 20 of the Securities Act of 1933, n130 as amended by the Sarbanes-Oxley Act of 2002, authorizes a court to prohibit any person who engaged in misconduct in the offering of a penny stock from participating in the offering of a penny stock, conditionally or unconditionally for such period of time as the court deems appropriate. n131 This amendment effectively authorized the courts to grant a form of relief that the SEC was already authorized to issue in administrative proceedings.

[d] Clawback of Certain Compensation and Stock Profits

Section 304 of the Sarbanes Oxley Act of 2002, encaptioned, "Forfeiture of Certain Bonuses and Profits," provides that a CEO and CFO of an issuer is, under certain circumstances, required to "reimburse" the issuer for certain additional compensation and profits from the sale of stock:

(a) Additional Compensation Prior to Noncompliance With Commission Financial Reporting Requirements.--If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for--(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period. (b) Commission Exemption Authority.--The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.

Courts have held that Section 304 does not create a private cause of action. n132 The SEC has brought a number of enforcement actions involving Section 304. The SEC enforcement action against William McGuire, the former CEO of United Health, was the first SEC settlement involving Section 304. In that action, the SEC charged McGuire with having violated (or aided and abetted violations of) the antifraud, reporting, record-keeping, internal controls, proxy statement, and certification provisions of the federal securities laws. In addition to consenting to the entry of an injunctive order enjoining him from violating (or aiding and abetting violations of) these provisions, McGuire agreed to pay, among other things, reimbursement to United Health of approximately \$448 million. n133

In July 2009, the SEC brought an enforcement action against the former CEO of CSK Auto seeking an order that he pay CSK "more than \$4 million that he received in bonuses and stock sale profits while CSK was committing accounting fraud" without alleging that the former CEO had engaged in any misconduct. n134 Ruling on the motion to dismiss filed by the former CEO, the District Court held that "the plain language of the statute indicates that the misconduct of corporate officers, agents, or employees acting within the scope of their agency or employment is sufficient misconduct to meet this element of the statute." n135 Although the SEC had announced that it was seeking an order that would require the former CEO to pay to CSK all of the incentive compensation and stock profits that he received during the measurement period, the Court suggested--without deciding--that reimbursement would be limited to the amount by which the former CEO had unfairly benefitted from the misstatement of CSK's financial statements:

When a CEO either sells stock or receives a bonus in the period of financial noncompliance, the CEO may unfairly benefit from a misperception of the financial position of the issuer that results from those misstated financials, even if the CEO was unaware of the misconduct leading to misstated financials. It is not irrational for Congress to require that such additional compensation amounts be repaid to the issuer. n136

FOOTNOTES:

(n1)Footnote 1. *Report of the Task Force on SEC Settlements*, Committee on Federal Regulation of Securities of the ABA's Section of Business Law, 47 *Bus. Law.* 1087, 1098 (1992).

(n2)Footnote 2. Investment Advisers Act of 1940 § 214, 15 *U.S.C.S.* § 80b-14; Investment Company Act of 1940 § 44, 15 *U.S.C.S.* § 80a-43.

(n3)Footnote 3. *SEC v. Savoy Indus., Inc.*, 587 *F.2d* 1149 (D.C. Cir. 1977) .

(n4)Footnote 4. *SEC v. Capital Gains Research Bureau*, 375 *U.S.* 180, 193 (1963) (quoting the lower court dissent).

(n5)Footnote 5. *Aaron v. SEC*, 446 *U.S.* 680, 703 (1980) (Burger, C.J., concurring). *See also SEC v. Steadman*, 967 *F.2d* 636, 648 (D.C. Cir. 1992) . *Accord, SEC v. Yun*, 148 *F. Supp. 2d*. 1287 (M.D. Fla. 2001) ("Courts have previously noted that 'an injunction is a drastic remedy and not a mild prophylactic.' ") quoting *SEC v. Ingoldsby*, 1990 *U.S. Dist. LEXIS* 11383 *3 , No. 99-1001-MA (D. Mass. May 15, 1990), quoting *Aaron v. SEC*, 446 *U.S.* 680, 703 (1980) .

(n6)Footnote 6. *SEC v. American Bd. Of Trade*, 751 *F.2d* 529 (2d Cir. 1984) .

(n7)Footnote 7. *See, e.g.*, § 20(b) of the Securities Act of 1933, 15 *U.S.C.S.* § 77(b); § 21(d) of the Securities Exchange Act of 1934, 15 *U.S.C.S.* § 78u(d); § 42(e) of the Investment Company Act, 15 *U.S.C.S.* § 80a-41(e); § 209 of the Investment Advisers Act, 15 *U.S.C.S.* § 80b-9(e).

(n8)Footnote 7.1. *See* § 18.04[2][a] for a discussion of cease-and-desist proceedings.

(n9)Footnote 8. *See SEC v. Blatt*, 583 *F.2d* 1325, 1334 (5th Cir. 1978) ("To obtain injunctive relief the Commission must offer positive proof of the likelihood that the wrongdoing will recur. The Commission needs to go beyond the mere fact of past violations.") (citations omitted); *SEC v. Commonwealth Chem. Secs., Inc.*, 574 *F.2d* 90, 100 (2d Cir. 1978) (stating that the SEC must "go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence"); *SEC v. National Student Mktg. Corp.*, 457 *F. Supp.* 682, 715 (D.D.C. 1978) (stating that absent a showing of a cognizable danger of recurrent violation, injunctive relief is not appropriate).

(n10)Footnote 9. *See SEC v. Sargent*, 329 *F.3d* 34 (1st Cir. 2003) ; *SEC v. Holschuh*, 694 *F.2d* 130, 144 (7th Cir. 1982) ; *SEC v. Presto Telecommunications*, 237 *Fed. App'x* 198, 200 (citing *SEC v. Murphy*, 626 *F.2d* 633, 655 (9th Cir. 1980) (citations omitted) (also stating that "the existence of past violations may give rise to an inference that there

will be future violations; and the fact that the defendant is currently complying with the securities laws does not preclude an injunction"); *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992) ; *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977) (denying relief where the SEC could not show the danger of recurrence); *SEC v. Zale Corp.*, 650 F.2d 718, 720 (5th Cir. Unit A 1981) .

(n11)Footnote 10. *SEC v. Youmans*, 729 F.2d 413 (6th Cir. 1984) .

(n12)Footnote 11. *SEC v. Cavanagh*, 155 F.3d 129 (2d Cir. 1998) .

(n13)Footnote 12. *SEC v. Cassano*, 61 F. Supp. 2d 31, 34 (S.D.N.Y. 1999) (quoting *Chris-Craft, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 345 (2d Cir. 1973) (Mansfeld, J., concurring) (quoting *United States v. W.T. Grant Co.*, 345 U.S. 629, 1953 Trade Cas. (CCH) P67493 (1953) .

(n14)Footnote 13. *SEC v. John Adams Trust Corporation*, 697 F. Supp. 573, 578 n. 5 (D.Mass. 1988) .

(n15)Footnote 14. See *SEC v. Steadman*, 967 F.2d 636, 648 (D.C. Cir. 1992) (stating that "[i]njunctive relief is reserved for willful lawbreakers or those whose operations ... pose a continuing danger to the investing public," but not where none of the violations were flagrant or deliberate, most were "technical," and all were corrected immediately).

(n16)Footnote 15. *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993) (holding that the SEC need not prove reliance on the materially misleading materials in an action for injunctive relief); see also *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985) (per curiam); *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63, 84 (2d Cir. 1970) (describing reliance as "immaterial" in an SEC action for injunctive relief).

(n17)Footnote 16. See *SEC v. Unifund SAL*, 910 F.2d 1028, 1035-1039 (2d Cir.) , *reh'g denied*, 917 F.2d 48 (2d Cir. 1990) . But see *SEC v. Cherif*, 933 F.2d 403, 408 n.1 (7th Cir. 1991) (noting that the Second Circuit does not require that the SEC show irreparable injury or an inadequate legal remedy, but leaving open whether those elements are required in the Seventh Circuit).

(n18)Footnote 17. See, e.g., *Murphy*, 626 F.2d 633, 656 n.27 (9th Cir. 1980) ; *SEC v. Research Automation Corp.*, 585 F.2d 31, 36 (2d Cir. 1978) (noting that denial of guilt strengthens the inference that future violations are likely. Some courts have recognized that a defendant should not be penalized for litigating against the SEC. See *SEC v. Yun*, 148 F. Supp. 2d 1287 (M.D. Fla. 2001) ("[W]here litigants do not publicly acknowledge the wrongfulness of their conduct due to a decision to contest SEC enforcement, such actions should not prejudice those litigants since a full and vigorous defense is a 'right under our system of justice.' " and cases cited therein). See also *KPMG v. SEC*, 289 F.3d 109, 127 (D.C. Cir. 2002) (criticizing SEC order in which the SEC based its finding of a likelihood of future violations on respondent's "consistent failure to recognize the seriousness of its violations") (Randolph, J.) (dissenting). But see, e.g., *SEC v. Lipson*, 278 F.3d 656, 664 (7th Cir. 2002) (appropriate to consider defendant's steadfast assertion of innocence in assessing appropriate monetary penalty to be imposed).

(n19)Footnote 18. *SEC v. Brethen*, 1992 U.S. Dist. LEXIS 20665 *104 (S.D. Ohio Oct. 15, 1992) (citing *Youmans*, 729 F.2d 413) . See also *SEC v. Cavanagh*, 155 F.3d 129, 135 (2d Cir. 1998) ("The court looks at the following factors: the fact that the defendant has been found liable for illegal conduct; the degree of scienter involved; whether the infraction is an 'isolated occurrence;' whether defendant continues to maintain that his past conduct was blameless; and whether, because of his professional occupation, the defendant might be in a position where future violations could be anticipated.") (quoting *SEC v. Commonwealth Chem. Secs., Inc.*, 574 F.2d 90, 100 (2d Cir. 1978)); *SEC v. Calvo*, 378 F.3d 1211, 1216 (11th Cir. 2004) ; *SEC v. Pros Int'l, Inc.*, 994 F.2d 767, 769 (10th Cir. 1993) ; *SEC v. Murphy*, 626 F.2d 633, 655 (9th Cir. 1980) ; *Steadman*, 967 F.2d 636 ; *SEC v. Sargent*, 329 F.3d 34 (1st Cir. 2003) .

(n20)Footnote 19. *Report of the Task Force on SEC Settlements*, Committee on Federal Regulation of Securities of the ABA's Section of Business Law, 47 *Bus. Law.* 1987, 1099 (1992).

(n21)Footnote 20. *Pros Int'l*, 994 F.2d 767, 769 ; *SEC v. Wellshire Secs., Inc.*, 773 F. Supp. 569, 574 (S.D.N.Y. 1991) (noting that an injunction "would seriously affect [defendant's] ability to earn a livelihood").

(n22)Footnote 21. *Steadman*, 967 F.2d 636, 648 n.9 (noting that while it may not be a defense to the underlying charges, reliance on counsel is a factor to consider in deciding whether to grant injunctive relief).

(n23)Footnote 22. *Steadman*, 967 F.2d 636, 648 .

(n24)Footnote 23. *SEC v. Clark*, 1989 U.S. Dist. LEXIS 19135 (W.D. Wash. 1989) (issuing an injunction that automatically expired in five years and was limited to violations of *Rule 10b-5(3)*).

(n25)Footnote 24. *SEC v. Pros Int'l, Inc.*, 994 F.2d 767 (10th Cir. 1993) .

(n26)Footnote 25. *Pros Int'l, Inc.*, 994 F.2d at 769-770 (refusing to grant an injunction where an accountant had issued a clean audit opinion after performing little, if any, audit work on the financial statements). The SEC Staff subsequently initiated an administrative proceeding against the accountant and obtained an order pursuant to Rule 102(e)(1) of the Commission's Rules of Practice, permanently barring him from practicing before the Commission with a right to reapply after three years. *In re Stayner, Admin. Proceeding File No. 3-8330, 1994 SEC LEXIS 2963, 57 SEC Docket (CCH) 1856* (Sept. 29, 1994).

(n27)Footnote 26. *SEC v. Park Florida Assocs., Ltd.*, No. 91-1265-Civ-T-22, 54 SEC Docket 1222-747 (M.D. Fla. April 19, 1993).

(n28)Footnote 27. Slip op. at 21.

(n29)Footnote 28. *SEC v. Sargent*, 329 F.3d 34 (1st Cir. 2003) .

(n30)Footnote 29. *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978) .

(n31)Footnote 30. *Blatt*, 583 F.2d at 1335 .

(n32)Footnote 30.1. *SEC v. Conaway*, 2010 U.S. Dist. LEXIS 17057 (Feb. 25, 2010) .

(n33)Footnote 30.2. *Id.* at *116-20.

(n34)Footnote 30.3. *SEC v. Youmans*, 729 F.2d 413, 415 (6th Cir. 1984) .

(n35)Footnote 31. *SEC v. Price Waterhouse*, 797 F. Supp. 1217 (S.D.N.Y. 1992) .

(n36)Footnote 32. *Price Waterhouse*, 797 F. Supp. at 1242-1243 .

(n37)Footnote 33. *SEC v. Wellshire Secs.*, 773 F. Supp. 569 (S.D.N.Y. 1991) .

(n38)Footnote 34. *Wellshire Secs.*, 773 F. Supp. at 576 .

(n39)Footnote 35. *Wellshire Secs.*, 773 F. Supp. at 576 .

(n40)Footnote 36. John H. Sturc et al., *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990*, 24 Rev. of Sec. & Commodities Reg. 79 (1991).

(n41)Footnote 37. *SEC v. Brethen*, 1992 U.S. Dist. LEXIS 20665 (S.D. Ohio Oct. 15, 1992) .

(n42)Footnote 38. 1992 U.S. Dist. LEXIS 20665 *104 . *Accord SEC v. Yun*, 148 F. Supp. 2d 1287, 1294 (M.D. Fla. 2001) (denying injunction where insider trading was isolated occurrence within three-day period and not an egregious

violation and defendants did not have ready access to inside information).

(n43)Footnote 39. *SEC v. Ingram*, 694 F. Supp. 1437 (C.D. Cal. 1988) .

(n44)Footnote 40. *Ingram*, 694 F. Supp. at 1442 . See also *SEC v. Scott*, 565 F. Supp. 1513, 1537 (S.D.N.Y. 1983) , *aff'd sub nom*, *SEC v. Cayman Islands Reinsurance Corp.*, 734 F.2d 118 (2d Cir. 1984) (notwithstanding a finding that the violation was willful, court denied an injunction because there did not exist a reasonable likelihood that past wrongdoing would recur); *SEC v. Warner*, 674 F. Supp. 841 (S.D. Fla. 1987) (holding that the SEC had not met its burden of offering "positive proof" of the likelihood of future violations given that the defendant had been convicted of a felony and therefore was not likely to become involved in any publicly traded company).

(n45)Footnote 41. See *SEC v. Smyth*, 420 F.3d 1225, 1233 n.14 (11th Cir. 2005) .

(n46)Footnote 42. *SEC v. Smyth*, 420 F.3d 1225, 1233 n.14 (11th Cir. 2005) .

(n47)Footnote 43. *Smyth*, 420 F.3d 1225, 1233 .

(n48)Footnote 44. *SEC v. American Bd. of Trade, Inc.*, 751 F.2d 529 (2d Cir. 1984) .

(n49)Footnote 45. *American Bd. of Trade*, 751 F.2d at 533 (quoting *SEC v. American Bd. of Trade, Inc.*, 593 F. Supp. 335, 338 (S.D.N.Y. 1984)) .

(n50)Footnote 46. *SEC v. Cavanagh*, 155 F.3d 129, 132 (2d Cir. 1998) .

(n51)Footnote 47. *SEC v. Unifund SAL*, 910 F.2d 1028 (2d Cir. 1990) .

(n52)Footnote 48. *Unifund*, 910 F.2d 1028, 1037 .

(n53)Footnote 49. *Unifund*, 910 F.2d 1028, 1039-1040 (suggesting that the "serious questions" test is inappropriate because the government is relieved of the obligation imposed on private litigants to provide security for damages incurred by a party wrongfully enjoined); *SEC v. Cavanagh*, 155 F.3d 129 (2d Cir. 1998) (SEC need not show irreparable injury).

(n54)Footnote 50. *Unifund*, 910 F.2d 1028, 1040 .

(n55)Footnote 51. *Unifund*, 910 F.2d 1028, 1040-1042 (ordering that a preliminary injunction freezing assets would expire within 30 days unless the SEC gave notice within that period that it was ready for trial). See also *SEC v. Heden*, 51 F. Supp. 2d 296, 298 (S.D.N.Y. 1999) (asset freeze requires a lesser showing than a preliminary injunction against violations of federal securities laws).

(n56)Footnote 52. See, e.g., *SEC v. Cherif*, 933 F.2d 403, 416-417 (7th Cir. 1991) ; *SEC v. Coates*, 1994 U.S. Dist. LEXIS 11787 (S.D.N.Y. August 23, 1994) .

(n57)Footnote 53. *SEC v. Cavanagh*, 155 F.3d 129, 136 (2d Cir. 1998) (citing *SEC v. Colello*, 139 F.3d 674, 677 (9th Cir. 1998)) .

(n58)Footnote 54. Section 21C(c) of the Exchange Act, 15 U.S.C.S. 78u-3(c), as amended by the Sarbanes-Oxley Act § 110.3.

(n59)Footnote 55. 15 U.S.C.S. § 78u-3(c)(3).

(n60)Footnote 56. *SEC v. Gemstar-TV Guide Int'l, Inc.*, 401 F.3d 1031, 1038 (9th Cir. 2005) (en banc). The Court upheld the validity of the statute in a discussion which suggested that the SEC only commences investigations upon a

showing of probable cause, even though case law indicates that the SEC can commence an investigation without any evidence of wrongdoing.

(n61)Footnote 57. *401 F.3d 1031, 1042-1044* .

(n62)Footnote 58. *401 F.3d 1031, 1043* .

(n63)Footnote 59. *SEC v. American Bd. of Trade, Inc.*, *830 F.2d 431, 438 (2d Cir. 1987)* , cert. denied sub nom. *Economou v. SEC*, *485 U.S. 938 (1988)* ; see also *SEC v. Materia*, *745 F.2d 197, 200 (2d Cir. 1984)* , cert. denied, *471 U.S. 1053 (1985)* (stating that any form of ancillary relief may be granted when necessary and proper to effectuate the purposes of the federal securities laws). For a detailed examination of the history and development of ancillary relief in the context of securities law violations, see George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, *67 Minn. L. Rev.* 865 (1983).

(n64)Footnote 60. *SEC v. Manor Nursing Ctrs.*, *458 F.2d 1082 (2d Cir. 1972)* .

(n65)Footnote 61. *SEC v. Manor Nursing Ctrs.*, *458 F.2d at 1103* .

(n66)Footnote 62. *CFTC v. American Metals Exch. Corp.*, *991 F.2d 71, 78 (3d Cir. 1993)* .

(n67)Footnote 63. Sarbanes Oxley Act § 305 amending Exchange Act § 21(d) (to be codified at *15 U.S.C.S. § 78u(d)(5)*).

(n68)Footnote 64. *SEC v. Presto Telecommunications*, *237 Fed. App'x. 198, 200 (9th Cir. 2007)* (district court has authority to order defendant to disgorge "a reasonable approximation of profits causally connected to (defendant's) violations"); *SEC v. Huffman*, *996 F.2d 800, 802 (5th Cir. 1993)* (The court describes disgorgement as "an equitable remedy meant to prevent the wrongdoer from enriching himself by his wrongs."); *SEC v. First City Fin. Corp.*, *890 F.2d 1215, 1230 (D.C. Cir. 1989)* (Disgorgement is "designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws."); *SEC v. Interlink Data Network*, *1993 U.S. Dist. LEXIS 20163 *52 (C.D. Cal. Nov. 15, 1993)* ("Where liability under § 10(b) has been established the Court should fashion relief structured to deprive the defendant of all gains flowing from the illegal activity.") (quoting *SEC v. Lund*, *570 F. Supp. 1397, 1404 (C.D. Cal. 1983)*) .

(n69)Footnote 65. See, e.g., *SEC v. Clark*, *915 F.2d 439, 454 (9th Cir. 1990)* (citing *Elkind v. Liggett & Myers, Inc.*, *635 F.2d 156, 165 (2d Cir. 1980)*) ; *SEC v. Ferrero*, *1993 U.S. Dist. LEXIS 21379 *48-49 (S.D. Ind. Nov. 15, 1993)* (holding that the tipper can be ordered to disgorge the profits of his tippee, even where the tippee has not violated the securities laws).

(n70)Footnote 66. *SEC v. Unifund SAL*, *910 F.2d 1028, 1041 (2d Cir. 1990)* ; *SEC v. Commonwealth Chem. Secs., Inc.*, *574 F.2d 90, 100-102 (2d Cir. 1978)* . A more extensive discussion of disgorgement can be found at § 18.09 below .

(n71)Footnote 67. *SEC v. Calvo*, *378 F.3d 1211, 1215-16 (11th Cir. 2004)* .

(n72)Footnote 68. See, e.g., *In re English, Admin. Proceeding File No. 3-6401, 1986 SEC LEXIS 2162, 34 SEC Docket (CCH) 1230* (Jan. 8, 1986) (ordering respondent to provide an accurate disclosure statement meeting the requirements of Investment Advisers Act § 204).

(n73)Footnote 69. *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, *285 F.2d 162 (9th Cir. 1960)* .

(n74)Footnote 70. *Los Angeles Trust Deed & Mortgage Exch.*, *285 F.2d 162, 181-182* .

(n75)Footnote 71. *SEC v. Hughes*, *461 F.2d 974, 981-982 (2d Cir. 1972)* .

(n76)Footnote 72. *SEC v. Drexel Burnham Lambert*, 837 F. Supp. 587 (S.D.N.Y. 1993) .

(n77)Footnote 73. *SEC*, 837 F. Supp. 587, 615-616 . A voting trust allows the donor to retain ownership of the shares, but vests a trustee with the power to vote them.

(n78)Footnote 74. *SEC*, 837 F. Supp. 587, 616 .

(n79)Footnote 75. *See SEC v. Presto Telecommunications*, 237 Fed. App'x. 198 , 201 (9th Cir. 2007).

(n80)Footnote 76. *See Accounting and Auditing Enforcement Release No. 1586*, 2002 SEC LEXIS 1676 (June 28, 2002) .

(n81)Footnote 77. Exchange Act § 21, 15 U.S.C.S. § 78u.

(n82)Footnote 78. *See, e.g., SEC v. Sargent*, 329 F.3d 34 (1st Cir. 2003) (denying penalties); *SEC v. Yun*, 148 F. Supp. 2d 1287, 1295 (M.D. Fla. 2001) (and cases cited therein); *SEC v. Brethen*, 1992 U.S. Dist. LEXIS 20665 *98-99 (S.D. Ohio Oct. 15, 1992) (citing *SEC v. Youmans*, 729 F.2d 413 (6th Cir. 1984) (applying first three factors to determine the appropriateness of a penalty under the Insider Trading and Securities Fraud Enforcement Act of 1988); *see also SEC v. Chapnick*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,076, 98,654 (S.D. Fla. Feb. 11, 1994) (following *Brethen* factors in a case under the Insider Trading Sanctions Act of 1984).

(n83)Footnote 79. *Brethen*, 1992 U.S. Dist. LEXIS 20665, *104 .

(n84)Footnote 80. *Brethen*, 1992 U.S. Dist. LEXIS 20665 .

(n85)Footnote 81. *Brethen*, 1992 U.S. Dist. LEXIS 20665, *105-106 .

(n86)Footnote 82. *SEC v. Ingoldsby*, 1990 U.S. Dist. LEXIS 11383 (D. Mass. May 15, 1990) .

(n87)Footnote 83. *Ingoldsby*, 1990 U.S. Dist. LEXIS 11383 *8 . The court also found it unlikely that such a violation would occur in the future, citing the defendant's heretofore clean record, lack of bad faith, and sincerity during testimony. 1990 U.S. Dist. LEXIS 11383 *4 .

(n88)Footnote 84. Pub. L. No. 101-429, 104 Stat. 931 (1990).

(n89)Footnote 85. Securities Act § 20(d), 15 U.S.C.S. § 77t(d); Exchange Act § 21(d)(3), 15 U.S.C.S. § 78u(d)(3); Investment Company Act § 42(e), 15 U.S.C.S. § 80a-41(e); Investment Advisers Act § 209(e), 15 U.S.C.S. § 80b-9(e).

(n90)Footnote 86. S. Rep. No. 337, 101st Cong., 2d Sess. at 9 (1990) (the Senate Report) ("The Committee therefore concluded that authority to seek or impose substantial monetary penalties, in addition to the disgorgement of profits, is necessary to the deterrence of securities law violations that otherwise may provide great financial returns to the violator."); H.R. Rep. No. 515, 101st Cong. 2d Sess. 14, 18-19 (1990) (same).

(n91)Footnote 87. *See, e.g., Exchange Act § 21(d)(3)(B)*, 15 U.S.C.S. § 78u(d)(3)(B); Exchange Act § 21B, 15 U.S.C.S. § 78u-2.

(n92)Footnote 88. *See, e.g., Exchange Act § 21(d)(3)(B)*, 15 U.S.C.S. § 78u(d)(3)(B); Exchange Act § 21B, 15 U.S.C.S. § 78u-2.

(n93)Footnote 89. *See, e.g., Exchange Act § 21(d)(3)(B)*, 15 U.S.C.S. § 78u(d)(3)(B); Exchange Act § 21B, 15 U.S.C.S. § 78u-2. A table setting forth the maximum penalty amount for each violation can be found at 17 C.F.R. § 201.1002.

(n94)Footnote 90. S. Rep. No. 337, 101st Cong., 2d Sess. at 12.

(n95)Footnote 91. H.R. Rep. No. 515, 101st Cong. 2d Sess. 14, 18-19 (1990).

(n96)Footnote 92. S. Rep. No. 337, 101st Cong., 2d Sess. at 2.

(n97)Footnote 93. *See, e.g., SEC v. Interlink Data Network, 1993 U.S. Dist. LEXIS 20163 *56* (C.D. Cal. Nov. 15, 1993) .

(n98)Footnote 94. *SEC v. Ferrero, 1993 U.S. Dist. LEXIS 21379* (S.D. Ind. Nov. 15, 1993) .

(n99)Footnote 95. *1993 U.S. Dist. LEXIS 21379* .

(n100)Footnote 96. *1993 U.S. Dist. LEXIS 21379* .

(n101)Footnote 97. *See, e.g., SEC v. McCaskey, 2002 U.S. Dist. LEXIS 4915* (S.D.N.Y. March 26, 2002) (the SEC did not request and magistrate judge did not recommend that any multiplier be applied to the third-tier penalty even though there were many violative transactions); *SEC v. Kamadin, 2007 U.S. Dis. LEXIS 44260 at *6-7* (M.D. Fla. June 19, 2007) (without discussion, court did not apply a multiplier even though the fraudulent scheme involved the securities of seventeen issuers); *SEC v. Haligiannis, 470 F.Supp. 2d 373, 386* (S.D.N.Y. Jan. 17, 2007) (arguably implying that each mailing of a false statement to a defrauded investor is a separate violation).

(n102)Footnote 98. Stephen M. Cutler, "Speech to 24th Annual Ray Garrett Jr. Corporate and Securities Law Institute (April 29, 2004) ("Cutler Speech on Penalties"), www.sec.gov/news/speech/spch042904smc.htm.

(n103)Footnote 99. Cutler Speech on Penalties at 6.

(n104)Footnote 100. *See Chapter 3 above.*

(n105)Footnote 101. Cutler Speech on Penalties at 6.

(n106)Footnote 102. *SEC v. Lipson, 278 F.3d 656 (7th Cir. 2002)* (defendant has right to jury trial where the SEC seeks monetary penalties but the court set the amount of the penalty), *citing Tull v. United States, 481 U.S. 412 (1987)* .

(n107)Footnote 103. *Tull, 481 U.S. 412, 424-425* (describing disgorgement as a return to the status quo, and noting that the purposes of a penalty are markedly different). The court also notes that there are separate provisions in the statute at issue dealing with disgorgement and civil penalties, weakening an argument that the two are to be treated alike.

(n108)Footnote 104. *15 U.S.C.S. §§ 77t(e), 78u(d)(2)*. Sec. 305(a) of the Sarbanes-Oxley Act of 2002 makes explicit that the defendant's conduct is subject to an "unfitness" standard.

(n109)Footnote 105. *SEC v. Posner, 16 F.3d 520 (2d Cir. 1994)* .

(n110)Footnote 106. *Posner, 16 F.3d 520, 522* .

(n111)Footnote 107. *Hearings on Section 647, the Securities Law on Enforcement Remedies of 1989, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 101st Cong., 1st Sess. at 29 (1990)* (statement of Richard C. Breeden, Chairman, Securities and Exchange Commission).

(n112)Footnote 108. *SEC v. Patel, 61 F.3d 137 (2d Cir. 1995)* .

(n113)Footnote 109. *Patel, 61 F.3d 137, 140 (citing Jayne W. Barnard, When Is a Corporate Executive Substantially Unfit to Serve?, 70 N.C. L. Rev. 1489 (1992))*.

(n114)Footnote 110. *Patel*, 61 F.3d 137, 140 (citing Jayne W. Barnard, *When Is a Corporate Executive Substantially Unfit to Serve?*, 70 N.C. L. Rev. 1489 (1992)).

(n115)Footnote 111. *SEC v. Patel*, 1994 U.S. Dist. LEXIS 9479 *12 (S.D.N.Y. July 12, 1994) .

(n116)Footnote 112. *See SEC v. Shah*, 1993 U.S. Dist. LEXIS 10347 (S.D.N.Y. July 26, 1993) .

(n117)Footnote 113. *Patel*, 61 F.3d 137, 142 .

(n118)Footnote 114. The Ninth Circuit has also expressed approval of these factors. *SEC v. First Pacific Bancorp*, 142 F.3d 1186, 1193 (9th Cir. 1998) .

(n119)Footnote 115. *Patel*, 61 F.3d 137, 141 .

(n120)Footnote 116. *Patel*, 61 F.3d 137, 142 .

(n121)Footnote 117. *Patel*, 61 F.3d 137, 142 .

(n122)Footnote 118. *See SEC v. Shah*, 1993 U.S. Dist. LEXIS 10347 (S.D.N.Y. July 26, 1993) .

(n123)Footnote 119. *Shah*, 1993 U.S. Dist. LEXIS 10347 .

(n124)Footnote 120. *SEC v. Drexel Burnham Lambert*, 837 F. Supp. 587 (S.D.N.Y. 1993) .

(n125)Footnote 121. *SEC*, 837 F. Supp. 587, 589 .

(n126)Footnote 122. *SEC*, 837 F. Supp. 587, 615 .

(n127)Footnote 123. *SEC v. Sprecher*, 1993 U.S. Dist. LEXIS 18116 (D.D.C. Dec. 16, 1993) .

(n128)Footnote 124. *See, e.g., SEC v. Thrasher*, 1996 U.S. Dist. LEXIS 2141 (S.D.N.Y. Feb. 27, 1996) (SEC sought to bar non-trading tipper from serving as an officer or director of any public company).

(n129)Footnote 125. *SEC v. McCaskey*, 2001 U.S. Dist. LEXIS 13571 (S.D.N.Y. September 6, 2001) .

(n130)Footnote 126. Steven M. Cutler, "Remarks at the GlasserLegalWorks 20th Annual Federal Securities Institute" (February 15, 2002), *available at* www.sec.gov/news/speech/spch538.htm.

(n131)Footnote 127. The Sarbanes-Oxley Act § 305.

(n132)Footnote 128. Stephen M. Cutler, Cutler Speech on Penalties at 2 , www.sec.gov/news/speech/spch042904smc.htm.

(n133)Footnote 129. 15 U.S.C.S. § 78u(d).

(n134)Footnote 130. 15 U.S.C.S. § 77t.

(n135)Footnote 131. Exchange Act § 21(d)(6); 15 U.S.C.S. § 78u(d)(6). Essentially, a penny stock is an issue that trades for less than five dollars per share, is not listed on a national exchanges, or is issued by a company beneath a certain market capitalization. Exchange Act § 3(a)(51)(A); 15 U.S.C.S. § 78c(a)(51)(A).

(n136)Footnote 132. *See, e.g., Pedrolis v. Bartek*, 564 F.Supp.2d 683, 686 (E.D. Tex. 2008) and cases cited therein.

(n137)Footnote 133. "Former United Health Group CEO/Chairman Settles Stock Options Backdating Case for

\$468 Million," SEC Press Release 2007-235 (Dec. 6, 2007), available at <http://www.sec.gov/news/press/2007/2007-255.htm>.

(n138)Footnote 134. "SEC Seeks Return of \$4 Million in Bonuses and Stock Sale Profits From Former CEO of CSK Auto Corp.," SEC Litig. Release No. 21149A (July 23, 2009) available at <http://www.sec.gov/litigation/litreleases/2009/lr21149a.htm>.

(n139)Footnote 135. *SEC v. Jenkins*, 2010 U.S. Dist. LEXIS 57023 at *8-9 (D. Ariz. June 9, 2010) .

(n140)Footnote 136. *SEC v. Jenkins*, 2010 U.S. Dist. LEXIS 57023 at *10-11 (D. Ariz. June 9, 2010) .



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Securities Enforcement: Counseling and Defense

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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.04

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§ 18.04 Administrative Remedies

For the purpose of this chapter, administrative remedies are divided into two categories. The first includes administrative remedies available only against regulated entities, persons associated with such entities, and persons associated with penny stock offerings. The second category includes remedies also available against persons other than regulated entities, their associated persons, and persons associated with penny stock offerings.

In determining what sanctions are in the public interest sanctions, ALJs and the Commission consider:

[T]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurance against future violations, the defendant's recognition of the wrongful nature of his conduct, and likelihood that the defendant's occupation will present opportunities for future violations. n1

[1] Administrative Remedies Against Regulated Persons, Persons Associated with Regulated Persons, and Persons Associated with Penny Stock Offerings

The SEC has the power to censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of securities brokers or dealers, n2 municipal securities dealers, n3 government securities brokers, or government securities dealers, n4 transfer agents, n5 and investment advisers. n6 With respect to persons associated with such entities, the SEC also has the power to censure, place limitations on the activities of, suspend for a period not exceeding 12 months, or bar such persons from being associated with such entities. n7 The SEC also has the power to suspend the registration of a registered investment company n8 or to prohibit, either permanently or temporarily, a person from serving as an employee, director, member of the advisory board, investment adviser, or depositor of or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or such underwriter. n9 In addition, with respect to persons participating in the offering of a penny stock, the SEC has the power to censure, place limitations on the person's activities or functions, suspend the person for a period not exceeding 12 months, or bar a person from associating with such offerings. n10

[a] Limitations on Activity and Censure

The SEC has the authority to sanction regulated entities after making appropriate findings. n11 The Exchange Act, the Investment Company Act, and the Investment Advisers Act each authorizes sanctions, including censure, suspension, a bar from associating with certain persons, revocation of the entity's registration, and other limitations on activity. n12 As absolute bars are generally reserved for the most egregious cases, n13 the SEC often imposes a more limited sanction.

For example, an order imposing a bar might expressly provide that the respondent has a right to apply for removal of the bar after a certain number of years. Often, such right will depend on certain conditions. For example, *In re Thomas Fittin* n14 involved the bar of an individual associated with a broker-dealer. He was barred with the right to apply in six months, but only upon a showing that he would be adequately supervised in the new position.

Lesser sanctions include suspension for periods of less than one year, n15 and requiring certain undertakings. For example, the SEC may direct an entity to retain an outside consultant to review its policies and procedures and to address the problems identified by the consultant and report back regarding those problems and the solutions implemented. For example, in *In re Edgemont Asset Management Corp.*, n16 the SEC required the respondent to review and update its policies regarding securities purchases, disseminate those revised policies to its personnel, and hire an independent consultant to monitor its activities for six months and report findings to the Commission. n17 In *In re Walnut Street Securities, Inc.*, n18 the SEC entered into a settlement involving a failure by a securities broker dealer to supervise. The terms of the settlement required the respondent to retain an independent consultant to improve its supervisory procedures.

In order to impose these sanctions, the Commission must first find that the sanction is in the public interest, and:

- the entity either has made false statements in its filings with the SEC; n19
- violated federal securities laws; n20
- has been enjoined from violating federal securities law; n21
- aided in the commission of any such violation; n22 or
- has failed to supervise one who has committed such a violation. n23

Additional grounds include conviction of various classes of felonies, most involving fraud, deception, theft, or other illegal securities-related business. n24

The statutes provide little guidance as to which sanctions are appropriate in a given case. As most administrative proceedings are settled rather than litigated, there is also a dearth of precedent to afford defense counsel a reliable means of determining potential penalties if the enforcement proceeding were litigated and sanctions imposed by the administrative law judge. n25

In settled administrative proceedings in which a person is barred from associating with one registered entity (e.g., a broker-dealer), the SEC used to insist that the person agree to be barred from association with all forms of registered entities (e.g., investment companies and investment advisers). In 1999, the D.C. Circuit held that the Commission did not have statutory authority to impose a collateral bar. n26 One of the petitioners in *Teicher* argued that § 15(b)(6) of the Exchange Act did not supply the Commission with authority to exclude persons from the investment adviser industry. The court of appeals agreed, holding that § 15(b)(6) of the Exchange Act authorized the Commission to impose a bar or other limitation with respect to association with a broker dealer and that § 203(f) of the Advisors Act authorized the Commission to impose a bar or other limitation with respect to association with an investment adviser

only if the person is associated with, is seeking to become associated with, or at the time of the alleged misconduct was associated or was seeking to become associated with an investment adviser. Accordingly, the court held that the Commission lacked the authority to bar the petitioner from the investment advisory industry unless and until the petitioner sought to become associated with an investment advisor. n27 In August 2010, as part of the Dodd-Frank Act, Congress provided that when a securities professional is suspended or barred because of misconduct, the professional will be barred from being associated with any transfer agent, broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or nationally recognized statistical rating organization. n28

The other petitioner in *Teicher* argued that § 203(f) of the Advisers Act did not authorize the SEC to bar him from association with unregistered investment advisors. The court of appeals rejected this argument, holding that the Commission had authority to bar him from association with both registered investment advisers and unregistered investment advisors. n29

[b] Monetary Penalties

In addition to its power to sanction regulated entities, the SEC has since 1990 authorized to impose money penalties in administrative proceedings against regulated entities, persons affiliated with those entities, and persons associated with penny stock offerings. n30 In August 2010, as part of the Dodd-Frank Act, Congress granted the Commission the power to award monetary penalties in cease-and-desist proceedings against any person who violated or is a "cause" of a violation of the Securities Act, the Exchange Act, the Investment Advisors Act or the Investment Company Act. n31 The same three-tier structure of penalties applies here as in a civil injunctive action. n32

Comment

The SEC will impose second-tier penalties on deficient supervisors, finding that their supervisory lapses involved fraud where the deficient supervision enabled the supervised person to engage in fraud. n33

The provisions calling for money penalties provide for the consideration of the following six factors:

- (1) whether the act of omission ... involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
- (2) the harm to other persons resulting ... from such act or omission;
- (3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;
- (4) whether such person previously has been found ... to have violated the ... securities laws, has been enjoined by a court of competent jurisdiction from violation of such laws ..., or has been convicted ... of violations of such laws or [other classes of convictions];
- (5) the need to deter such person and other persons from committing such acts or omissions; and
- (6) such other matters as justice may require. n34

Comment

The federal securities laws provide different "tiers" of penalties, depending on the severity of the

infraction and the culpability of the actor. These tiers and the monetary penalties available thereunder, are the same as those available in a civil action under Exchange Act § 21A. n35

[c] Order of Accounting and Disgorgement

The SEC also possesses the authority to order an accounting and disgorgement from regulated entities, persons associated with those entities, and persons associated with penny stock offerings. n36 While the presence of illicit gains is a factor to consider in assessing penalties in administrative proceedings, this disgorgement provision gives the Commission direct authority to reclaim illegal profits. Prior to the Remedies Act, this option was available to the SEC only through the courts. Since 1995, the Commission has had authority to enter an order requiring an accounting and disgorgement of unlawful gains in any administrative proceeding in which it has the power to impose a civil penalty, and may include reasonable interest charges. n37 A more extensive discussion of disgorgement can be found at § 18.10 below .

[2] Other Administrative Remedies

[a] Cease-and-Desist Remedies

Under the Remedies Act, the SEC has broad powers to issue an order requiring that a person cease-and-desist from committing the violation or any future violation of the same provision, rule, or regulation. The Commission may enter an administrative cease-and-desist order against any person that is, was, or is about to violate any provision of the federal securities laws and any person "that is, was, or would be a cause of the violation due to an act or omission the person knew or should have known would contribute to such violation." n38

Congress granted the SEC this authority as part of the Remedies Act. The legislative history of the Remedies Act indicates that Congress provided the cease-and-desist remedy as an alternative remedy that permits flexibility to address violations that do not warrant injunctions or the collateral consequences of an injunction. n39 The House Report noted that it would be appropriate for the SEC to use the cease-and-desist remedy against persons "who commit isolated infractions and present a lesser threat to investors" and to avoid protracted litigation or settlement negotiations resulting from concerns regarding the severe collateral consequences that may arise from an injunction. n40

In connection with a proceeding against KPMG LLP, the Commission and the D.C. Circuit have taken the position that to issue a cease-and-desist order, there must be "some likelihood of future violations." n41 This requires a showing of likelihood considerably less stringent than that required for an injunction to issue. However, because the nature of the cease-and-desist remedy is inherently forward-looking, if there is no possible risk of future harm, then the imposition of a cease-and-desist order is unwarranted. "Though 'some' risk is necessary, it need not be very great to warrant issuing a cease-and-desist order. Absent evidence to the contrary, a finding of violation raises a sufficient risk of future violation. To put it another way, evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits our ordering him to cease and desist." n42

In *KPMG*, the Commission stated that the issuance of a cease and desist order is not "automatic" on the finding of a past violation. n43 In addition to the risk of future violation, the Commission announced that it will continue to consider its "traditional factors" in determining whether such an order is an appropriate sanction. These "traditional factors" include:

- The seriousness of the violation
- The isolated or recurrent nature of the violation
- The respondent's state of mind

- The sincerity of the respondent's assurances against future violations
- The respondent's recognition of the wrongful nature of his or her conduct
- The respondent's opportunity to commit future violations
- Whether the violation is recent
- The degree of harm to investors or the marketplace resulting from the violation
- The remedial function to be served by the cease-and-desist order in the context of other sanctions being sought in the same proceeding. n44

The D.C. Circuit affirmed the Commission opinion holding that a negligence standard is sufficient to establish causing liability under § 21C of the Exchange Act and to warrant the imposition of a cease-and-desist order. n45 KPMG argued that the Commission invoked the cease and desist remedy of § 21C as a means of circumventing the scienter requirement of Rule 102(e), which it contended was the exclusive basis for disciplinary actions against accountants. The court dismissed this argument, holding that the Commission has authority to administratively discipline professionals under § 21C. Moreover, the court found that the plain language of § 21C established a negligence standard of liability. Section 21C(a) grants the SEC authority to issue a cease-and-desist order against any person who causes a violation "due to an act or omission that the person *knew or should have known* would contribute to such violation." n46 The court agreed with the Commission that such language sets a negligence standard. n47 Accordingly, the D.C. Circuit upheld the imposition of the cease-and-desist order against KPMG for its negligent conduct causing a primary violation that did not require scienter.

In one administrative case decided and affirmed before the landmark *KPMG* case cited above, an administrative law judge dismissed a proceeding against the former head high-yield bond trader at Drexel Burnham Lambert because the only remedy available to the Commission, a cease-and-desist order, was unwarranted because the Commission did not show a likelihood of future violation. n48 The case against the trader was not instituted until nine years after the alleged violation. By the time the case was heard, the respondent had been out of the securities business for five years, and there were no recurrent violations in the interim. Even though the respondent did not forswear reentering the securities business, doing so was "a 'mere possibility' rather than a 'likelihood.'" The Commission affirmed the decision, finding no likelihood of future violation and determining that no remedial purpose would be served by issuing a cease-and-desist order. n49

The cease-and-desist provisions also provide that the Commission may:

- require a respondent to comply or take steps to effect compliance with the relevant provisions of the federal securities laws upon such terms and conditions as the SEC may specify and issue an order requiring an accounting and disgorgement, including reasonable interest. n50

The hearing on the injunction must take place no earlier than 30 days, and no later than 60 days, after issuance of the order instituting proceedings, unless the SEC and the respondent mutually agree on an earlier or later date. n51

The Remedies Act confers on the courts the power to issue civil penalties for violations of a cease-and-desist order. n52 The Remedies Act further provides that each day of a continuing failure to comply with the order is deemed a separate violation making per diem penalties available.

Section 301 of the Private Securities Litigation Reform Act of 1995 ("PSLRA") imposes certain duties on an independent public auditor that detects or otherwise becomes aware "of information indicating that an illegal act

(whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred." n53 The section authorized the SEC to issue a cease-and-desist order and impose monetary penalties against an independent public accountant that willfully violates certain of the duties imposed on the independent public auditor.

[b] Accounting and Disgorgement

In any administrative proceeding to obtain a cease-and-desist order, the SEC may also enter an order "requiring accounting and disgorgement." n54

[c] Temporary Cease-and-Desist Authority

As discussed *above*, the SEC has broad authority to issue permanent cease-and-desist orders as a result of the Remedies Act. n55 This authority is not limited to regulated entities. The SEC also has the authority under Section 21C(c)(2) of the Exchange Act to issue temporary orders, but only against regulated entities (brokers, dealers, investment advisers, investment companies, municipal securities dealers, government securities brokers, or transfer agents) and persons associated or seeking to become associated with such entities. n56 In 2002, the Sarbanes-Oxley Act § 3(b)(3) amended Exchange Act § 21C(c)(2) to authorize the Commission to issue temporary cease-and-desist orders against "registered public accounting firms" as well. n57 The same findings required for issuance of a permanent order must also be made before issuance of a temporary order. Additionally, the SEC must find that the violation giving rise to the order "is likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest" to warrant the temporary order. n58

Absent unusual circumstances, the SEC may issue a temporary cease-and-desist order only after formal notice and hearing. However, the Commission may enter a temporary order without formal notice and hearing requirements if it determines that such requirements would be impracticable or against the public interest. n59 The House report on the Remedies Act states that the entry of a cease-and-desist order on an *ex parte* basis is an extraordinary remedy and not a "wholesale substitute for the range of Commission procedures." n60 The House and Senate reports cite a number of circumstances that might warrant a temporary cease-and-desist order being issued without prior notice and hearing:

- respondent's flight from prosecution;
- destruction of evidence;
- transfer of assets or records;
- improper conversion of assets;
- impeding the SEC's ability to identify or trace the source or disposition of funds; and
- further harm to investors. n61

Otherwise, the SEC must give notice and an opportunity for a hearing before the entry of a temporary cease-and-desist order. As a temporary order becomes effective at the time of service, the SEC must provide for an expeditious hearing should a party contest the issuance of the order. According to § 21C of the Exchange Act, the respondent has 10 days from the service of the order to request a hearing before the Commission, which shall hold a hearing and render a decision at the earliest possible time.

[d] Administrative Orders Barring Service as an Officer or Director of a Public Company

By the Sarbanes-Oxley Act of 2002, Congress amended the Exchange Act and the Securities Act to authorize the SEC

to prohibit a person from serving as an officer or director of a public company if that person violated Exchange Act § 10(b), any rule thereunder, or Exchange Act § 17(a)(1) and the conduct of that person demonstrates unfitness to serve as an officer or director of the public company. n62 Prior to the Sarbanes-Oxley Act, if the Commission wanted an individual to be barred from acting as an officer or director of a public company, the Commission had to file a civil action in federal court. In addition to changing the threshold from "substantial unfitness" to "unfitness," the Sarbanes-Oxley Act gave the Commission the option to seek this remedy in an administrative proceeding. Since the enactment of the Sarbanes-Oxley Act, the SEC has been much more aggressive in seeking officer and director bars against officers and directors charged with securities fraud.

[e] Section 15(c)(4) of the Exchange Act

Section 15(c)(4) of the Exchange Act confers on the SEC the power to issue administrative orders requiring compliance with §§ 12, 13, 14, and 15(d) of the act, or any rule or regulation thereunder. n63 This provision has fallen into disuse since the Remedies Act authorized the SEC to issue cease-and-desist orders. While Congress was considering the Remedies Act, there was considerable debate as to whether § 15(c)(4) authorizes the SEC to issue general orders for future compliance (i.e., a general order that the respondent comply with certain sections of the Exchange Act, or some rules or regulations thereunder), as opposed to only authorizing orders to require a respondent to take action to correct specific violations.

In 1991, the SEC decided that it was and ought to be constrained from imposing orders of general future compliance under § 15(c)(4). n64 Since the Remedies Act authorized the Commission to order a respondent to cease-and-desist from "committing or causing ... any future violation" of the provision, rule, or regulation that had been violated, the SEC prefers to proceed pursuant to its cease-and-desist authority.

[f] Refusal Orders, Stop Orders, and Examinations

Sections 8(b) and 8(d) of the Securities Act authorize the SEC to issue refusal orders and stop orders, respectively. Both sections provide that if the Commission finds that a registration statement is defective, it may issue an order preventing the statement from becoming effective.

Section 8(b) provides, in part, that the Commission may, after notice and hearing, issue an order prior to the effective date of a registration statement refusing to permit the statement to become effective until it has been amended in accordance with such order. n65 In order to invoke § 8(b), the SEC must provide notice (by personal service or by confirmed telegraphic notice) to the registrant not later than 10 days after filing of the registration statement. Unless otherwise agreed by the registrant, the SEC must set the hearing for a date within 10 days after the date of such notice. When the registration statement has been amended in accordance with the order, the Commission shall so declare, and the statement may become effective.

Section 8(d) differs from § 8(b) primarily in that § 8(d) permits the Commission to provide notice at any time after the filing of the registration statement if it appears that the statement includes any untrue statement of material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not materially misleading. Under § 8(d), unless the registrant agrees otherwise, the Commission must hold an evidentiary hearing within 15 days of providing notice. A stop order suspends the effectiveness of the registration statement until the statement has been amended in accordance with the stop order. The stop order remains effective until the Commission declares that the registration statement has been amended in accordance with the order.

Under § 8(e), the Commission may conduct an examination to determine whether a stop order should be issued under § 8(d). n66 In conducting such examination, the Commission or any officer or officers designated by the Commission shall have access to and may demand the production of any books and papers of, and may administer oaths and affirmations to and examine, the issuer, underwriter, or any other person, in respect of any matter relevant to the

examination, and may, in its discretion, require the production of a balance sheet exhibiting the assets and liabilities of the issuer, or its income statement, or both, to be certified to by a public accountant approved by the Commission. Section 8(e) provides that if the issuer or underwriter fails to cooperate, or obstructs or refuses to permit the making of an examination, such conduct shall be proper grounds for the issuance of a stop order. n67 The Commission has held that a § 8(e) examination is not a pre-requisite for a § 8(d) stop order. n68

Moreover, § 5 of the Securities Act provides that it shall be unlawful for any person to sell or offer to buy securities through a prospectus or otherwise while the registration statement is the subject of any public proceeding or examination under § 8. n69

A registrant subject to a proceeding or examination under § 8 may not use the exemption from registration provided by Securities Act Regulation A unless, upon a showing of good cause and without prejudice to any other action by the SEC, the Commission determines that it is not necessary that the exemption be denied. n70 Securities Act Rule 258 provides remedies with respect to Regulation A that are similar to the remedies provided by § 8 with respect to a registration statement. n71

[g] Trading Suspensions

Exchange Act 12(k) authorizes the SEC to suspend trading for 10 days without any hearing or procedural safeguards. The section provides, in part, "If in its opinion the public interest and the protection of investors so require, the Commission is authorized by order ... summarily to suspend trading in any security (other than an exempted security) for a period not exceeding 10 business days. ..." n72 This provision is intended "to allow the Commission to take emergency action for 10 days while it prepares to deploy other remedies, such as a temporary restraining order, a preliminary or permanent injunction, or a suspension or revocation of the registration of a security." n73

This provision does not empower the Commission to continue to "roll over" suspension orders for the same allegedly improper activity simply upon a redetermination that the continued suspension is "required" by the public interest and for the protection of investors. In *SEC v. Sloan*, n74 the Supreme Court held:

Even though there be periodic redetermination of whether such action is required by "the public interest" and for "the protection of investors," the Commission is not empowered to issue, based upon a single set of circumstances, a series of summary orders which would suspend trading beyond the initial 10-day period. n75

In order for the SEC to suspend trading in a security for more than 10 days, the Commission must either identify improper conduct in addition to the improper conduct relied upon for the prior suspension(s), or proceed under Exchange Act § 12(j), which states that the Commission can issue an order only after providing notice and an opportunity for a hearing. Specifically, Exchange Act § 12(j) authorizes the Commission to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of the Exchange Act or the rules and regulations thereunder. Exchange Act 12(j) prohibits any broker or dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended pursuant to the preceding sentence. n76

As a practical matter, once the SEC has temporarily suspended trading in a security, U.S. brokers and dealers will not publish quotations for the security until the issue has been resolved. When the SEC announces the suspension of trading in a security, the SEC warns brokers and dealers that

pursuant to Rule 15c2-11 under the Exchange Act, at the termination of the trading suspension, no

quotation may be entered unless and until they have strictly complied with all of the provisions of the rule. If any broker-dealer has any questions as to whether or not it has complied with the rule, it should not enter any quotation but immediately contact the staff in the Division of Market Regulation, Office of Interpretation and Guidance, at (202) 551-5760. If any broker-dealer is uncertain as to what is required by Rule 15c2-11, it should refrain from entering quotations relating to the securities of the companies listed above until such time as it has familiarized itself with the rule and is certain that all of its provisions have been met. If any broker-dealer enters any quotation that is in violation of the rule, the Commission will consider the need for prompt enforcement action. n77

Comment

NASDAQ sometimes tacks a trading halt onto a 10-day suspension imposed by the SEC. Such action may result in extensions of suspensions beyond that permitted by *Sloan*.

[h] Deregistration

[i] Disciplining Professionals Who Practice Before the Commission

The SEC has long asserted authority over professionals who practice before the Commission. Historically, the SEC based this authority on Rule 2(e) of the SEC Rules of Practice. In 1995, the SEC recodified its Rules of Practice, and Rule 2(e) became Rule 102(e). By the Sarbanes-Oxley Act of 2002, Congress amended the Exchange Act to incorporate Rule 102(e)(1) into the Exchange Act. n78

Before the Sarbanes-Oxley Act of 2002, no statute expressly authorized the Commission to suspend and disbar professionals practicing before the SEC. A number of courts held, however, that the Commission had this authority. n79

In *Checkosky v. SEC* n80 and *Davy v. SEC*, n81 the District of Columbia and Ninth Circuits, respectively, largely adopted the reasoning of the Second Circuit in *Touche Ross v. SEC*. n82 In *Touche Ross*, the Second Circuit upheld Rule 2(e) of the SEC Rules of Practice on the grounds that

[t]he Commission, through its Rule 2(e) proceeding, is merely attempting to preserve the integrity of its own procedures, by assuring the fitness of those professionals who represent others before the Commission. Indeed, the Commission has made it clear that its intent in promulgating Rule 2(e) was not to utilize the rule as an additional weapon in its enforcement arsenal, but rather to determine whether a person's professional qualifications, including his character and integrity, are such that he is fit to appear and practice before the Commission. n83

The Second Circuit explained that "[i]f incompetent or unethical accountants should be permitted to certify financial statements, the reliability of the disclosure process would be impaired." n84 The court held that Rule 2(e) was therefore reasonably related to the purposes of the federal securities laws and therefore validly promulgated under provisions such as Exchange Act § 23(a)(1), which authorizes the SEC to "make such rules and regulations as may be necessary or appropriate to implement the provisions of this title for which [it is] responsible" n85

The SEC sometimes imposes a permanent bar on a professional with a right to apply after a fixed number of years. n86 There is a question whether this practice is consistent with the language of Rule 102(e)(1) and § 4C. As ALJ Kelly observed in *In re Carroll A. Wallace*, this practice is inconsistent with SEC Rule of Practice 102(e) which provides that a person who is " 'permanently suspended or disqualified' under Rule 102(e)(1) may apply for reinstatement 'at any time.' " n87

Commission practice is to either censure a certified public accountant ("CPA") or deny the CPA the right to practice before the Commission, but not to impose both penalties. n88

Section 4C of the Exchange Act n89 and Rule 102(e) set forth mechanisms for the discipline of professionals who practice before the SEC. Section 4C, added to the Exchange Act by the Sarbanes-Oxley Act of 2002, incorporates the mechanisms set forth in SEC Rule 102(e)(1).

[ii] Section 4C and SEC Rule 102(e)(1)

Section 4C and SEC Rule of Practice 102(e)(1) give the Commission authority to "censure any person, or deny, temporarily or permanently, to any person the privilege of practicing before the Commission" if, after notice and opportunity for a hearing, that person is found:

- Not to possess the requisite qualifications to represent others;
- To be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or
- To have willfully violated, or willfully aided and abetted the violation of the securities laws and regulations thereunder.

Specifically, Exchange Act § 4C(a) and Rule 102(e)(1) provide:

The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for a hearing in the matter: (i) not to possess the requisite qualifications to represent others; or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

Both the statute and the rule provide that for licensed accountants "improper professional conduct" includes "intentional or knowing conduct, including reckless conduct, that results in a violation of the applicable professional standards." n90 In addition to intentional or reckless misconduct, the statute also provides that "negligent conduct in the form of ... a single instance of highly unreasonable conduct that results in a violation of applicable professional standards" or "repeated instances of unreasonable conduct ... that indicate a lack of competence to practice before the Commission" are grounds to censure or bar a licensed accountant from practice before the Commission.

There is considerable controversy regarding the "improper professional conduct" standards. In *Checkosky*, n91 the respondent, a partner at the "Big Six" accounting firm of Coopers & Lybrand had been sanctioned pursuant to SEC Rule of Practice 2(e). On appeal to the D.C. Circuit, the respondent argued that the SEC did not have authority to discipline professionals for mere negligence. The appeals court determined that it was unclear whether the Commission had applied a negligence standard in finding that the respondent had engaged in improper professional conduct, and remanded the matter so that the Commission could clarify the standard of conduct applied to the respondent.

On remand, the Commission found that the auditors had been reckless and that such conduct was sufficient to warrant imposition of a Rule 102(e) sanction. n92 The Commission further stated that "negligent actions by a professional may, under certain circumstances" warrant imposition of such a sanction. n93 However, it declined to identify these circumstances.

The auditors appealed this decision of the Commission. The court of appeals focused on the Commission's statement, "We believe that Rule 2(e)(1)(ii) does not mandate a particular mental state and that negligent actions by a professional may, *under certain circumstances*, constitute improper professional conduct" and held that "[e]lementary administrative

law norms of fair notice and reasoned decision making demand that the Commission define those circumstances with some degree of specificity." n94 Because the Commission's opinion yielded "no clear and coherent standard for violations of Rule 2(e)(1)(i)," the court of appeals remanded the proceeding with instructions to dismiss as to the accountants. n95

In response, the Commission amended Rule 102(e) to define "improper professional conduct" under Rule 102(e)(ii) with respect to persons licensed to practice as accountants. Under this amendment, persons licensed to practice as accountants have engaged in "improper professional conduct" within the meaning of the Rule if they engaged in:

- (1) [a] single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
- (2) [r]epeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

In its promulgating release, the Commission explained that the "highly unreasonable conduct" prong of the definition was intended to reach violations of applicable professional standards that demonstrate that an accountant lacks either technical competence or the willingness and ability to adhere to professional standards, including standards of honesty and fair dealing. n96

[iii] Rule 102(e)(2)

Under the Rules of Practice, any attorney, accountant, or engineer whose license to practice has been revoked in any state, or who has been convicted of a felony or crime involving moral turpitude, is automatically suspended from appearing or practicing before the SEC. n97

[iv] Rule 102(e)(3)

In general, the SEC may suspend or bar a person only after notice and hearing. The SEC may, however, suspend from appearing or practicing before it any attorney, accountant, engineer, or other professional or expert who has been by name:

- (1) permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder; or
- (2) found by any court of competent jurisdiction in any action brought by the Commission to which he or she is a party or found by the Commission in any administrative proceeding to which he or she is a party to have violated (unless the violation was found not to have been willful) or aided and abetted the violation of any provision of the Federal securities laws or of the rules and regulations thereunder. n98

The order of temporary suspension may not be entered by the Commission more than 90 days after the date on which the final judgment or order entered in the judicial or administrative proceeding has become effective, whether upon completion of review or appeal procedures, or because further review or appeal procedures are no longer available. n99

A temporary suspension remains effective until lifted by the SEC. Any person temporarily suspended from appearing and practicing before the Commission may, within 30 days after service upon him or her of the order of temporary suspension, petition the Commission to lift the suspension. The Rules of Practice provide that if the suspended person does not file a petition within 30 days after service of the order, the suspension shall become permanent. n100

Upon receipt of a petition to lift a temporary suspension, the SEC has 30 days to either lift the suspension or set the matter down for hearing at a time and place it designates, or both. If it does not lift the suspension, the proceeding must be conducted on an expedited basis pursuant to the 500 series of the SEC Rules of Practice, which require that every hearing shall be held and every decision shall be rendered "at the earliest possible time" consistent with the other responsibilities of the Commission or the hearing officer.

At the hearing, the Staff has the burden of showing only that the criteria for the issuance of the temporary suspensions were satisfied. Under the Rules of Practice, such a showing is sufficient to form the basis for a censure or disqualification. n101 Once the Staff has made this showing, the petitioner then has the burden of showing why he or she should not be censured or temporarily or permanently disqualified from appearing or practicing before the Commission. n102

The Rules of Practice state that the petitioner may not contest any finding made against the petitioner or fact admitted by the petitioner in the judicial or administrative proceeding upon which the temporary suspension is predicated. The rules further state it shall be presumed that a person who has consented, without admitting or denying the facts alleged by the Commission, to the entry of a permanent injunction by a court of competent jurisdiction by reason of his or her misconduct in an SEC enforcement action from violating or aiding and abetting a violation of the federal securities laws was enjoined by reason of the facts alleged in the complaint. n103 After opportunity for a hearing, the Commission may censure the petitioner or disqualify the petitioner from appearing or practicing before it for a period of time or permanently. n104

[v] Practice Before the SEC

There is no clear definition of the term "practicing before the Commission." The SEC Rules of Practice provide only limited guidance regarding the scope of the term:

For the purposes of these Rules of Practice, practicing before the Commission shall include, but shall not be limited to:

- (1) transacting any business with the Commission; and
- (2) the preparation of any statement, opinion, or other paper by any attorney, accountant, engineer, or other professional or expert, filed with the Commission in any registration statement, notification, application, report or other document with the consent of each attorney, accountant, engineer or other professional or expert. n105

The SEC has interpreted the phrase "practicing before the Commission" broadly. For example, the SEC has found that such practice includes an attorney providing legal advice regarding the securities laws. n106 The SEC has also sanctioned an attorney pursuant to Rule 2(e) where the attorney made a misrepresentation in a letter to an escrow settlement that had been established in connection with a registered offering of securities, even though it was not clear that the respondent was even practicing securities law in rendering advice to the escrow agent. n107 As to accountants, the SEC has indicated that the term at issue includes the preparation of financial statements to be filed with the SEC by inside accountants, as well as the audit or review of such financial statements. n108

The application of Rule 102(e) against corporate officers who were acting in a corporate, as opposed to a professional, capacity is particularly open to question. Indeed, during the oral argument of the leading case regarding Rule 2(e), when Judge Gurfein asked, "What about a treasurer of a company; suppose he does something wrong? Does the SEC, without the intervention of the Court, have the power to tell him never to file again before the Commission? It doesn't seem right

to me." The counsel for the SEC responded, "I don't think it does under any of its rules," even though the SEC had already asserted this power in over a dozen cases against corporate officers. n109

[vi] Attorneys

Prior to the Sarbanes-Oxley Act of 2002, the SEC had a practice of not bringing administrative enforcement actions against attorneys, unless it has first obtained an injunction or the attorney has been convicted of a crime involving moral turpitude. In the wake of the Sarbanes-Oxley Act, the SEC appears willing to litigate administrative proceedings against attorneys who did not engage in conduct warranting a court action.

[vii] Reinstatement

If the Rule 102(e) bar specified a period after which the respondent could apply for reinstatement, the Commission typically grants an application for reinstatement that was filed following the expiration of a 102(e) bar. The Commission is especially likely to grant reinstatement if the application specified additional training or other steps taken to address the issue that had given rise to the initial bar or sought limited relief (e.g., if the application was limited to working at an audit firm but not as the partner-in-charge of an audit).

Comment

Neither Exchange Act § 4C nor Rule 102(e) define "improper professional conduct" with respect to an attorney. It is not clear whether a proceeding against an attorney that was based on the attorney's "improper professional conduct" would be vulnerable to attack based on the opinion of the appeal court in *Checkosky*.

FOOTNOTES:

(n1)Footnote 1. *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979) (quoting *SEC v. Blatt*, 583 F.2d 1325, 1334 n. 29 (5th Cir. 1978), *aff'd on other grounds*, 450 U.S. 91 (1981) . See, e.g., *In re Huber Hogan*, Initial Decision Release No. 212, 2002 SEC LEXIS 2081, 78 SEC Docket 756-73 (August 13, 2002) (considering imposition of censure, monetary penalties and cease-and desist order on investment adviser); *In re Brett Bouchy*, Initial Decision Release No. 209, 2002 SEC LEXIS 1743, 77 SEC Docket 3251-55 (July 9, 2002) (considering imposition of an Exchange Act § 15(b)(6) bar on a person associated with broker dealer); *In re Carroll A. Wallace*, Initial Decision Release No. 178, 2000 SEC LEXIS 2798 (December 18, 2000) (considering impositions of Rule 102(e) sanctions on CPA practicing before the Commission).

(n2)Footnote 2. Exchange Act § 15(b)(4), 15 U.S.C.S. § 78o(b)(4).

(n3)Footnote 3. Exchange Act § 15B(c)(2), 15 U.S.C.S. § 78o-4(c)(2).

(n4)Footnote 4. Exchange Act § 15C(c)(1), (c)(2), 15 U.S.C.S. § 78o-5(c)(1), (c)(2).

(n5)Footnote 5. Exchange Act § 17A(c)(3), 15 U.S.C.S. § 78q-1(c)(3).

(n6)Footnote 6. Investment Advisers Act § 203(e), 15 U.S.C.S. § 80b-3(e).

(n7)Footnote 7. Exchange Act § 15(b)(6), 15 U.S.C.S. § 78o(b)(6); Exchange Act § 15B(c)(4), 15 U.S.C.S. § 78o-4(c)(4); Exchange Act § 15C(c)(1)(C), 15 U.S.C.S. § 78o-5(c)(1)(C); Exchange Act § 17A(c)(4)(C), 15 U.S.C.S. § 78q-1(c)(4)(C); Investment Advisers Act § 203(f), 15 U.S.C.S. § 80b-3(f).

(n8)Footnote 8. Investment Company Act § 8(f), 15 U.S.C.S. § 80a-8(f).

(n9)Footnote 9. Investment Company Act § 9(b), 15 U.S.C.S. § 80a-9(b).

(n10)Footnote 10. Exchange Act § 15(b)(6), *15 U.S.C.S. § 78o(b)(6)*.

(n11)Footnote 11. *See, e.g.,* Exchange Act § 15(b)(4), (6), *15 U.S.C.S. § 78o(b)(4), (6)*; Investment Advisers Act § 203(e), (f), *15 U.S.C.S. § 80b-3(e), (f)*; Investment Company Act §§ 8, 9, *15 U.S.C.S. § 80a-8, 9*.

(n12)Footnote 12. *See* Exchange Act § 15(b)(4), (6), *15 U.S.C.S. § 78o(b)(4), (6)* (providing for sanctions against registered broker-dealers and their associated persons); Investment Advisers Act § 203(e), (f), *15 U.S.C.S. § 80b-3(e), (f)* (providing for sanctions against registered investment advisers and their associated persons); Investment Company Act § 9(b), *15 U.S.C.S. § 80a-9(b)* (allowing the commission to bar certain persons from association with a registered investment company).

(n13)Footnote 13. *See, e.g., In the Matter of Beach, 50 S.E.C. 507, 508, 50 SEC 507, 508*, Exchange Act Release No. 28,898 (Feb. 19, 1991). In this instance, respondent had pled guilty to several counts of mail fraud relating to misrepresentations made to customers. As a result, the commission found that "the public interest requires Beach's exclusion from the securities business."

(n14)Footnote 14. *In the Matter of Fittin, 50 S.E.C. 544, 50 SEC 544*, Exchange Act Release No. 29,173 (May 8, 1991).

(n15)Footnote 15. Terms of the suspension often require an affidavit to be filed with the Commission, stating that the individual has complied with the sanction. *See, e.g., In the Matter of Landy, 50 S.E.C. 278, 50 SEC 278*, Exchange Act Release No. 28,314 (Aug. 6, 1990) (requiring respondent to submit an affidavit at the end of his six month suspension declaring that he complied with the terms of the suspension).

(n16)Footnote 16. *In the Matter of Edgemont Asset Management Corp., 50 S.E.C. 592, 50 SEC 592*, Exchange Act Release No. 29,326 (June 18, 1991).

(n17)Footnote 17. *In the Matter of Edgemont Asset Management Corp., 50 S.E.C. 592, 50 SEC 592*, Exchange Act Release No. 29,326 (June 18, 1991).

(n18)Footnote 18. *In re Walnut St. Secs. Inc., Admin. Proceeding File No. 3-8754, 1995 SEC LEXIS 1793, 59 SEC Docket (CCH) 2027* (July 17, 1995).

(n19)Footnote 19. *See, e.g.,* Exchange Act § 15(b)(4)(A), *15 U.S.C.S. § 78o(b)(4)(A)*.

(n20)Footnote 20. Exchange Act § 15(b)(4)(D), *15 U.S.C.S. § 78o(b)(4)(D)*.

(n21)Footnote 21. Exchange Act § 15(b)(4)(C), *15 U.S.C.S. § 78o(b)(4)(C)*.

(n22)Footnote 22. Exchange Act § 15(b)(4)(E), *15 U.S.C.S. § 78o(b)(4)(E)*.

(n23)Footnote 23. Exchange Act § 15(b)(4)(E), *15 U.S.C.S. § 78o(b)(4)(E)*. There is a safe harbor, however, for failure to supervise cases. *See* Exchange Act § 15(b)(4)(E)(i)-(ii), *15 U.S.C.S. § 78o(b)(4)(E)(i)-(ii)*.

(n24)Footnote 24. Exchange Act § 15(b)(4)(B), *15 U.S.C.S. § 78o(b)(4)(B)*.

(n25)Footnote 25. *See In re Merriam, Admin. Proceeding File No. 3-8693, 1995 SEC LEXIS 11127, 59 SEC Docket (CCH) 642* (May 11, 1995) (barring respondent from association with any regulated entity, and also from participating in any offering of penny stock); *In re Uyeda, Admin. Proceeding File No. 3-8587, 1995 SEC LEXIS 1, 58 SEC Docket (CCH) 1515* (Jan. 9, 1995) (barring respondent from association with regulated entities, with ability to reapply in three years). Sanctions imposed tend to be quite fact specific, making it difficult to predict the likely penalty for any specific violation.

(n26)Footnote 26. *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999) .

(n27)Footnote 27. *Teicher*, 177 F.3d 1016, 1019-1020 .

(n28)Footnote 28. Dodd-Frank Act § 925.

(n29)Footnote 29. *Teicher*, 177 F.3d 1016, 1018-1019 .

(n30)Footnote 30. *See, e.g.*, Exchange Act § 21B(a), 15 U.S.C.S. § 78u-2(a) (authorizing the commission to impose civil penalties in administrative proceedings).

(n31)Footnote 31. Dodd-Frank Act § 929P.

(n32)Footnote 32. *See* § 18.02 [2](a)[ii] above.

(n33)Footnote 33. *In re George J. Kolar*, Exchange Act Release No. 46127, 2002 SEC LEXIS 1647, 77 SEC Docket 2944-35 (June 26, 2002).

(n34)Footnote 34. Exchange Act § 21B(a), 15 U.S.C.S. § 78u-2(a); Investment Advisors Act § 203(I), 15 U.S.C.S. § 80b-3(i)(3). *See, e.g.*, *In re G. Bradley Taylor*, Initial Decision Release No. 215, 2002 SEC LEXIS 2429 (September 24, 2002) . In *In re Robert Bruce Lohmann*, ALJ Kelly discussed these factors in considerable detail. In its discretion, the Commission may consider evidence of a respondent's inability to pay. *In re Robert Bruce Lohmann*, Initial Decision Release No. 214, 2002 SEC LEXIS 2380 (September 19, 2002 (Kelly, ALJ) Exchange Act § 21B(d), 15 U.S.C.S. § 78u-2(d).

(n35)Footnote 35. *See* discussion and chart at § 18[2][a][ii] above.

(n36)Footnote 36. *See, e.g.*, Exchange Act § 21B(e), 15 U.S.C.S. § 78u-2(e).

(n37)Footnote 37. *See, e.g.*, Exchange Act § 21B(e), 15 U.S.C.S. § 78u-2(e).

(n38)Footnote 38. *See, e.g.*, Securities Act § 8A(a), 15 U.S.C.S. § 77h-1(a); Exchange Act § 21C(3), 15 U.S.C.S. § 78u-3.

(n39)Footnote 39. *See* S. Rep. No. 337, 101st Cong., 2d Sess. 18 (1990); H.R. Rep. No. 616, 101st Cong. 2d Sess. 23 (1990).

(n40)Footnote 40. H.R. Rep. No. 616 at 23-23.

(n41)Footnote 41. *In re KPMG Peat Marwick*, 2001 SEC LEXIS 98 *101 (SEC Release No. 43862) (Jan. 19, 2001) (opinion of the commission) *aff'd* 289 F.3d 109 (D.C. Cir. 2002) .

(n42)Footnote 42. *In re KPMG Peat Marwick*, 2001 SEC LEXIS 98, *101 , SEC Release No. 43862 (Jan. 19, 2001) (opinion of the commission) *aff'd* 289 F.3d 109 (D.C. Cir. 2002) .

(n43)Footnote 43. *In re KPMG Peat Marwick*, 2001 SEC LEXIS 422, *20 , SEC Release No. 44050 (Mar. 8, 2001) (order denying request for reconsideration).

(n44)Footnote 44. *See* 2001 SEC LEXIS 98, *116 , SEC Release No. 43862 (opinion of the Commission).

(n45)Footnote 45. *KPMG, LLP v. SEC*, 289 F.3d 109 (D.C. Cir. 2002) .

(n46)Footnote 46. 15 U.S.C.S. § 78u-3(a).

(n47)Footnote 47. "[T]he plain language of Section 21C invokes, as the Commission stated, 'classic negligence language.'" 289 F.3d 109, 120 quoting 2001 SEC LEXIS 98, *82, SEC Release No. 43862 (Jan. 19, 2001) (opinion of the Commission).

(n48)Footnote 48. *Warren G. Trepp*, 1997 SEC LEXIS 1682, SEC Release No. ID-115 (Aug. 18, 1997), *aff'd*, 1999 SEC LEXIS 1967, SEC Release No. 41913 (Sept. 24, 1999). *See also David T. Barr*, 2000 SEC LEXIS 1548, SEC Release No. ID-170 (July 27, 2000) (finding that a cease-and-desist order was not warranted in the public interest under Section 8A of the Securities Act for respondent's violation of Sections 5(a) and (c) of the Act); *Feeley and Willcox Asset Management*, 2000 SEC LEXIS 980, SEC Release No. ID-165 (May 16, 2000) (cease-and-desist order not necessary when firm no longer engages in the type of business that gave rise to the violation).

(n49)Footnote 49. 1999 SEC LEXIS 1967, SEC Release No. 41913 (Sept. 24, 1999).

(n50)Footnote 50. Securities Act § 8A, 15 U.S.C.S. § 77h-1; Exchange Act § 21C(e), 15 U.S.C.S. § 78u-3(c).

(n51)Footnote 51. *See, e.g.*, Securities Act § 8A(a), 15 U.S.C.S. § 77h-1(a); Exchange Act § 21C(b), 15 U.S.C.S. § 78u-3(b).

(n52)Footnote 52. *See, e.g.*, Exchange Act § 21(d)(3), 15 U.S.C.S. § 78u(d)(3).

(n53)Footnote 53. Exchange Act § 10A, 15 U.S.C.S. § 78j-1.

(n54)Footnote 54. Exchange Act § 21C(e), 15 U.S.C.S. § 78u-3(e).

(n55)Footnote 55. *See* the discussion in § 18.04[2][a] above.

(n56)Footnote 56. *See, e.g.*, Exchange Act § 21C(c)(2), 15 U.S.C.S. § 78u-3(c)(2).

(n57)Footnote 57. *See, e.g.*, Exchange Act § 21C(c)(2), 15 U.S.C.S. § 78u-3(c)(2). *See* definition of "registered public accounting firm" at § 2(11) of the Sarbanes-Oxley Act of 2002.

(n58)Footnote 58. *See, e.g.*, Exchange Act § 21C(c)(1), 15 U.S.C.S. § 78u-3(c)(1).

(n59)Footnote 59. *See, e.g.*, Exchange Act § 21C(c)(1).

(n60)Footnote 60. H.R. Rep. No. 616 at 25 n.4.

(n61)Footnote 61. H.R. Rep. at 32, S. Rep. No. 337 at 20-21.

(n62)Footnote 62. Sarbanes-Oxley Act § 1105(a) amending Securities Act § 8A and Exchange Act § 21C.

(n63)Footnote 63. 15 U.S.C.S. § 78o(c)(4).

(n64)Footnote 64. *In re Kern*, 1991 SEC LEXIS 1222, Exchange Act Release No. 29,356, 49 SEC Docket 422-138 (June 21, 1991).

(n65)Footnote 65. 15 U.S.C.S. § 77h(b).

(n66)Footnote 66. 15 U.S.C.S. § 77h(e).

(n67)Footnote 67. 15 U.S.C.S. § 77h(e).

(n68)Footnote 68. *In re Breeze Corporations, Inc.*, Securities Act Release No. 1786, 1938 SEC LEXIS 442 (Aug. 5, 1938).

(n69)Footnote 69. *See Las Vegas Hawaiian Dev. Co. v. SEC*, 466 F. Supp. 928, 931 (D. Haw. 1979) .

(n70)Footnote 70. 17 C.F.R. § 230.262.

(n71)Footnote 71. 17 C.F.R. § 230.258.

(n72)Footnote 72. 15 U.S.C.S. § 78l(r).

(n73)Footnote 73. *SEC v. Sloan*, 436 U.S. 103, 115 (1978) .

(n74)Footnote 74. *SEC v. Sloan*, 436 U.S. 103 (1978) .

(n75)Footnote 75. *Sloan*, 436 U.S. 103, 106 .

(n76)Footnote 76. 15 U.S.C.S. § 78l(j).

(n77)Footnote 77. See, e.g., "Securities and Exchange Commission Suspends Trading in the Securities of China Technology Global Corp. For Failure to Make Required Periodic Filings," SEC News Digest Issue 2010-89 (May 14, 2010), available at <http://www.sec.gov/news/digest/2010/dig051410.htm>.

(n78)Footnote 78. Sarbanes-Oxley Act § 602, amending Exchange Act § 4B, 15 U.S.C.S. § 78d-2.

(n79)Footnote 79. *See Checkosky v. SEC*, 23 F.3d 452 (D.C. Cir. 1994) ; *Davy v. SEC*, 792 F.2d 1418, 1421 (9th Cir. 1986) ; *Touche Ross & Co. v. SEC*, 609 F.2d 570, 579 (2d Cir. 1979) .

(n80)Footnote 80. *Checkosky v. SEC*, 23 F.3d 452 (D.C. Cir. 1994) .

(n81)Footnote 81. *Davy v. SEC*, 792 F.2d 1418 (9th Cir. 1986) .

(n82)Footnote 82. *Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979) .

(n83)Footnote 83. *Touche Ross & Co. v. SEC*, 609 F.2d 570, 579 .

(n84)Footnote 84. *Touche Ross & Co. v. SEC*, 609 F.2d 570, 581 .

(n85)Footnote 85. *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 citing 15 U.S.C.S. § 78u(a)(1).

(n86)Footnote 86. See, e.g., *In re Ponce*, Securities Exchange Act Release No. 43235, 2000 SEC LEXIS 1814, 73 SEC Docket 358-33 (August 31, 2000).

(n87)Footnote 87. *Initial Decision 178*, 2000 SEC LEXIS 2798, *182 (December 18, 2000) (barring respondent from appearing and practicing before Commission for one year).

(n88)Footnote 88. *In re Horton & Company and Edward C. Horton*, Initial Decision Release No. 208, 2002 SEC LEXIS 1712, *46 n.25 (July 2, 2002) .

(n89)Footnote 89. 15 U.S.C.S. § 78d-3, Sarbanes-Oxley Act of 2002 § 602.

(n90)Footnote 90. 15 U.S.C.S. § 78d-3(b)(1).

(n91)Footnote 91. *Checkosky v. SEC*, 23 F.3d 452 (D.C. Cir. 1994) .

(n92)Footnote 92. *In re Checkosky*, Exchange Act Release No. 38183, 1997 SEC LEXIS 137, 63 SEC Docket (CCH) 1691-4, 1696 (Jan. 21, 1997).

(n93)Footnote 93. *Checkosky*, 1997 SEC LEXIS 137, 63 SEC Docket (CCH) 1691-4, 1700.

(n94)Footnote 94. *Checkosky v. S.E.C.*, 139 F.3d 221, 224 (D.C. Cir. 1998) (emphasis supplied by court of appeals).

(n95)Footnote 95. *Checkosky v. S.E.C.*, 139 F.3d 221, 225-226 .

(n96)Footnote 96. 63 Fed. Reg. 57122 (1998) .

(n97)Footnote 97. Rule 102(e)(2).

(n98)Footnote 98. Rule 102(e)(3)(i).

(n99)Footnote 99. Rule 102(e)(3)(i).

(n100)Footnote 100. Rule 102(e)(3)(ii).

(n101)Footnote 101. Rule 102(e)(3)(iv).

(n102)Footnote 102. Rule 102(e)(3)(iv).

(n103)Footnote 103. Rule 102(e)(3)(iv).

(n104)Footnote 104. Rule 102(e)(1).

(n105)Footnote 105. Rule 102(f).

(n106)Footnote 106. *In re Hecht*, Admin Proceeding File No. 3-6224, 1983 SEC LEXIS 692, 28 SEC Docket (CCH) 1174 (Sept. 27, 1983); *In re Hodgkin*, Exchange Act Release No. 16,225, 1979 SEC LEXIS 624, [1979 -1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,334, 18 SEC Docket 458-01 (Sept. 27, 1979). See also Securities & Exchange Com. v. Ezrine No. 72-3161, (S.D.N.Y. Aug. 2, 1972) (summarized in [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,594 (Aug. 2, 1972)).

(n107)Footnote 107. *In re Coven*, Exchange Act Release No. 16,448, 1979 SEC LEXIS 54, 19 SEC Docket (CCH) 12-01 (Dec. 21, 1979) (Karmel, Commissioner, dissenting).

(n108)Footnote 108. *In re Zarcone*, Exchange Act Release No. 32,290, 1993 SEC LEXIS 1015, 54 SEC Docket (CCH) 125-83 (May 11, 1993). See also *In re Briggs*, Exchange Act Release No. 30,665, 1992 SEC LEXIS 1046, 51 SEC Docket 607-393 (May 6, 1992) (audit of financial statements filed with commission); *In re Lipoff*, Exchange Act Release No. 34,714, 1994 SEC LEXIS 2877 & 1994 SEC LEXIS 3058, 57 SEC Docket (CCH) 1700-984 (Sept. 23, 1994) (preparation by chief financial officer of financial statements filed with the SEC); *In re Murphy*, Exchange Act Release No. 33,014, 1993 SEC LEXIS 2728, 55 SEC Docket (CCH) 398-211 (Oct. 5, 1993) (CFO of subsidiary that reported inflated income figures to parent company, which reported inflated income figures to the Commission). An ALJ has suggested the phrase "practice before the Commission" is so broad and vague as to be subject to a "void-for-vagueness challenge." *In re Carroll A. Wallace*, Initial Decision Release No. 178, 2000 SEC LEXIS 2798, 73 SEC Docket 3050-88 (December 18, 2000).

(n109)Footnote 109. George J. Seidel, *Rule 2(e) and Corporate Officers*, 39 Bus. Law. 455 (1984).



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.05

AUTHOR: Kenneth B. Winer

§ 18.05 Section 21(a) Report

In addition to authorizing the SEC to determine whether any person has violated the Exchange Act, § 21(a) of the act authorizes the Commission, "in its discretion, to publish a report concerning such investigations." n1 Although technically not an administrative sanction, the publicity attendant to the issuance of a § 21(a) report frequently has aspects of a sanction. The Commission sometimes issues these reports as an alternative to formal civil or administrative enforcement remedies and sometimes in conjunction with such remedies. In 1979, the SEC issued a release in which it explained that "the Commission has issued reports of investigations relating to various subjects where, in the Commission's judgment, substantial issues of public concern, wide-spread investor impact, or other matters of significance relating to the federal securities laws were involved." n2 The Commission rarely issues § 21(a) reports. n3

FOOTNOTES:

(n1)Footnote 1. *See, e.g., In re John H. Gutfreund, 1992 SEC LEXIS 2939, *2 n.1, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,067, 85,598 n.1, 52 SEC Docket 2849-490 (Dec. 3, 1992).*

(n2)Footnote 2. *The Commission's Practice Relating to Reports of Investigations and Statements Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of 1934, 1979 SEC LEXIS 1939, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,014 (March 21, 1979).*

(n3)Footnote 3. The SEC issued six § 21(a) reports between August 8, 1996 and May 2005. www.sec.gov/litigation/investreports.html.



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.06

AUTHOR: Kenneth B. Winer

§ 18.06 Willful Acts That Violate Federal Securities Laws

The SEC maintains that, in the context of the civil provisions of the federal securities laws, "willfully" means "intentionally committing the act which constitutes the violation. There is no requirement that the actor also be aware that he is violating the federal securities laws." n1 A number of courts, with little or no analysis, have agreed with this definition. For example, the D.C. Circuit has held that willfully "means no more than that the person charged with the duty knows what he is doing. It does not mean that, in addition, he must suppose that he is breaking the law." n2

Much of the SEC defense bar believes that the SEC's definition of "willfully" is inconsistent with the plain meaning of the term, the legislative history of the federal securities laws, and Supreme Court precedent. n3 First, the SEC definition of "willfully" virtually reads the term out of the federal securities laws. Second, shortly before the enactment of the Exchange Act, the Supreme Court provided a different explanation of the term "willful" in the context of federal criminal tax law:

Congress did not intend that a person, by reason of a bona fide misunderstanding of his liability for the tax, as to his duty to make a return, or as to the adequacy of the records he maintained, should become a criminal by his mere failure to measure up to the prescribed standard of conduct. n4

Given the complex and technical nature of the laws and regulations governing regulated entities, and the fact that Congress used identical statutory language in making it a felony to "willfully violate ... any provision of" the federal securities laws, n5 it appears likely that Congress intended that "willfully" be interpreted as the Supreme Court did in *United States v. Murdock*. n6 Third, the court recently held that "willfulness" in the context of federal criminal tax laws means the "voluntary, intentional violation of a known legal duty." n7

FOOTNOTES:

(n4)Footnote 1. *In re Minges, Admin. Proceeding File No. 3-8389, 1994 SEC LEXIS 1687, 56 SEC Docket (CCH) 2372-1273 (June 7, 1994).*

(n5)Footnote 2. *Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)* ; *see also Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965)* (noting that "[i]t has been uniformly held that 'willfully' in this context means intentionally committing the act which constitutes the violation. There is no requirement that the actor also be aware that he is violating one of the Rules

or Acts.").

(n6)Footnote 3. *See, e.g.*, Kenneth B. Winer and Samuel J. Winer, "A Burr Under the SEC's Saddle: Changing Standards for SEC Enforcement Remedies," 21 Insights (July 2007); Jonathan Eisenberg, "Willful Violations" of the Federal Securities Laws: Why the SEC's No-Fault Approach is Now Ripe for Rejection, Insights, 13 (Aug. 1991).

(n7)Footnote 4. *United States v. Murdock*, 290 U.S. 389, 396 (1933) .

(n8)Footnote 5. *See, e.g.*, Exchange Act § 32(a), 15 U.S.C.S. § 78ff(a).

(n9)Footnote 6. *United States v. Murdock*, 290 U.S. 389 (1933) , *overruled in part on other grounds*, *Murphy v. Waterfront Comm'n of New York Harbor*, 378 U.S. 52 (1964) ("The word ['willfully'] often denotes an act which is intentional, or knowing, or voluntary, as opposed to accidental. But when used in a criminal statute it generally means an act done with bad purpose, without justifiable excuse, stubbornly obstinately, perversely. The word is also employed to characterize a thing done without ground for believing it is lawful, or conduct marked by careless disregard whether or not one has the right so to act.") (citations omitted).

(n10)Footnote 7. *Cheek v. United States*, 498 U.S. 192, 199 (1991) , *quoting United States v. Bishop*, 412 U.S. 346, 360 (1973) .



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.07

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§ 18.07 Burden of Proof

The federal securities laws do not specify the burden of proof that governs SEC enforcement proceedings. The D.C. Circuit held that the clear-and-convincing standard would govern a proceeding in which the Staff sought, among other matters, revocation of the respondent's broker-dealer registration based on violations of the federal securities laws. n1 The Supreme Court subsequently held that, under the Administrative Procedure Act, the preponderance-of-the-evidence standard applied to an administrative proceeding to discipline a person for violations of the anti-fraud provisions of the Investment Company Act and the Investment Advisers Act. n2 Since this decision, the Commission and the ALJs have consistently applied the preponderance-of-the-evidence standard to administrative proceedings. n3

Similarly, the vast majority of the courts that have addressed this issue have held that judicial enforcement actions brought by the SEC are governed by the preponderance-of-the-evidence standard. n4

FOOTNOTES:

(n1)Footnote 1. *Collins Sec. Corp. v. SEC*, 562 F.2d 820, 824 (D.C. Cir. 1977) . See also *Whitney v. SEC*, 604 F.2d 676, 680 (D.C. Cir. 1979) .

(n2)Footnote 2. *Steadman v. SEC*, 450 U.S. 91 (1981) .

(n3)Footnote 3. See, e.g., *In re Jett*, 1996 SEC LEXIS 1434, 61 SEC Docket 2517-498 (May 17, 1996) (Foelak, ALJ); *In re Brett L. Bouchy*, Initial Decision Release No. 209, 2002 SEC LEXIS 1743, 77 SEC Docket 3251-55 (July 9, 2002) (Mahony, ALJ).

(n4)Footnote 4. See *SEC v. Moran*, 922 F. Supp. 867 (S.D.N.Y. 1996) (and cases cited therein).



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.08

AUTHOR: Kenneth B. Winer

§ 18.08 Statute of Limitations

With one exception, there is no statute of limitations expressly governing SEC enforcement actions. The exception involves the civil penalties imposed pursuant to the insider trading provisions of the Exchange Act, which are expressly subject to a five-year statute of limitations. n1 Arguing that "no statute of limitations will be applied in civil actions brought by the Government, unless Congress explicitly imposes such time limitations," n2 until recently the SEC took the position that most of its enforcement proceedings were not governed by any statute of limitations.

The court in *SEC v. Willis* n3 held, for example, that the SEC's claims for civil penalties under the insider trading provisions were time-barred because the provisions specifically subject such claims to a five-year statute of limitations, but the SEC successfully argued that its claims for equitable relief were not subject to any statute of limitations. n4 The court noted, however, that it would consider the timing of the violation in determining whether to grant the requested relief. n5

In 1993, the SEC persuaded the Ninth Circuit that SEC actions are not governed by any fixed period of limitations. n6 The court explained that the absence of a statute of limitations was appropriate because government should not be constrained when acting in the public interest. n7

In 1994, the D.C. Circuit held, in the context of an Environmental Protection Agency action involving 3M Company, that the five-year statute of limitations of 28 U.S.C. § 2462 applied not only to judicial proceedings, but also to administrative proceedings. n8 The section provides for a five-year statute of limitations for proceedings for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise: "Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued." n9

The D.C. Circuit drew parallels between the underlying concerns for the limitation in each instance. n10 More significantly, the court stated that the provision should apply to all federal agencies, in that the catch-all statute of limitations is a provision of general applicability. n11

Although this holding n12 appeared to establish that the five-year statute of limitations applied to SEC judicial and

administrative proceedings for "fines, penalties, and forfeitures," there continued to be an issue as to the scope of this term. For example, the SEC construed the term narrowly and continued to take the position that no statute of limitations applied, for example, to proceedings to censure, suspend, or bar securities industry professionals.

In 1996, the District of Columbia Circuit held that § 2462 applied to an SEC administrative proceeding under Exchange Act § 15(b) to censure a securities branch manager named Johnson and suspend her for six months from acting in a supervisory capacity. n13 Before the *3M* case, the Commission denied the branch manager's motion to dismiss on the grounds that "[s]ection 2462 does not apply to Commission administrative proceedings." n14 After the *3M* case, the Commission denied another motion to dismiss on the grounds that the "proceeding before us does not seek to impose a civil penalty, but rather to determine the appropriate remedial action. The intent of Johnson's suspension is to protect the public from future harm at her hands." n15

The District of Columbia Circuit held that "a 'penalty,' as the term is used in § 2462, is a form of punishment imposed by the government for unlawful or proscribed conduct, which goes beyond remedying the damage caused to the harmed parties by the defendant's action." n16 Turning to the sanctions imposed on Johnson, the court applied two criteria. First, it found that the sanctions resembled punishment in the ordinary sense of the word not only because they precluded the branch manager from being a supervisor during the period of the suspension, but also because they would have longer lasting repercussions on her ability to earn a living. n17 Second, the court found that in imposing the sanctions the Commission focused solely on the past misconduct of the branch manager and not on her current competence or the degree of risk that she posed to the public. n18

There also are arguments that the passage of time weakens the Commission's ability to obtain an injunction. First, an argument can be made that, at least in certain circumstances, an injunction is a civil penalty within the meaning of 28 *U.S.C.S. § 2462*. Second, an argument can be made that the passage of time weakens the ability of the SEC to make the proper showing based upon which an injunction may be issued. As the Supreme Court has explained, § 21(d) of the Exchange Act provides:

that the Commission may seek injunctive relief whenever it appears that a person "is engaged or [is] about to engage in any acts or practices" constituting a violation of the ... 1934 Act[] or regulations promulgated thereunder and that, "upon a proper showing," a district court shall grant the injunction. The elements of "a proper showing" thus include, at a minimum, proof that a person is engaged or is about to engage in a substantive violation of either one of the Acts or of the regulations promulgated thereunder.
n19

In *SEC v. Monarch Fund*, n20 the Second Circuit held that injunctive relief was inappropriate, even assuming a *Rule 10b-5* violation had occurred, given *inter alia*, the passage of time since the acts in question and the absence of recent violations. n21

Courts have disagreed on whether to apply a discovery rule to the five-year statute of limitations. Section 2642 provides for a five year statute of limitations "from the date when the claim first accrued if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon." A number of courts have held that the five-year period begins to run once the factual and legal prerequisites for filing suit were in place. n22 At least one court, however, has held that "the date of accrual of the five-year statute of limitations of 28 *U.S.C. § 2642* for securities fraud cases is governed by the 'discovery of violation' rule." n23

The scope of the five-year statute of limitations is not clear. The limitations period appears to apply to monetary penalties. n24 One court held that whether the limitations period applies to injunctive relief depends on whether SEC has "offered facts that suggest that the requested injunction is aimed at protecting the public from future harm," but that disgorgement claims are not subject to the five-year limitations period. n25

Since *Johnson*, n26 a number of SEC administrative actions have been dismissed by ALJs on statute-of-limitations grounds. n27 However, ALJs do use conduct outside the statutory period in determining the sanction that is in the public interest with respect to conduct that occurred within the limitations period. n28 In addition, the SEC has held that in circumstances in which the administrative sanction is based on an injunction or a criminal conviction, the limitations period runs from the date of the injunction or conviction, and not from the date of the underlying conduct. n29

FOOTNOTES:

(n1)Footnote 1. *See* Exchange Act § 21A(d)(5), 15 U.S.C.S. § 78u-1(d)(5).

(n2)Footnote 2. *Dole v. Local 427*, 894 F.2d 607, 610 (3d Cir. 1990) .

(n3)Footnote 3. *SEC v. Willis*, 777 F. Supp. 1165 (S.D.N.Y. 1991) .

(n4)Footnote 4. *SEC v. Willis*, 777 F. Supp. 1165, 1174 (citing 15 U.S.C.S. § 78u-1(d)(5)).

(n5)Footnote 5. *SEC v. Willis*, 777 F. Supp. 1165, 1174 (citing 15 U.S.C.S. § 78u-1(d)(5)). *See also SEC v. Rind*, 991 F.2d 1486, 1492 (9th Cir. 1993) (stating that "[a]lthough no fixed period of limitations governs Commission actions, a court may exercise its discretion to limit the Commission's power to seek relief.").

(n6)Footnote 6. *Rind*, 991 F.2d 1486 .

(n7)Footnote 7. *Rind*, 991 F.2d 1486 .

(n8)Footnote 8. *3M Co. v. Browner*, 17 F.3d 1453 (D.C. Cir. 1994) .

(n9)Footnote 9. 28 U.S.C.S. § 2462.

(n10)Footnote 10. *3M Co. v. Browner*, 17 F.3d 1453, 1461 .

(n11)Footnote 11. *3M Co. v. Browner*, 17 F.3d 1453, 1461 .

(n12)Footnote 12. *3M Co. v. Browner*, 17 F.3d 1453 (D.C. Cir. 1994) .

(n13)Footnote 13. *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996) .

(n14)Footnote 14. *Johnson v. SEC*, 87 F.3d 484, 486 (quoting Order Denying Motion to Dismiss).

(n15)Footnote 15. *Johnson v. SEC*, 87 F.3d 484, 486 (quoting Opinion of the Commission).

(n16)Footnote 16. *Johnson v. SEC*, 87 F.3d 484, 488 .

(n17)Footnote 17. *Johnson v. SEC*, 87 F.3d 484, 488 .

(n18)Footnote 18. *Johnson v. SEC*, 87 F.3d 484, 489 .

(n19)Footnote 19. *See Aaron v. SEC*, 446 U.S. 680, 700-701 (1980) . *See also SEC v. Monarch Fund*, 608 F.2d 938, 943 (2d Cir. 1979) .

(n20)Footnote 20. *SEC v. Monarch Fund*, 608 F.2d 938 (2d Cir. 1979) .

(n21)Footnote 21. *Accord, SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1244 (S.D.N.Y. 1992) (a long "delay weighs heavily against an injunction"); *SEC v. Caterinicchia*, 613 F.2d 102, 105-107 (5th Cir. 1980) (affirming denial of injunctive relief despite past violations of Rule 10b-5 due to failure to prove "the likelihood that the wrongdoing will recur"); *SEC v. Glick*, 1980 U.S. Dist. LEXIS 12141 *5 (D. Nev. June 12, 1980) ("If the remoteness in time is substantial

and there have been no intervening violations, it is highly improbable that a court, in the exercise of its discretion, would grant injunctive relief."); *SEC v. Parklane Hosiery Co.*, 558 F.2d 1083, 1089 (2d Cir. 1977) (affirming denial of injunction based on lack of proof of "reasonable likelihood of recurrence" of *Rule 10b-5* violations); *SEC v. Bausch & Lomb Inc.*, 565 F.2d 8, 18 (2d Cir. 1977) (same, noting injunctive relief is not available without "positive proof of a reasonable likelihood that past wrongdoing will recur.").

(n22)Footnote 22. *SEC v. Jones*, 476 F. Supp. 2d 374 (S.D.N.Y. 2007) . See also Richard J. Morvillo, Peter H. White and Ryan P. Farley, "Five Years Is Enough For A Civil Penalty Assessment: No 'Discovery of Violation' Rule For The SEC Under 28 U. S. C. § 2642," 39 Sec. Reg. Law Rep., No. 16 at 635 (BNA April 23, 2007) (and cases cited therein). The opinion in *SEC v. Jones* also contains a discussion of doctrine of fraudulent concealment in the context of an SEC enforcement action charging securities fraud.

(n23)Footnote 23. *SEC v. Buntrock*, 2004 U.S. Dist. LEXIS 9495 at *37-*38 (N.D. Ill. May 25, 2004) .

(n24)Footnote 24. *SEC v. Jones*, 476 F. Supp. 2d 374, 381 (S.D.N.Y. 2007) .

(n25)Footnote 25. *SEC v. Jones*, 476 F. Supp. 2d at 385 .

(n26)Footnote 26. *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996) .

(n27)Footnote 27. See, e.g., *In re Danna*, Admin. Proceeding File No. 3-8196, 1997 SEC LEXIS 807, 64 SEC Docket (CCH) 720 (Apr. 14, 1997), and *In re Arnold, East & Payne*, Admin. Proceeding File No. 3-8509, 3-8955, 1997 SEC LEXIS 632, 64 SEC Docket 333-202 (March 19, 1997).

(n28)Footnote 28. See, e.g., *In re Entman*, Admin. Proceeding File No. 3-8584, 1996 SEC LEXIS 2273, 62 SEC Docket 1729-50 (Aug. 20, 1996); *In re Graham*, Admin. Proceeding File No. 3-8511, 1997 SEC LEXIS 287, 63 SEC Docket (CCH) 2059-66 (Feb. 7, 1997).

(n29)Footnote 29. *In re Michael J. Markowski*, 2001 SEC LEXIS 502, 74 SEC Docket 1291-5 (March 20, 2001); *In re Bob Sayegh*, 1999 SEC LEXIS 639, 69 SEC Docket 1049-86 (March 30, 1999); *In re Koch*, Admin. Proceeding File No. 3-8832, 1996 SEC LEXIS 2702, 62 SEC Docket (CCH) 2689-298 (Sept. 27, 1996), vacated on other grounds, *Koch v. SEC*, 177 F.3d 784 (9th Cir. 1999) .



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.09

AUTHOR: Kenneth B. Winer

§ 18.09 Double Jeopardy Clause

In circumstances where criminal penalties have already been imposed on the prospective defendant/respondent, a strong argument can be made that the *Fifth Amendment's double jeopardy clause* precludes the SEC from imposing punitive civil sanctions based on the same conduct. In *United States v. Halper*,ⁿ¹ the Supreme Court held that the sanction imposed in a civil proceeding may constitute the sort of multiple punishment prohibited by the clause. Irwin Halper was a medical laboratory technician who defrauded the Medicare program of \$585 by submitting 65 false claims for reimbursement. When his fraud was discovered, Halper was convicted, sentenced to prison for two years, and fined \$2,000. Subsequently, the government filed suit under the civil False Claims Act seeking to recover statutory penalties totaling \$130,000. The Supreme Court held that the *double jeopardy clause* precluded the imposition of the statutory penalty in light of the criminal penalties already imposed. The court set forth the test for determining whether assessing a civil penalty triggered the application of the clause:

Simply put, a civil as well as a criminal sanction constitutes punishment when the sanction as applied in the individual case serves the goals of punishment, ... retribution and deterrence... . From these premises, it follows that a civil sanction that cannot fairly be said solely to serve a remedial purpose, but rather can only be explained as also serving either retributive or deterrent purposes, is punishment... . We therefore hold that under the *Double Jeopardy Clause* a defendant who already has been punished in a criminal prosecution may not be subjected to an additional civil sanction to the extent that the second sanction may not fairly be characterized as remedial. n2

The Supreme Court recognized that the process of fixing a sanction that compensates the government for its costs involves an "element of rough justice" and explained that a civil sanction is not punishment merely because the precise amount of the government's damages and costs may be difficult to ascertain. n3

Although *Halper* involved a nominally civil sanction that followed imposition of an explicitly criminal sanction, its holding has been extended to situations where the explicitly criminal sanction followed imposition of the nominally civil sanction. n4 Thus, it appeared that the imposition of civil penalties might preclude a subsequent criminal action by federal prosecutors. n5

In December 1997, however, the Supreme Court disavowed the approach it had adopted in *Halper*.ⁿ⁶ In *Hudson v. United States*,ⁿ⁷ the court articulated a standard that arguably makes it substantially less likely that a sanction imposed in an SEC enforcement proceeding would be treated as criminal punishment for the purpose of the *double jeopardy clause*. Under the standard articulated in *Hudson*, a sanction will be deemed a criminal punishment for the purpose of the *double jeopardy clause* only if either: (1) in establishing the sanction, the legislature indicated either expressly or impliedly that the sanction be considered a criminal punishment, or (2) the statutory scheme is so punitive either in purpose or effect as to transform what was intended as a civil remedy into a criminal remedy. The court stressed that "only the clearest proof" will suffice to override legislative intent and transform what has been denominated a civil remedy into a criminal penalty."ⁿ⁸

In *SEC v. Palmisano*, the court of appeals applied the *Hudson* standard and concluded "that there is little indication, and certainly not the 'clearest proof' required under *Hudson*, that disgorgement and the fines provided by the Remedies Act are criminal punishments."ⁿ⁹ In *Palmisano*, the SEC conceded that payments that Palmisano made pursuant to the restitution order in the criminal case should be credited toward disgorgement ordered in the SEC enforcement matter, explaining, "Defendant is only required to give back the proceeds of his securities fraud once."ⁿ¹⁰

The SEC routinely includes in settlement documents a statement by the settling defendant/respondent waiving "any claim of Double Jeopardy based on the settlement of this proceeding, including the imposition of any monetary penalty or other remedy herein." In addressing an argument that a defendant's conviction was barred by that defendant's prior settlement of an SEC enforcement proceeding, the U.S. Court of Appeals for the Seventh Circuit, noting that waivers of constitutional rights must be knowing and voluntary, held that the language of the purported waiver was not so clear that it was willing to reject the defendant's argument based on the waiver alone.ⁿ¹¹

FOOTNOTES:

(n1)Footnote 1. *United States v. Halper*, 490 U.S. 435 (1989) .

(n2)Footnote 2. *United States v. Halper*, 490 U.S. 435, 448-449 .

(n3)Footnote 3. *United States v. Halper*, 490 U.S. 435, 449 .

(n4)Footnote 4. *United States v. Furllett*, 974 F.2d 839, 843 n.2 (7th Cir. 1992) ; *United States v. Walker*, 940 F.2d 442, 443 n.2 (9th Cir. 1991) ; *United States v. Marcus Schloss & Co., Inc.*, 724 F. Supp. 1123, 1126 (S.D.N.Y. 1989) (noting the unimportance of the timing where the effect is the same).

(n5)Footnote 5. *United States v. Morse, No. S1 96 CR. 732 (RPP)*, 1997 U.S. Dist. LEXIS 4765 (S.D.N.Y. Apr. 14, 1997) .

(n6)Footnote 6. *Halper*, 490 U.S. 435 .

(n7)Footnote 7. *Hudson v. United States*, 522 U.S. 93, 118 S. Ct. 488, 139 L. Ed. 2d 450 (1997) .

(n8)Footnote 8. *Hudson v. United States*, 522 U.S. 93, 100, 118 S. Ct. 488, 139 L. Ed. 2d 450 .

(n9)Footnote 9. 135 F.3d 860, 866 (2d Cir. 1998) .

(n10)Footnote 10. 135 F.3d 860, 863 (quoting SEC Brief On Appeal at 13 n.11).

(n11)Footnote 11. *U.S. v. Van Waeyenberghe*, 481 F.3d 951, 957-958 (7th Cir. 2007) .



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.10

AUTHOR: Kenneth B. Winer

§ 18.10 Control-Person Liability

The SEC has taken the position that it may rely on the Exchange Act § 20(a) control-person provisions in bringing an enforcement action under the federal securities laws to enjoin a particular practice. Section 20(a) provides that every person who, directly or indirectly, controls any person liable under any provision of the Exchange Act or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. n1

The Courts divided on whether Section 20(a) is available to the SEC in an enforcement action. n2 There was a substantial question, however, as to the extent to which Section 20(a) is properly read as applying to actions brought by the SEC. n3

In August 2010, as part of the Dodd-Frank Act, Congress amended Section 20(a) to provide that control person liability does extend to actions that the Commission brings under Section 21(d)(1) (authorizing the Commission to bring actions in federal court seeking injunctions) and Section 21(d)(3) (authorizing the Commission to bring actions in federal court seeking a monetary penalty). n4 It is not clear how this will work. Will the Commission be able to obtain an injunction against a control person who acted reasonably and in good faith and as to whom there is no likelihood of a future violation (e.g., a control person who is no longer alive)? Will the Commission be able to obtain third Tier penalties against a control person who acted reasonably and in good faith? Will a control person be able to litigate whether the monetary penalty to which a controlled person settled was appropriate?

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C.S. § 78t(a)*. In contrast, *15 U.S.C.S. § 77o*, the control person liability provision of the Securities Act, is expressly limited to liability under §§ 11 and 12 of the Securities Act.

(n2)Footnote 2. See, e.g., *United States v. Smith*, 2006 U.S. App. LEXIS 30976 (6th Cir. 2006) (holding that Section 20(a) is available); *SEC v. First Jersey Sec.*, 101 F.3d 1450 (2d Cir. 1995) (applying control person liability to individual who owned 100% of First Jersey and was its chairman and CEO); *SEC v. J.W. Barclay & Co.*, 442 F.3d 834 (3rd Cir. 2006) (stating that Section 20(a) would not be available in an SEC enforcement action).

(n3)Footnote 3. Kenneth Winer & Kimberly Shur, "A Mighty Sword: Should the SEC Bring Enforcement Actions Solely on the Basis of Control Person Liability?" *41 Sec. Reg. & L. Rep. 1686* (Sep. 14, 2009), available at http://www.foley.com/publications/pub_detail.aspx?pubid=6411 (arguing that "[t]he statutory language, and legislative history, of the relevant provisions of the Exchange Act and public policy do not support the application of [Section] 20(a) to SEC enforcement actions.").

(n4)Footnote 4. Exchange Act § 20(a), as amended by Dodd-Frank Act § 922.



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.11

AUTHOR: Kenneth B. Winer

§ 18.11 Disgorgement

The remedy of disgorgement is available both in judicial and in certain administrative proceedings. Disgorgement may be ordered for any violation of the federal securities laws. The purpose of disgorgement is to deprive a person of ill-gotten gains and to prevent unjust enrichment; the remedy of disgorgement is not a penalty. n1 This subsection addresses various issues related to disgorgement. Specifically, it examines the following issues: the measurement of the amount to be disgorged; whether an order of disgorgement is dischargeable in bankruptcy; the right to a jury trial in a judicial action in which the Commission seeks disgorgements; the ability of the SEC to obtain disgorgement from a person who has been enriched as the result of the unlawful conduct of another; and prejudgment interest.

[1] Measure of Disgorgement

As set forth below, it often is difficult to determine the precise amount of a person's ill-gotten gains and unjust enrichment.

District courts and ALJs have broad discretion in determining whether to order disgorgement and in calculating the amount of disgorgement. n2 Courts have stated that the disgorged amount must be "causally connected to the violation," but it need not be figured with exactitude. n3 These courts reason that "[t]he wrongdoer, who has created the uncertainty by his violation, bears the risk of uncertainty," n4 and that the difficulty in separating legal from illegal profits makes it more reasonable to simply assume that all of a defendant's profits gained while in violation of the law are subject to disgorgement. n5 If the defendant can show a break in causation between the alleged illegal conduct and the profits the government seeks to be disgorged, then he may prevail on his defense. In *SEC v. MacDonald*, the First Circuit indicated that a person who buys stock based on inside information is not required to disgorge profits earned by holding the stock for a long period of time after the market digested the previously-undisclosed information. n6

Courts have stated that the SEC bears the burden of persuasion that its proposed disgorgement amount reasonably approximates the amount of unjust enrichment and that once the SEC has established that the proposed amount is reasonable, the burden shifts to the defendant to demonstrate that the amount requested is not a reasonable approximation of the unlawfully obtained profits. n7

The SEC employed an aggressive theory of disgorgement in its March 17, 2003 settlement with Merrill Lynch & Co., Inc. n8 The SEC alleged that Merrill aided and abetted Enron in materially misstating its 1999 financial statements by entering into two year-end transactions. Merrill consented, without admitting or denying the Commission's allegations in the complaint, to the entry of a permanent injunction prohibiting future violations of the antifraud provisions of the federal securities laws. According to the Commission's complaint, Merrill's profit from the two transactions totaled less than \$10 million. Merrill nevertheless agreed to pay \$37.5 million in disgorgement, an equal amount in penalties and \$5 million in pre-judgment interest and to consent to the entry of an injunction. The complaint indicated that Merrill agreed to the two year-end transactions in part because Enron was an important Merrill client and it appears that the disgorgement included not only Merrill's profits from the two transactions, but also fees and other profits that Merrill earned from subsequent transactions with Enron.

In insider trading cases, some courts measure disgorgement as the difference between the insider's transaction price and the market price a reasonable time after public disclosure of the information. n9 Using this method, the crucial determination is the identification of "a reasonable time" after public disclosure. In *SEC v. MacDonald*, n10 the First Circuit stated that "the court should consider the volume and price at which [the] shares were traded following disclosure, insofar as they suggested the date by which the news had been fully digested and acted upon by investors." n11

The government has succeeded in obtaining disgorgement in insider trading cases of losses avoided. In *SEC v. Patel*, n12 the insider sold shares at an average of \$21 per share based on material non-public information. The day before the news was disclosed, the stock was trading at \$10. Two days later, the stock was at \$7.125, down \$2.875 per share. The district court adopted the position urged by the SEC and ordered disgorgement of 28.75 percent of the insider's proceeds, the percentage decrease in value two days after disclosure. The Second Circuit affirmed this order.

Comment

The opinion is noteworthy in that disgorgement was not ordered based on the difference between the insider's sale price and the price after disclosure. It should also be noted that the insider apparently did not argue that he should have been ordered to pay just \$2.875 per share rather than 28.75 percent of his proceeds from the sale.

In insider trading cases involving a tipper and a tippee, the SEC routinely seeks to hold the tipper and the tippee jointly liable for the profit gained or the loss avoided. n13 The Second Circuit explained:

A tippee's gains are attributable to the tipper, regardless whether benefit accrues to the tipper. The value of the rule in preventing misuse of insider information would be virtually nullified if those in possession of such information, although prohibited from trading for their own accounts, were free to use the insider information on trades to benefit their families, friends, and business associates. n14

While this reasoning overlooks the monetary penalties available against the tipper, other courts have adopted this reasoning. n15

The SEC routinely seeks pre-judgment interest on the unjust enrichment running from the date of the unlawful gain to the entry of judgment at the IRS rate for underpayment of taxes. n16 Other courts have imposed a lower rate of interest. n17 In one case, the court held that because of the unfairness that resulted from imposing this high rate of prejudgment interest as to the relief defendants, the court would impose pre-judgment interest only from the filing of the SEC complaint. n18

In a case involving a false SEC filing, a person might be ordered to disgorge any profits resulting from the inadequacy of such false disclosure. n19 The District of Columbia Circuit held in *Bilzerian* n20 that the defendant, who was

ordered to disgorge the appreciation in the value of his stock resulting from his faulty filing, bore "the burden of establishing that the price increases that occurred during his ownership of the stocks were attributable to market forces rather than to his violations." n21 In addition to any trading profits, a person might be ordered to disgorge salary or other compensation that was obtained as a result of violating the federal securities laws. n22 In *Posner*, n23 the defendants were found to have fraudulently acquired control of Fischbach Corp. The Second Circuit affirmed a district court order that the Posners disgorge income earned as officers and directors of the company, explaining that "[b]ut for their illegal conduct, [they] would not have been in a position to plunder Fischbach." n24 In *Hateley v. SEC*, n25 a brokerage firm and certain persons associated with the firm were ordered to disgorge the commissions received as a result of conduct that violated certain FINRA rules.

In determining the amount of unjust enrichment, some courts offset expenses incurred from the amount improperly received or the loss improperly avoided. n26 In *Hateley*, the respondent securities firm had entered into an agreement with a person not associated with the firm that he would receive, as a finders fee, 90 percent of the commissions generated by any securities transactions he solicited for the firm. The SEC found this arrangement to be a violation of FINRA rules, and ordered the respondent to disgorge all the commissions generated by that person. Stating that the disgorgement should be limited to the firm's unjust enrichment, the Ninth Circuit held it unreasonable and excessive for the SEC to have ordered the securities firm to disgorge all the commissions, considering that the firm had paid 90 percent of those commissions as a finder fee. Instead, the court held that the proper disgorgement was the 10 percent of the commissions retained by the firm. n27

Similarly, in *Shah*, n28 the district court found that "[a]llowing a deduction for reasonable brokers' commissions incurred in making insider trades is consistent with the view in the Second Circuit that disgorgement is not a penalty assessment, but merely a means of divesting a wrongdoer of ill-gotten gains." n29 On the other hand, a number of courts have stated that no offset should be permitted. n30 In *SEC v. Interlink Data Network*, n31 the court pointedly stated that defendants "should receive no credit for operational or other business expenses incurred, because to do so would be tantamount to allowing a bank robber to deduct the price of the getaway car." n32

[2] Other Considerations

[a] Bankruptcy

Debts incurred in the violation of securities laws are nondischargeable in bankruptcy. n33 Although the title of the code section refers to debts "incurred in violation of securities *fraud* laws" (emphasis added), the text of the statute makes clear that "the violation of *any* of the Federal securities laws ..., any of the State securities laws, or any regulation or order issued under such Federal or State securities laws" prevents the discharge of those debts in bankruptcy. n34

Debts which are nondischargeable include those incurred by a judgment, consent order, settlement agreement, or court or administrative order for damages, fines, penalties, or costs. The Code explicitly includes debts that result from any court or administrative order for disgorgement payments, fines, and attorneys fees as among the obligations which are not dischargeable in bankruptcy. The 2002 revision to the federal bankruptcy laws puts to rest the issue of whether an obligation to pay pursuant to a disgorgement order is dischargeable in bankruptcy, n35 explicitly providing that such payments are nondischargeable.

[b] Right to Jury Trial

Defendants have a right to a jury if, as is usually the case in court actions, the SEC seeks a monetary penalty. n36 Courts have held, however, that defendants in SEC actions seeking disgorgement are not entitled to a jury trial if the SEC seeks only an injunction disgorgement, and other equitable relief.

[c] Disgorgement from Innocent Persons

In *SEC v. Cherif*, n37 the Seventh Circuit addressed the situation where a person holds, in a depository capacity, funds gained as a result of violations of the federal securities laws, but did not himself or herself violate the law. The court stated that such a person could be named as a "nominal defendant," explaining that a " 'nominal defendant' is a person who can be joined to aid the recovery of relief without an assertion of subject matter jurisdiction only because he has no ownership interest in the property which is the subject of litigation." n38 The Seventh Circuit further explained:

A nominal defendant holds the subject matter of the litigation "in a subordinate or possessory capacity as to which there is no dispute." Because the nominal defendant is a "trustee, agent or depository," who has possession of the funds which are the subject of litigation, he must often be joined purely as a means of facilitating collection... . Because of the non-interested status of the nominal defendant, there is no claim against him and it is unnecessary to obtain subject matter jurisdiction over him once jurisdiction over the defendant is established. n39

The court held that where the person holding the funds arguably has title to the funds, the SEC can obtain relief as to those funds only by showing that the holder violated the federal securities laws. n40

In *SEC v. Antar*, n41 a district court held that disgorgement may be ordered where "the nominal defendants do not have a legitimate claim to the illegal profits." n42 The illegal transactions at issue here were executed through custodial accounts held for the defendant's children. Finding that Deborah Rosen Antar retained control of the accounts, the court ruled that disgorgement was proper, as any other result would allow a person trading in material non-public information to retain ill-gotten gains by simply trading through another account. n43

In *SEC v. Cross Financial Services, Inc.*, n44 a defendant argued that a district court lacked jurisdiction to order him to disgorge funds that he received from a company engaged in securities fraud because the federal securities laws tie jurisdiction to violations of the laws, and the SEC did not allege that he had violated them. n45 Relying on *Cherif* and *Antar*, the court ordered the defendant to disgorge the funds that he had received from the company, finding that he had been "unjustly enriched at the expense of [the company's investors] and as between their interests and his, those of the investors must prevail." n46

Conversely, innocent persons who can demonstrate that they are *bona fide* purchasers for value of disputed property are entitled to protection against disgorgement. In *SEC v. Lehman Brothers*, n47 the First Circuit held that a brokerage firm which extended a margin loan to a client who purchased securities on inside information had priority under state law to the trading profits needed to repay the margin debt. n48 Lehman Brothers was entitled to repayment of the margin loan unless the government could show that it acted with actual knowledge of the client's fraud when it executed the trades. n49

[d] Inability to Pay

Financial inability to pay is a basis to seek the discharge of court-ordered disgorgement. n50 The defendant, however, has the burden of proving this defense by a preponderance of the evidence. n51 Some courts have declined to consider a defendant's inability to pay in ordering disgorgement. n52

In *SEC v. Musella*, n53 a defendant was held in contempt for failure to comply with a disgorgement order. The court explained that the defendant's inability to pay the entire amount by the specified date was not enough to avoid the contempt finding. n54

In administrative actions, the Commission has discretion to consider evidence concerning a respondent's ability to pay in determining whether disgorgement is in the public interest. n55

Comment

Based on discussions with the Staff, the author believes that the Commission is increasingly reluctant to waive disgorgement based on inability to pay.

[3] Prejudgment Interest

Courts have equitable discretion to award prejudgment interest on the amounts disgorged. n56 In determining whether an award of interest is fair and equitable, courts should consider the nature and extent of the defendant's personal wrongdoing. n57 A number of courts have found that, in the context of a § 10(b) and *Rule 10b-5* action, proof of the defendant's scienter is sufficient to justify an award of prejudgment interest. n58

There is no consensus on the appropriate rate to be applied in calculating prejudgment interest in judicial actions. In *SEC v. Lorin*, n59 the court calculated prejudgment interest based on the delinquent tax rate determined by the Internal Revenue Service, and noted that it is assessed on a quarterly basis. n60 The SEC has promulgated rules that provide that in administrative proceedings, prejudgment interest shall be calculated using the delinquent tax rate. n61 Courts may rely on this regulation in determining the appropriate rate of interest in civil actions as well. In *Interlink*, the court stated that prejudgment interest should be calculated according to 28 U.S.C. § 1961, "unless the equities of a particular case demand a different rate." n62 Some courts, however, have applied the interest rate provided by state law. n63

The Rules of Practice, which govern administrative proceedings, provide that, in general, prejudgment interest shall be due on any amount required to be paid pursuant to an order of disgorgement:

The disgorgement order shall specify each violation that forms the basis for the disgorgement ordered; the date which, for purposes of calculating disgorgement, each such violation was deemed to have occurred; the amount to be disgorged for each such violation; and the total sum to be disgorged. Prejudgment interest shall be due from the first day of the month following each such violation through the last day of the month preceding the month in which payment or disgorgement is made. The order shall state the amount of prejudgment interest owed as of the date of the disgorgement order and that interest shall continue to accrue on all funds owed until they are paid. n64

The rules also prescribe that, in general, the payment of prejudgment interest will be made at the delinquent tax rate of interest established under § 6621(a)(2) of the *Internal Revenue Code*, 26 U.S.C. 6621(a)(2). n65

Given that the prejudgment interest rate obtained by the SEC exceeds the rate that an investor could obtain on risk-free investments, persons who believe that they are likely to either enter into a settlement that includes disgorgement or be found liable for disgorgement might consider placing the expected amount of disgorgement into an escrow account. The Rules of Practice provide that:

[t]he Commission or the hearing officer may, by order, specify [a rate lower than the underpayment rate of interest established under *Section 6621(a)(2) of the Internal Revenue Code*] as to any funds which the respondent has placed in an escrow [account] or otherwise guaranteed for payment of disgorgement upon a final determination of the respondent's liability. n66

The comment to this rule provides, in part, that in calculating the rate of prejudgment interest as to such funds, the actual interest rate obtained on the funds while in escrow, with appropriate adjustments for the expense of the escrow or guarantee, may be taken into account in calculating the prejudgment rate of interest. n67 This provision in the Rules of Practice can provide a useful mechanism in circumstances in which a person expects to pay disgorgement, but the disgorgement order has not yet been entered (e.g., the person has negotiated with the Staff the terms of a settlement that it is prepared to recommend to the Commission once the Staff has completed its investigation as to other persons).

The Rules of Practice also provide that, in general, funds due pursuant to an order by the Commission requiring the payment of disgorgement, interest, or penalties shall be paid no later than 21 days after service of the order, and funds due pursuant to an order by a hearing office shall be paid on the first day after the order becomes final. n68 The rules further provide that a stay of any order requiring the payment of disgorgement, interest, or penalties may be sought at any time pursuant to Rule 401. n69

Procedures for execution of a money judgment are not available in an administrative proceeding. If a respondent does not pay disgorgement, interest, or penalties as ordered, the SEC can enforce its order by bringing a court action or by referring the matter to the Department of Justice for collection.

[4] Collection of Disgorgement

The SEC has been criticized for its poor collection rate on disgorgement orders. n70 According to a January 2001 *USA Today* news story, since 1994, the SEC has fallen to collecting only about \$1.69 of every \$10 (16.9%) that was ordered disgorged. n71 In March 2001, BNA reported that over \$880 million in court-ordered disgorgement and civil penalties went unpaid in 1999 and 2000; only approximately \$7.68 million in 1999 and \$3.09 million in 2000 was collected. n72

FOOTNOTES:

(n1)Footnote 1. *See, e.g., SEC v. Rind, 991 F.2d 1486, 1490 (9th Cir. 1993) ; Hateley v. SEC, 8 F.3d 653, 656 (9th Cir. 1993) .*

(n2)Footnote 2. *SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1474-1475 (2d Cir. 1996) ; SEC v. Lorin, 76 F.3d 458, 462 (2d Cir. 1996) .*

(n3)Footnote 3. *SEC v. First Pacific Bancorp, 142 F.3d 1186, 1192 n.6 (9th Cir. 1998)* (disgorgement need only be a reasonable approximation); *SEC v. First City Fin. Corp., 890 F.2d 1215, 1230-1231 (D.C. Cir. 1989)* (disgorgement need only be a reasonable approximation); *SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1475 (2d Cir. 1996) ; accord In re G. Bradley Taylor, Initial Decision Release No. 215, 2002 SEC LEXIS 2429, 78 SEC Docket 1501-112 (Sept. 24, 2002).*

(n4)Footnote 4. *SEC v. Drexel Burnham Lambert, 837 F. Supp. 587, 612 (S.D.N.Y. 1993)* (citing *First City, 890 F.2d 1215, 1232*) . *See also 837 F. Supp. 587, 612* ("The SEC need only offer a prima facie reasonable approximation; the burden then shifts to defendant to rebut the presumption.") (quoting *SEC v. Bilzerian, 814 F. Supp. 116, 121 (D.D.C. 1993)*) .

(n5)Footnote 5. *SEC, 837 F. Supp. 587, 612* (quoting *Bilzerian, 814 F. Supp. 116, 121*) ; *SEC v. Seibald, 1997 U.S. Dist. LEXIS 14940 *18* (S.D.N.Y. Sept. 30, 1997)) .

(n6)Footnote 6. *SEC v. MacDonald, 699 F.2d 47, 52-55 (1st Cir. 1983) (en banc).*

(n7)Footnote 7. *SEC v. Robinson, 2002 U.S. Dist. LEXIS 12811 *27* (S.D.N.Y. July 16, 2002) (quoting *SEC v. Grossman, 1997 U.S. Dist. LEXIS 6225 *25* (S.D.N.Y. May 6, 1997) . *Accord SEC v. Antar, 97 F. Supp. 2d 576, 578 (D.N.J. 2000)* .

(n8)Footnote 8. *SEC v. Merrill Lynch & Co., Inc., Daniel H. Bayly, Thomas W. Davis, Robert S. Furst, Schuyler M. Tilney, Litig. Rel. No. 18038, 2003 SEC LEXIS 620, 79 SEC Docket 2533-97* (S.D. Tx. March 17, 2003).

(n9)Footnote 9. *SEC v. Chapnick, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,076* (S.D. Fla. Feb. 11, 1994) (citing *SEC v. MacDonald, 699 F.2d 47, 53-55 (1st Cir. 1983)* .

(n10)Footnote 10. *SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983)* .

(n11)Footnote 11. *MacDonald*, 699 F.2d 47, 55 . See also *SEC v. Shah*, 1993 U.S. Dist. LEXIS 10347 (S.D.N.Y. July 26, 1993) (using the price at which the stock closed two days after the company had disclosed the adverse information).

(n12)Footnote 12. *SEC v. Patel*, 61 F.3d 137 (2d Cir. 1995) .

(n13)Footnote 13. See, e.g., *SEC v. Clark*, 915 F.2d 439, 454 (9th Cir. 1990) .

(n14)Footnote 14. *SEC v. Warde*, 151 F.3d 42, 49 (2d Cir. 1998) .

(n15)Footnote 15. See, e.g., *SEC v. Yun*, 148 F. Supp. 2d 1287, 1292 (M.D. Fla. 2001) (recognizing the significance of the monetary penalties, but concluding that the imposition of joint and several liability was endorsed by the House of Representatives in enacting the monetary penalties and that members of a conspiracy are held criminally liable for the reasonably foreseeable actions of their co-conspirators).

(n16)Footnote 16. See, e.g., *SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1476 (2d Cir. 1996) .

(n17)Footnote 17. See, e.g., *SEC v. Yun*, 148 F. Supp. 2d 1287, 1292 (M.D. Fla. 2001) (applying the interest rate of the 52-week U.S. Treasury Bill).

(n18)Footnote 18. *SEC v. Antar*, 97 F. Supp. 2d 576, 592 (D.N.J. 2000) .

(n19)Footnote 19. See *SEC v. Bilzerian*, 29 F.3d 689, 696-697 (D.C. Cir. 1994) (defining the amount of profit causally related to Bilzerian's wrongdoing as the stock appreciation resulting from the untimely and inaccurate Schedule 13D filing).

(n20)Footnote 20. *SEC v. Bilzerian*, 29 F.3d 689 (D.C. Cir. 1994) .

(n21)Footnote 21. *Bilzerian*, 29 F.3d 689, 697 .

(n22)Footnote 22. See *SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994) ; *Hateley v. SEC*, 8 F.3d 653 (9th Cir. 1993) .

(n23)Footnote 23. *Posner*, 16 F.3d 520 .

(n24)Footnote 24. *Posner*, 16 F.3d 520, 522 .

(n25)Footnote 25. *Hateley v. SEC*, 8 F.3d 653 (9th Cir. 1993) .

(n26)Footnote 26. See, e.g., *Hateley v. SEC*, 8 F.3d 653 (9th Cir. 1993) ; *SEC v. Rosenfeld*, 2001 U.S. Dist. LEXIS 166 *6 (S.D.N.Y. January 9, 2001) ("A court may in its discretion, deduct from the defendant's gross profits certain expenses incurred while garnering the illegal profits, including ... transaction costs such as brokerage commissions."); *SEC v. Thomas James Assoc., Inc.*, 738 F. Supp. 88, 94 (W.D.N.Y. 1990) ("In determining the proper amount of restitution, a Court may consider as an offset the sums which a defendant paid to effect a fraudulent transaction.").

(n27)Footnote 27. *Hateley*, 8 F.3d 653, 656 . See also *SEC v. Washington County Utility Dist.*, 676 F.2d 218, 227 n.20 (6th Cir. 1982) (holding that where defendant received one-half of improperly obtained fees, disgorgement should be ordered in that amount).

(n28)Footnote 28. *SEC v. Shah*, 1993 U.S. Dist. LEXIS 10347 (S.D.N.Y. July 26, 1993) .

(n29)Footnote 29. 1993 U.S. Dist. LEXIS 10347 *14 . See also *SEC v. Thomas James Assoc., Inc.*, 738 F. Supp. 88, 94 (W.D.N.Y. 1990) (stating that the court may consider an offset for sums paid to effect a fraudulent transaction, such as commissions, telephone charges, underwriting expenses, and overhead); *Litton Indus. v. Lehman Bros. Kuhn Loeb*

Inc., 734 F. Supp. 1071, 1077 (S.D.N.Y. 1990) (permitting an offset for such expenses and costs as brokerage commissions).

(n30)Footnote 30. *See, e.g., SEC v. Great Lakes Equities Co.*, 775 F. Supp. 211, 215 n.22 (E.D. Mich. 1991) (holding that an offset for overhead and other fixed expenses incurred in perpetuating fraud is not warranted, as expenses still would have been incurred absent the fraud); *SEC v. United Monetary Servs., Inc.*, 1990 U.S. Dist. LEXIS 11334 *25 (S.D. Fla. May 13, 1990) (holding that defendants are not entitled to any offset because "[c]ourts have routinely required wrongdoers in securities frauds to disgorge the gross sums received from investors.").

(n31)Footnote 31. *SEC v. Interlink Data Network*, 1993 U.S. Dist. LEXIS 20163 (C.D. Cal. Nov. 15, 1993) ; *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1 (D.D.C. 1998) (and cases cited therein).

(n32)Footnote 32. 1993 U.S. Dist. LEXIS 20163 *54 n.118 .

(n33)Footnote 33. The Sarbanes-Oxley Act of 2002, amending the Bankruptcy Code, 11 U.S.C.S. § 523(a).

(n34)Footnote 34. Section 803(3) of the Sarbanes-Oxley Act, 11 U.S.C.S. 523(a)(19)(i). See the Exchange Act expansive definition of "securities laws" 15 U.S.C.S. 78c(a)(47).

(n35)Footnote 35. *See SEC v. Huffman*, 996 F.2d 800 (5th Cir. 1993) .

(n36)Footnote 36. *See Tull v. United States*, 481 U.S. 412 (1987) (defendant has right to a jury trial in government enforcement action seeking injunction and civil penalties).

(n37)Footnote 37. *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991) .

(n38)Footnote 38. *Cherif*, 933 F.2d 403, 414 .

(n39)Footnote 39. *Cherif*, 933 F.2d 403, 414 (citations omitted).

(n40)Footnote 40. *Cherif*, 933 F.2d 403, 413-414 .

(n41)Footnote 41. *SEC v. Antar*, 831 F. Supp. 380 (D.N.J. 1993) .

(n42)Footnote 42. *Antar*, 831 F. Supp. 380, 401 (noting that the court has subject matter jurisdiction over the nominal defendants because they lack such a claim to the profits).

(n43)Footnote 43. *Antar*, 831 F. Supp. 380 , (noting that such "estate planning" would not be an acceptable result). The court also noted that failure to order disgorgement of the profits would result in unjust enrichment for the remaining family members.

(n44)Footnote 44. *SEC v. Cross Fin. Servs., Inc.*, 908 F. Supp. 718 (C.D. Calif. 1995) .

(n45)Footnote 45. *Cross Fin. Servs., Inc., Id.* 908 F. Supp. 718 , 730.

(n46)Footnote 46. *Cross Fin. Servs., Inc.*, 908 F. Supp. 718, 732 . *See also SEC v. Seibald*, 1997 U.S. Dist. LEXIS 14940 (S.D.N.Y. Sept. 30, 1997) .

(n47)Footnote 47. 157 F.3d 2 (1st Cir. 1998) .

(n48)Footnote 48. 157 F.3d 2, 9 .

(n49)Footnote 49. In *SEC v. Antar*, 97 F. Supp. 2d 576, 592 (D.N.J. 2000) , the court recognized the unfairness of requiring relief defendants from pay pre-judgment interest at the IRS rate for underpayment of taxes. The court

addressed this unfairness by requiring prejudgment interest from the relief defendants only from the date that the SEC filed its complaint.

(n50)Footnote 50. *See SEC v. AMX, Int'l, Inc.*, 7 F.3d 71, 73 (5th Cir. 1993) (citing *Donovan v. Sovereign Secs., Ltd.*, 726 F.2d 55, 59 (2d Cir. 1984)) .

(n51)Footnote 51. *SEC v. Huffman*, 996 F.2d 800, 803 (5th Cir. 1993) .

(n52)Footnote 52. *See, e.g., SEC v. Robinson*, 2002 U.S. Dist. LEXIS 12811 (S.D.N.Y. July 16, 2002) (and cases cited therein); *SEC v. McCaskey*, 2002 U.S. Dist. LEXIS 4915 *1 (S.D.N.Y. March 26, 2002) (present financial hardship does not preclude disgorgement) (and cases cited therein).

(n53)Footnote 53. *SEC v. Musella*, 818 F. Supp. 600 (S.D.N.Y. 1993) .

(n54)Footnote 54. *SEC*, 818 F. Supp. 600, 602 .

(n55)Footnote 55. 17 C.F.R. § 201.630(a).

(n56)Footnote 56. *See, e.g., SEC v. Musella*, 748 F. Supp. 1028, 1042 (S.D.N.Y. 1989) (collecting cases); *see also SEC v. Interlink Data Network*, 1993 U.S. Dist. LEXIS 20163 *55 (C.D. Cal. Nov. 15, 1993) (awarding prejudgment interest in light of particularly egregious nature of defendants' violations).

(n57)Footnote 57. *Musella*, 748 F. Supp. 1028, 1042-1043 .

(n58)Footnote 58. *SEC v. Shah*, 1993 U.S. Dist. LEXIS 10347 (S.D.N.Y. July 26, 1993) ; *Musella*, 748 F. Supp. 1028, 1043 ; *SEC v. Drexel Burnham Lambert*, 837 F. Supp. 587, 612 (1993) (stating that proof of scienter justifies award of prejudgment interest to avoid unjust enrichment).

(n59)Footnote 59. *SEC v. Lorin*, 877 F. Supp. 192 (S.D.N.Y. 1995) .

(n60)Footnote 60. *Lorin*, 877 F. Supp. 192, 201 . *See also SEC*, 837 F. Supp. 587, 612 n.8 (and cases cited therein).

(n61)Footnote 61. Rule 600(b), SEC Rules of Practice, 17 C.F.R. § 201.600(b).

(n62)Footnote 62. *SEC v. Interlink Data Network*, 1993 U.S. Dist. LEXIS 20163, *56 (C.D. Cal. 1993) (employing coupon issue yield equivalent of the average accepted auction price for the last auction of 52-week U.S. Treasury bills settled immediately prior to the date of judgment). *See also SEC v. Cross Fin. Servs., Inc.*, 908 F. Supp. 718, 734 (C.D. Calif. 1995) .

(n63)Footnote 63. *See, e.g., SEC v. Musella*, 748 F. Supp. 1028, 1043 (S.D.N.Y. 1989) (holding that the district court may set the rate of prejudgment interest by referring to state law); *SEC v. Hasho*, 784 F. Supp. 1059, 1112 (S.D.N.Y. 1992) (applying New York law to calculate prejudgment interest award); *SEC v. Ferrero*, 1993 U.S. Dist. LEXIS 21379, *51 (S.D. Ind. Dec. 2, 1993) (applying the rate of prejudgment interest specified by Indiana law).

(n64)Footnote 64. Rule 600(a), 17 C.F.R. § 201.600(a).

(n65)Footnote 65. Rule 600(b), 17 C.F.R. § 201.600(b).

(n66)Footnote 66. Rule 600(b), 17 C.F.R. § 201.600(b).

(n67)Footnote 67. Rule 600, cmt., 60 Fed. Reg. 32738 (1995) , reprinted at [1995 Transfer Binder] *Fed. Sec. L. Rep. P 32,738* (1995).

(n68)Footnote 68. Rule 601(a), *17 C.F.R. § 201.601(a)*.

(n69)Footnote 69. Rule 601(b), *17 C.F.R. § 201.601(b)*.

(n70)Footnote 70. *33 Sec. Reg. & L. Rep. (BNA) 439* (Mar. 26, 2001) .

(n71)Footnote 71. *33 Sec. Reg. & L. Rep. (BNA) 439* .

(n72)Footnote 72. *33 Sec. Reg. & L. Rep. (BNA) 439 ; 33 Sec. Reg. L. Rep. (BNA) 319* (Mar. 5, 2001).



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.12

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§ 18.12 Ability of SEC to Obtain Remedy Against Aiding and Abetting

In 1994, the United States Supreme Court held that there is no implied private right of action under § 10(b) of the Exchange Act for aiding and abetting. n1 As a result of this opinion, there was considerable doubt as to whether the SEC could bring an aiding and abetting enforcement action. n2

In 1995, legislation was enacted clarifying that the SEC had authority to bring enforcement actions against aiders and abettors. Section 104 of the Private Securities Litigation Reform Act of 1995 amended § 20 of the Exchange Act to provide that for the purpose of SEC enforcement actions, "any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." n3

The SEC Staff interpreted this provision aggressively. Section 20(e) of the Exchange Act permits Commission actions against aiders and abettors of primary violations, but only if such persons "knowingly" provided substantial assistance to primary violators. The two leading opinions on this issue have rejected the SEC's position. In *Fehn*, the only appellate decision to have analyzed and applied the "knowingly" requirement of Section 20(e), the court explicitly rejected prior decisions defining the scienter element as "actual knowledge or reckless disregard" because Section 20(e), "by its plain terms, requires 'know[ledge]' as an element of aiding and abetting." n4 In a well-reasoned discussion, Judge Cote addressed and refuted the SEC's arguments that recklessness satisfies the "knowingly" standard established by Section 20(e). n5

The Staff relied on *Graham v. SEC*, n6 and *SEC v. Milan Capital Group, Inc.*, n7 in asserting that recklessness is sufficient to establish a violation of Section 20(e). A careful reading of the cases shows that neither case supports the Staff's position. *Graham* did not address Section 20(e) because it was a broker's appeal from an SEC administrative proceeding to which Section 20(e) does not apply (because Section 20(e) applies only to injunctive and civil penalty cases). n8 *Milan Capital Group* ignored the plain language of the statute and legislative history relating to the Bryan Amendment and instead simply relied on case law that predated the Supreme Court decision in *Central Bank*. In addition, the *Milan Capital Group* court held that recklessness sufficed in that case only because the defendant, "as a broker, owed investors a fiduciary duty of care."

To the extent the Staff asserted that "knowingly" in Section 20(e) means "knowingly or recklessly" because Congress could have drafted Section 20(e) to say "actually knowingly" instead of just "knowingly," the unreasonableness of assuming that a word means something other than what it says because it does not have the word "actually" in front of it was illustrated by the late Judge Jerome Frank of the Second Circuit (himself a former SEC Chairman) by "the old story about the man, ejected from a theatre because of his failure to obey a 'No Smoking' sign, who defended himself indignantly on the ground that the sign did not say 'Absolutely No Smoking.'" n9

In August 2010, as part of the Dodd-Frank Act, Congress expanded the power of the SEC to bring aiding and abetting claims. Congress gave the SEC the power to bring claims for aiding and abetting violations of the Securities Act and the Investment Company Act and the power to seek monetary penalties for persons charged with aiding and abetting violations of the Investment Advisors Act. n10 In addition, Congress explicitly provided that the SEC could maintain an aiding and abetting claim against any person that acted recklessly. n11 The Dodd-Frank Act did not create a private right of action, but directs GAO to study whether a private right of action should be created. n12

FOOTNOTES:

(n1)Footnote 1. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) .

(n2)Footnote 2. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 192 (Stevens, J., dissenting).

(n3)Footnote 3. Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, § 104 (codified at 15 U.S.C.S. § 78t).

(n4)Footnote 4. *See SEC v. Fehn*, 97 F.3d 1276, 1288 (9th Cir. 1996) .

(n5)Footnote 5. 2005 U.S. Dist. LEXIS 39032 (S.D.N.Y. Dec. 28, 2005) .

(n6)Footnote 6. 1997 SEC LEXIS 287, 63 SEC Docket 2059-66 (Feb. 7, 1997).

(n7)Footnote 7. 2001 U.S. Dist. LEXIS 11804 (S.D.N.Y. Aug. 14, 2001) .

(n8)Footnote 8. *See* 15 U.S.C.S. § 78t(e).

(n9)Footnote 9. *See Crowley's Milk Co. v. Brannan*, 198 F.2d 861, 871 (2d Cir. 1952) (Frank, J., dissenting).

(n10)Footnote 10. Dodd-Frank Act §§ 929M, 929N.

(n11)Footnote 11. Dodd-Frank Act §§ 929M, 929N, 929O.

(n12)Footnote 12. Dodd-Frank Act § 929Z.



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CHAPTER 18 REMEDIES

1-18 Securities Enforcement: Counseling and Defense § 18.13

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§ 18.13 Conclusion

Congress has repeatedly added to the arsenal of enforcement remedies available to the SEC. With this arsenal, the SEC has the power to obtain substantial sanctions against individuals and entities who violate, or cause another to violate, the federal securities laws.



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CHAPTER 19 SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

1-19 Securities Enforcement: Counseling and Defense 19.syn

AUTHOR: Marc B. Dorfman Kenneth B. Winer

§ 19.syn Synopsis to Chapter 19: SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

§ 19.01 Introduction

§ 19.02 Format of the Rules of Practice, Use of Explanatory Comments, and Availability of Relevant Opinions by Administrative Law Judges

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[d] Transcripts and Transcript Exhibits

[e] Other Documents Obtained from Persons Not Employed by the SEC

[f] Final Examination or Inspection Reports

[7] Timing of the Respondent's Access to Documents under Rule 230(a)

[8] Documents Withheld from the Respondent

[9] Subpoenas for Documents

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§ 19.05 The Evidentiary Hearing

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§ 19.08 Respondent's Success May Depend on Which ALJ Is Assigned to the Proceeding

Marc B. Dorfman
Kenneth B. Winer



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CHAPTER 19 SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

1-19 Securities Enforcement: Counseling and Defense § 19.01

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§ 19.01 Introduction

Since October 1990, when the Securities Enforcement Remedies and Penny Stock Reform Act n1 took effect, administrative proceedings have played an important role in the Securities and Exchange Commission's enforcement program. Administrative enforcement proceedings initiated, as a percentage of total enforcement actions initiated, more than doubled during the period from fiscal year 1990 to fiscal year 1996. During fiscal years 1998 through 2003, the number of administrative proceedings as a percentage of total enforcement actions initiated remained relatively stable, ranging between 47% and 57%, with fiscal year 2003 at 54%. n2

With these trends in mind, this section provides an overview of enforcement proceedings brought by the SEC in its own administrative forum.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 101-429, *104 Stat. 931 (1990)*.

(n2)Footnote 2. SEC 2003 Annual Report, at 17, available at the SEC's website: at www.sec.gov.



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CHAPTER 19 SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

1-19 Securities Enforcement: Counseling and Defense § 19.02

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§ 19.02 Format of the Rules of Practice, Use of Explanatory Comments, and Availability of Relevant Opinions by Administrative Law Judges

The rules are organized into six broad categories based on the phase or type of proceeding that they govern. The six broad categories are:

- general rules;
- institution of proceedings and prehearing rules;
- hearing rules;
- rules regarding appeals to the SEC and subsequent review;
- rules regarding temporary orders, suspension of a registration, and summary suspensions of trading;
and
- rules governing disgorgement and penalty payments.

Within each group, related rules are placed together. Rules that formerly covered multiple topics have been divided into shorter rules limited to fewer topics.

Rule headings and subheadings are designed to guide a user to the appropriate rule. Each of the six major groups of rules is numbered in a separate series, from 100 through 600. n1

An important feature of the current organization of the rules is the addition of explanatory "comments." In the "comments" to a rule, the SEC explains the basis for the rule, describes the rule's rationale, references related rules, or provides information concerning pertinent Commission practice. The comments are designed to assist persons consulting the Rules in a more thorough understanding of the Rules. Because the SEC stated that comments are not rules, it appears that the Commission would not consider a comment to be binding. n2 Nonetheless, comments are likely

to be influential in guiding the application of the rules.

Comment

Persons appearing before the Commission in connection with any proceeding should consult the comments in addition to the text of any rule. The comments were not included in the Code of Federal Regulations, but may be found in the adopting release. n3

The current numbering has complicated research concerning precedents established under the old rules. For example, the current numbering system transformed Rule 2(e) into Rule 102(e). The rules are accompanied, however, by cross-reference tables, which list where provisions of the former rules were recodified in the current rules.

In addition, as recommended by the task force, the SEC publishes initial administrative law judge ("ALJ") decisions, as well as significant procedural orders. These decisions provide additional guidance concerning the Commission's administrative process. n4

FOOTNOTES:

(n1)Footnote 1. SEC Rules of Practice, available at www.sec.gov. In addition to improving the ease of use of the SEC Rules of Practice, the current numbering system was intended to provide the Commission with greater flexibility when future amendments and additions to the rules occur.

(n2)Footnote 2. *But see Stinson v. United States*, 508 U.S. 36 (1993) (commentary in Federal Sentencing Guidelines manual that interprets or explains guideline is authoritative unless it violates United States Constitution or federal statute or is inconsistent with or is a plainly erroneous reading of that guideline).

(n3)Footnote 3. *Exchange Act Release No. 35,833*, 1995 SEC LEXIS 1505, Rules of Practice -- Rule Adoptions and Amendments, Securities and Exchange Commission, [1995 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 85,627* (June 9, 1995).

(n4)Footnote 4. In August 1992, the SEC published approximately 400 orders it and administrative law judges issued between 1964 and 1992, 1995 SEC LEXIS 1505, 52 SEC Docket (CCH) 3 (Aug. 18, 1992). Assembled by the Task Force on Administrative Proceedings of the United States Securities and Exchange Commission, these previously unpublished orders concern interpretations of the former rules of practice or other procedural issues. Beginning in September 1992, initial decisions and procedural orders designated for publication by the ALJs were published in the *SEC Docket* as soon as they were issued. Decisions and orders issued from 1996 forward are also available at the Commission's website at www.sec.gov. All procedural orders and initial decisions published by the Commission in the *SEC Docket* are available on LEXIS.



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CHAPTER 19 SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

1-19 Securities Enforcement: Counseling and Defense § 19.03

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§ 19.03 Overview of the Administrative Hearing Process

Administrative proceedings can be viewed as having four major phases:

- from institution to hearing before an ALJ;
- from hearing through issuance of the ALJ's initial decision;
- from issuance of the initial decision to appeal to the Commission; and
- from the Commission decision on appeal to review by a court of the Commission order, if the Staff prevailed on the appeal to the Commission.

In addition, there may be a remedial phase, in which an ALJ or the Commission will oversee payment of disgorgement or the completion of other steps ordered to "effect compliance." There may also be a preliminary relief phase, in which proceedings are held to determine whether to enter a temporary cease-and-desist order or temporary suspension prior to the hearing on the need for a permanent sanction.



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CHAPTER 19 SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

1-19 Securities Enforcement: Counseling and Defense § 19.04

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§ 19.04 The Phase from Institution to a Hearing Order Instituting Proceedings

[1] Order Instituting Proceedings

The Commission initiates an administrative enforcement proceeding by issuing an order instituting administrative proceedings ("OIP"). The respondent will usually have advance notice of the institution of the proceedings. In addition to the notice received as part of the Wells process, the Staff will usually notify the prospective defendant when the SEC has authorized it to bring the enforcement proceeding and enter into settlement discussions.

Comment

Practice varies as to whether the Staff will notify the respondent when the order instituting the proceedings is about to be issued. n1

The OIP typically sets forth the basis for the proceedings, describes the issues to be considered, and sets forth the relief sought. n2 The SEC Rules of Practice provide that an administrative proceeding can be heard by the Commission, or by a hearing officer duly designated by the Commission. n3 In virtually all cases, the OIP specifies that the case is being assigned to an ALJ.

The Commission has five ALJs on its Staff. Each of the ALJs served as a law judge at another agency before transferring to the SEC Staff. None were on the Staff in any capacity or had practiced securities law extensively prior to becoming an ALJ.

From at least 1964 through 1994, a majority of the Commission's ALJs had been members of the Staff prior to becoming ALJs. Prior service on the Staff provided a high degree of expert knowledge as to the securities laws and the securities industry.

Comment

The implications of the change in the ALJs' securities law background could prove to be meaningful to practitioners. It positions respondent's counsel on a more level playing field with the Division Staff, and

offers respondent's counsel a better opportunity to inform the ALJ about the norms and practices of the securities industry.

Some observers believed, however, that ALJs who had themselves been on the Staff would be unable to shed their former allegiance and would tend to be sympathetic to or even biased to the Staff's positions. New ALJs are recommended by the Chief Administrative Law Judge pursuant to guidelines established by the Office of Personnel Management.

The role of an ALJ is more narrowly defined than that of a federal district court judge. The ALJ's primary responsibility is "to develop factual records in matters requiring consideration of technical expertise, as opposed to common judgement; discern facts; and make fair and impartial decisions based on those facts." n4 ALJs typically focus on developing a factual record rather than disposing of a case on matters of law. Furthermore, the Commission clearly discourages motions addressing legal issues, especially when such motions are based on evidentiary matters. n5 In fact, the Rules of Practice clearly disfavor such motions. n6 Although the order is issued in the Commission's name, it is drafted by the trial attorneys in the Division of Enforcement, who will be responsible for litigating the case, and then circulated to the Commission for approval.

Historically, the Division usually brought trial attorneys into a matter only after a Wells notice has been given, and it was apparent the matter probably would not be settled. Accordingly, the Staff's legal theories often changed between the authorization of an action and the issuance of an order instituting proceedings. For these reasons, and because of competing priorities, a significant amount of time sometimes elapsed between the SEC's decision to authorize the enforcement proceeding and the issuance of the order.

On June 11, 2003, the SEC amended its Rules of Practice in order to improve the timeliness of its administrative proceedings. n7 The amendments include a requirement that the Commission include in each OIP a maximum time period for completion by the ALJ of the initial decision of the proceeding. n8 The Rules of Practice now specify that the Commission in its discretion and after consideration of the nature, complexity, and urgency of the subject matter, and with due regard for the public interest and protection of investors, shall set a time period of 120, 210, or 300 days from the date of service of the OIP. n9 The Rules also specify the amount of time between service of the OIP and the hearing:

Under the 300-day timeline, the hearing officer shall issue an order providing that there shall be approximately 4 months from the order instituting the proceeding to the hearing, approximately 2 months for the parties to obtain the transcript and submit briefs, and approximately 4 months after briefing for the hearing officer to issue an initial decision. Under the 210-day timeline, the hearing officer shall issue an order providing that there shall be approximately 2 1/2 months from the order instituting the proceeding to the hearing, approximately 2 months for the parties to review the transcript and submit briefs, and approximately 2 1/2 months after briefing for the hearing officer to issue an initial decision. Under the 120-day timeline, the hearing officer shall issue an order providing that there shall be approximately 1 month from the order instituting the proceeding to the hearing, approximately 2 months for the parties to review the transcript and submit briefs, and approximately 1 month after briefing for the hearing officer to issue an initial decision. These deadlines confer no substantive rights on respondents. n10

As provided in Rule 360(a)(3), if during the proceeding the presiding hearing officer were to decide that the proceeding could not be concluded in the time specified, the hearing officer could request an extension of the stated deadline. To obtain an extension, the hearing officer must first consult with the Chief ALJ. If the Chief ALJ concurs in the need for an extension, the Chief ALJ must file a motion with the Commission on behalf of the hearing officer explaining why circumstances require an extension and specifying the length of the extension. An extension can be granted by the Commission, in its discretion, on the basis of the motion filed by the Chief ALJ. Parties to the proceeding would be provided copies of the motion and could separately or jointly file in support of or in opposition of the request. Any such

motion by the Chief ALJ must be filed no later than thirty days prior to the expiration of the time period specified in the order instituting proceedings.

To complement this new procedure, the Commission amended Rule 161 to state explicitly a policy of strongly disfavoring extensions, postponements or adjournments "except in circumstances where the requesting party has a strong showing that the denial of the request or motion would substantially prejudice their case." n11 This amendment to Rule 161 effected significant change in administrative cease-and-desist proceedings. Section 21C(b) of the Securities Exchange Act of 1934 (and parallel provisions in the other Federal securities laws) requires that the notice instituting proceedings "shall fix a hearing date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served." n12 Under prior practice, parties routinely requested extensions of the 60-day deadline, and the hearing officers routinely granted such requests. The amendment exempts from the policy of strongly disfavoring such requests, proceedings for which this would typically be the case under both the 300-day and 210-day timelines articulated in new Rule 360(a)(2).

Comment

Once the order has been entered by the Secretary of the Commission, *ex parte* contacts between the Division and the Commission concerning the case are permitted only in rare circumstances. n13

It is the Commission's practice to make copies of an order instituting proceedings, and sometimes a press release, available on its website and to distribute them to the press and wire services. According, the issuance of the order sometimes generates media coverage.

[2] Service of the Order Instituting Proceedings

The rules provide that

- (1) Whenever an order instituting proceedings is issued by the Commission, appropriate notice thereof shall be given to each party to the proceeding by the Secretary or another duly designated officer of the Commission;
- (2) Each party must be given notice of any hearing within a time reasonable in light of the circumstances, in advance of the hearing; n14 and
- (3) Unless otherwise ordered by the Commission, notice of any public hearing shall be given general circulation by release to the public. n15

The service of orders instituting proceedings is governed by Rule 141. Service of the order may be made by "[t]he Secretary, or another duly authorized officer of the Commission." n16 The Secretary may direct the Division of Enforcement to assist in making service, for example, by directing a Division Staff member personally to serve the respondent. The Rule provides for a waiver of the formalities of service, which permits the Secretary, upon the agreement of the respondent, to provide a copy of the order by first class mail, or other reliable means.

Furthermore, Rule 141 explicitly provides for service on corporations or entities by service upon "an officer, managing or general agent, or any other agent authorized by appointment or by law to receive such notice." n17 This provision clarifies the Secretary's authority to serve an agent designated for service of process under state law.

Rule 141 includes a separate provision for service upon persons registered with the Commission. The Secretary of the Commission is authorized to serve such persons by sending the order by certified, registered, or Express Mail to the most recent address shown on the person's registration form, and obtaining a confirmation of attempted delivery.

Persons who are registered with the SEC are obligated to promptly notify it of any change in their address. In addition, FINRA's Form U-4, which is used to register broker-dealer registered representatives, purports to make a registered representative amenable to service in Commission proceedings through the agent for service of process appointed when the Form U-4 is submitted by the representative's employer.

[3] Initial Scheduling Order

The secretary of the Commission formally notifies the ALJs of the institution of an administrative proceeding by sending a copy of the order instituting the proceeding. Upon receipt of the order, the chief ALJ assigns the case to himself or herself or one of the other ALJs, and issues an order reflecting this fact.

Under the current rules, unless otherwise ordered, a respondent is allowed 20 days to answer an order instituting proceedings, n18 and is entitled access to investigation documents only 7 days after service of the order instituting proceedings. n19 The hearing can be held at the Commission's offices in Washington, or at a location convenient for the parties and witnesses. n20 The place of hearing, and whether there will need to be hearings in more than one city, is usually decided by the ALJ after each side identifies the witnesses to be called at the hearing.

[4] Filing of an Answer and Motion for More Definite Statement

Under SEC Rule of Practice 220(a), a respondent must file an answer only if such a filing is required by the order instituting proceedings. The form of the order used in enforcement proceedings requires the respondent to file an answer to its allegations.

Rule 220(c) requires that

[u]nless otherwise directed by the hearing officer or the Commission, an answer shall specifically admit, deny, or state that the party does not have, and is unable to obtain, sufficient information to admit or deny each allegation in the order instituting proceedings. When a party intends in good faith to deny only a part of an allegation, the party shall specify so much of it as is true and shall deny only the remainder. A statement of a lack of information shall have the effect of a denial... . Any allegation not denied shall be deemed admitted. n21

Under Rule 220(b), a respondent required to file an answer must file it within 20 days after the date of service of the order instituting proceedings. n22 The rules require that "[a] defense of res judicata, statute of limitations or any other matter constituting an affirmative defense shall be asserted in the answer." n23 Prior to 1995, they did not require that affirmative defenses be asserted in the answer. n24

As a corollary to the requirement to plead affirmative defenses, the rules allow amendment of an answer by consent of all parties or by leave of the Commission or hearing officer and specify that leave to amend "shall be freely granted when justice so requires." n25 There is a strong argument that such leave should be literally granted to respondents given that the respondent will not gain access to investigation file documents until seven days after the OIP is served and may not have been able to review the file before filing the answer. Rule 220(f) provides that if an answer is not filed within the time provided, the respondent may be deemed in default. n26

Pursuant to Rule 220(d), a respondent may file a motion for a more definite statement with an answer. The rule provides that "[s]uch motion shall state the respects in which, and the reasons why, each such matter of fact or law should be required to be made more definite." n27

[5] Notice of Appearance or Withdrawal

SEC Rule of Practice 102 governs appearance and practice before the Commission. Under the Rule, the respondent's

attorney, or, if the respondent is appearing *pro se*, the respondent himself or herself, must file a notice of appearance prior to, or at the time of, making the first filing or otherwise appearing in a case. Ordinarily, this means a notice of appearance must precede or accompany the filing of an answer. The notice must include an address and telephone number, and the notice must be kept current. In a significant change from the prior rules, an individual appearing in a representative capacity may withdraw only by order of the SEC or hearing officer.

[6] Availability of Investigation-Related Documents for Inspection and Copying

When the SEC Rules of Practice were being drafted, the Division of Enforcement opposed giving the parties broad discovery rights on the grounds that broad discovery might result in inappropriate delay and undue expense. With certain exceptions noted below, the scope of discovery permitted by the current rules is largely limited to requirements that the Division turn over certain documents to respondents prior to the evidentiary hearing. The rules do not provide for interrogatories or discovery depositions.

Comment

Members of the defense bar have long argued that, especially given the severity of the sanctions that can be imposed in administrative proceedings, the lack of such broad discovery is unfair to the respondent in light of the power of the Commission to take extensive discovery during the investigation preceding the enforcement proceeding.

In asserting that only limited discovery is appropriate, the Division has noted that only such discovery is available to defendants in criminal trials. Of course, in such trials, the defendant is entitled to a number of protections not available to respondents in SEC administrative proceedings. Most notably, in criminal cases no adverse inference can be drawn for the assertion of the *Fifth Amendment* right against self-incrimination, and the government has the burden of proving its case beyond a reasonable doubt.

There are several avenues by which a respondent in an instituted proceeding is able to obtain documentary materials from the Commission concerning his or her case. As revised in 1995, the SEC Rules of Practice codify the previous practices followed by a majority of the Staff to make available major portions of the investigative file to respondents for inspection and copying. n28 The codification of these practices is set forth in Rule 230, which governs the availability of documents for inspection and copying without demand by the respondent. On June 11, 2003, the Commission amended Rule 230 to require the Staff to make the investigative record more available for inspection seven days after service of the OIP. n29

In addition, the Staff, in accord with the principles of the Jencks Act, n30 makes available documents that could be used to impeach a trial witness. n31 Under the *Brady v. Maryland* doctrine, n32 the Staff also makes available documents containing exculpatory material. Respondents are also able to seek documents pursuant to subpoenas issued by the ALJs. n33 Although often not either necessary or useful as a source of information that would be relevant in most administrative proceedings, a respondent could, depending upon the nature of the information sought, make a request for documents under the Freedom of Information Act. n34

Under Rule 230(a), the respondent does not need to make a formal request for access through the hearing officer; the right of a respondent to inspect and copy documents is automatic. Under Rule 230(f), the Staff must give the respondent access to the documents at the Commission's offices or at such other place as the parties may agree during normal business hours for copying of documents at the respondent's expense. Unless otherwise ordered, charges for copies made by the Staff at the request of the respondent should be charged at the rate set forth in the fee schedule at *17 C.F.R. § 200.80(e)* as noted in Rule 230(f). n35

Rule 230(a) provides that the Staff shall make available for inspection and copying by any party:

- documents
- obtained by the Division of Enforcement
- prior to the institution of proceedings
- in connection with the investigation leading to the Division's recommendation to institute proceedings.

The term "documents" is defined in the rule, and includes information stored in computers. Information obtained by the Staff is usually in paper format. In some instances, though, a witness will produce computer diskettes or compact disks, or the Staff will obtain market surveillance data that is transmitted by modem and stored in a computer.

The rule applies to documents obtained by the Division of Enforcement. Documents in the files of other Divisions or Offices, which are not forwarded to or "obtained" by the Division of Enforcement, are outside the terms of the rule. n36 While the Staff has no obligation to seek out documents for the respondent's benefit under Rule 230(a), a respondent may seek such documents through a request for a subpoena or other means. n37 In addition, the SEC Rules of Practice do not define the term "obtain." Accordingly, it is arguable whether the term would include the review of documents, even if the Division never made copies of the documents or took the documents to its offices.

Although Rule 230(a) refers generally to the Staff's obligation to provide access to documents "obtained" by the Division of Enforcement, three of the six specific categories of documents that the rule requires to be made available cover documents that the Staff itself creates. The six categories are:

- (i) each subpoena issued;
- (ii) every other written request to persons not employed by the Commission to provide documents or to be interviewed;
- (iii) the documents turned over in response to any such subpoenas or other written requests;
- (iv) all transcripts and transcript exhibits;
- (v) any other documents obtained from persons not employed by the Commission; and
- (vi) any final examination or inspection reports prepared by the Office of Compliance Inspections and Examinations, the Division of Market Regulation, or the Division of Investment Management.

[a] Subpoenas

This category of documents is useful to respondents primarily as a method of evaluating the documents that the Division of Enforcement received during the investigation. It is not unusual for the Division to modify subpoenas. Such modifications are often reflected in correspondence between the Division and the recipient of the subpoena. Counsel to the respondent should confirm that such correspondence has been turned over by the Division.

[b] Other Written Requests

During formal investigations, the Division of Enforcement usually uses subpoenas to obtain documents from witnesses.

The Division uses written requests other than subpoenas primarily during information inquiries (before the issuance of the Formal Order by which the SEC authorizes the Division to issue subpoenas) when seeking documents from regulated entities pursuant to the Commission's examination powers (for example, the "blue sheet" requests to securities broker-dealers seeking trading information) and when the Commission seeks cooperation from other agencies. Before making these materials available to respondents, the Staff may evaluate them in order to determine whether the materials can be withheld based on a claim of privilege.

[c] Documents Turned Over to the Division in Response to a Subpoena or Written Request

This category often covers a large quantity of documents. The documents produced to the Staff in response to its subpoenas and requests are often stored together based on the identity of the witness who produced them to the Staff, and are usually stamped with a request for confidentiality that identifies the source of the document. In addition, documents are usually produced to the SEC accompanied by transmittal letters that contain useful information. For example, such correspondence might reflect the negotiated scope of the subpoena or the source(s) of the documents produced.

The document storage facilities available to the Staff often have limitations. Facilities may be overcrowded and documents may be moved without knowledge of the Staff member responsible for an investigation. Moreover, documents may be misplaced by Staff members during or after the investigation. To the extent possible, a respondent should therefore assess the documents made available for inspection for the purpose of determining whether documents are missing from the set turned over by the Staff.

In addition, the Staff might have obtained documents in electronic form. For example, in a matter involving securities transactions, the Staff might have obtained electronic trading data from securities broker-dealers in response to blue sheet requests. Respondent's counsel should be prepared to address whether to seek such material in electronic form or to seek printouts of such materials.

The Division is likely to evaluate documents obtained from other government agencies to determine whether they can be withheld based on a claim of privilege. Respondent's counsel should confirm that the Staff has turned over all draft and finalized affidavits and declarations.

[d] Transcripts and Transcript Exhibits

Transcripts of testimony are often of great importance in defending an enforcement proceeding. Moreover, the key documents in an investigation will usually be marked as exhibits to testimony transcripts. Accordingly, respondent's counsel should consider requesting that this category of documents be among those first turned over by the Staff.

Comment

Respondents have a strong argument that testimony transcripts and exhibits should be among the documents produced the most promptly in that they are often kept by the Staff attorneys themselves and will have been reviewed in preparing the order instituting proceedings.

The Staff is likely to take the position that its notes of interviews are excluded from production under Rule 230(b)(1)(ii). Staff interview notes may, however, be made available to a respondent under other provisions.

[e] Other Documents Obtained from Persons Not Employed by the SEC

This category is a "catch-all" provision and includes, among other possible items, documents that may have been obtained from persons who were interviewed, but whose statement was not transcribed on the record.

Respondent's counsel should request a list of any witnesses whom the Staff interviewed, but whose statements are not being provided to the respondent. Although Rule 230(a) does not explicitly require the Staff to turn over this information, a respondent may ask an ALJ to order that it provide such names. n38 A strong argument can be made that such identification of witnesses would further the purpose of Rule 230(a), which is to provide respondents with access to all non-privileged information gathered from third parties during the investigation. No public policy would be served by permitting the Staff to conceal the identity of a witness interviewed during the investigatory phase simply by avoiding the creation of any documents reflecting the interview.

This category includes Wells statements and offers of settlement that are not accepted. The Commission has argued that a Wells statement is not protected by either the work-product doctrine or attorney-client privilege. n39 The Staff therefore takes the position that, in general, a Wells statement constitutes admissible evidence. n40 Accordingly, it should ordinarily make available to the respondent each Wells statement submitted in the investigation. In addition, the Staff will make available written offers of settlement submitted by potential defendants and respondents, even if such offers are, by their terms, not admissible.

[f] Final Examination or Inspection Reports

Rule 230(a)(1)(iv) requires the Staff to make available "any final examination or inspection reports prepared by the Office of Compliance Inspections and Examinations, the Division of Market Regulation, or the Division of Investment Management." This requirement is a departure from the general standard of Rule 230(a), which requires the Staff to make available only those documents, such as subpoenas, which were already sent to third parties, and therefore could not be subject to a claim of attorney-client privilege or work-product protection.

Other than in litigation, the SEC resists turning over final inspection reports, citing, among other reasons, the need to protect the confidentiality of the "internal staff reviewing procedures, techniques and strategies" and to encourage candor by regulated entities to the inspections Staff. n41 The comment to Rule 230(a), states that the Commission does not believe final inspection reports should routinely be made public:

[t]he Commission has determined as a general matter that these final reports will be made available, but only to named respondents in Commission-initiated adjudicative proceedings. This rule does not restrict the Commission's ability to withhold these reports from public disclosure in other contexts, such as pursuant to a request under the Freedom of Information Act. 5 *U.S.C.S.* § 552. n42

Comment

In light of the SEC's concern regarding confidentiality of final examination reports, it is likely that before the Staff turns over such a report pursuant to Rule 230(a), it will seek a protective order limiting disclosure of the report to non-parties. n43 It is also likely that the Staff will resist production of any documents underlying the final inspection report on the grounds that Rule 230(a) refers specifically only to the final report.

The turnover provision of Rule 230(a) applies to documents that the Staff obtained in connection with the investigation leading to the Division of Enforcement's recommendation to institute proceedings. It usually is clear which investigation led to the institution of the enforcement proceedings and which requests for documents and which testimony are associated with that investigation. Infrequently, a person is a witness or potential defendant in more than one investigation. Documents relating to a particular respondent that are obtained in connection with a different investigation arguably are not subject to the rule, unless the documents are transferred to or otherwise become a part of the investigation that led to the instant proceedings.

Comment

A strong argument can be made that materials obtained from the public in one investigation are covered by Rule 230(a) if they were considered in connection with the investigation that formally led to the institution of the enforcement proceeding.

Rule 230(a) covers documents obtained by the Division "prior to the institution of proceedings." Thus, the Rule covers documents obtained by the Staff during and after the Wells process. A strong argument can also be made that the Rule covers documents obtained during the period between the SEC's authorization to institute a proceeding and the order instituting such proceeding.

[7] Timing of the Respondent's Access to Documents under Rule 230(a)

SEC Rule of Practice 230(d) requires the Staff to "*commence* making documents available ... *no later* than 7 days after service of the order instituting proceedings." The Staff is not obligated to provide access to all documents by the 7th day, but only to "*commence*" making documents available.

Comment

Nevertheless, the policy behind Rule 230 indicates that the Staff should turn over documents as soon as practicable.

If the Staff and the respondents cannot agree on the pace at which the Staff provides access to documents, either party can raise the matter with the ALJ. In light of the Commission's guideline to the ALJs that proceedings be concluded, when feasible, within 7 months of the issuance of an order instituting proceedings, n44 a strong argument can be made in favor of prompt access to documents.

[8] Documents Withheld from the Respondent

There are four categories of documents that may be withheld by the Division of Enforcement even though they are covered by SEC Rules of Practice 230(b). Under Rule 230(b), a document may be withheld if

- (i) the document is privileged;
- (ii) the document is an internal memorandum, note or writing prepared by a Commission employee, other than a [final] examination or inspection report prepared by the Division of Market Regulation or the Division of Investment Management, or is otherwise attorney work-product and will not be offered in evidence;
- (iii) the document would disclose the identity of a confidential source; or
- (iv) the hearing officer grants leave to withhold a document or category of documents as not relevant to the subject matter of the proceeding or otherwise, for good cause shown.

There are a number of mechanisms by which a respondent might be able to obtain production of documents that Rules 230(b) exempts from the automatic pretrial disclosure process established by Rule 230(a). Rule 230(b) states that nothing in the rule "authorizes the Division of Enforcement in connection with an enforcement or disciplinary proceeding to withhold, contrary to the doctrine of *Brady v. Maryland*, n45 documents that contain material exculpatory evidence." In addition, Rule 230(a) states that nothing in it "shall limit the right of the Division to make available any other document, or shall limit the right of a respondent to seek access to or production pursuant to subpoena of any other document, or shall limit the authority of the hearing officer to order the production of any document pursuant to subpoena."

Rule 230(c) expressly authorizes the ALJ to require the Division of Enforcement to submit for review a list of documents withheld pursuant to Rule 230(b), or to submit any document withheld. Rule 230(c) also authorizes the ALJ to order the Division to make available for inspection and copying by a respondent documents withheld pursuant to Rule 230(b). n46

Rule 230(b) authorizes the Staff to seek permission to withhold nonprivileged, nonwork-product documents that would otherwise be subject to disclosure. Under this Rule, the Staff might seek to withhold documents that are technically part of a single investigative file, but that do not relate in any way to the allegations ultimately brought.

Rule 230(h) provides that "in the event a document required to be made available to a respondent pursuant to this rule is not made available by the [Enforcement Staff], no rehearing or rededication of a proceeding already heard or decided shall be required unless the respondent [establishes] that the failure to make the document available was not harmless error."

[9] Subpoenas for Documents

Pursuant to SEC Rule of Practice 232, any party may request from the hearing officer the issuance of "subpoenas requiring the production of documentary or other tangible evidence returnable at any designated time or place." n47 By allowing subpoenas that require the return of documents prior to hearing, Rule 232 represents an opportunity for both the respondent and the Staff to compel the production of documents that were not obtained during the investigation. n48

Under Rule 232, requests for issuance of a subpoena, unless made on the record at a hearing, must be in writing and served on each party. This requirement provides an opportunity for the other parties to object to the issuance of the subpoena. Moreover, the rules require the ALJ to scrutinize each request, regardless of whether a party challenges the requested issuance of a subpoena:

Where it appears to the person asked to issue the subpoena that the subpoena sought may be unreasonable, oppressive, excessive in scope, or unduly burdensome, he or she may, in his or her discretion, as a condition precedent to the issuance of the subpoena, require the person seeking the subpoena to show the general relevance and reasonable scope of the testimony or other evidence sought. If after consideration of all the circumstances, the person requested to issue the subpoena determines that the subpoena or any of its terms is unreasonable, oppressive, excessive in scope, or unduly burdensome, he or she may refuse to issue the subpoena, or issue it only upon such conditions as fairness requires.

Subpoenas issued under Rule 232 may be directed either to third persons or parties to the proceeding.

In addition, the ALJ may order a party to comply with a request for documents without resorting to the formality of issuing a subpoena. n49 In general, interlocutory review of interim procedural orders, including orders requiring persons other than SEC personnel to produce documents, is not favored. Rule 400, nevertheless, provides that an ALJ may certify for interlocutory review any ruling that "would compel testimony of Commission members, officers or employees or the production of documentary evidence in their custody." n50

ALJs are liberal in issuing subpoenas for arguably relevant documents. First, in providing that the ALJ must issue the subpoena unless he or she finds that it is "unreasonable, oppressive, excessive in scope, or unduly burdensome," the rule arguably creates a presumption in favor of issuance. Second, as a practical matter, in that the ALJ will often have to rule on the request for a subpoena early in the course of the proceeding, it will frequently be difficult to determine whether a subpoena is unreasonable, oppressive, excessive in scope or unduly burdensome. Third, some ALJs might be influenced by the fact that refusal to issue a subpoena, particularly if requested by a respondent, may ultimately become grounds for an appeal if the respondent loses. In contrast, the issuance of a subpoena will rarely, if ever, afford grounds for an appeal.

On the other hand, the Staff may oppose certain subpoena requests on the grounds that granting the issuance of the subpoena could cause inappropriate delays in the administrative proceeding. n51 In addition to the factors explicitly set forth in Rule 232, the ALJ is likely to evaluate subpoena requests in light of his or her obligation to manage the prehearing process n52 and to complete proceedings in a timely manner. n53

Comment

One significant weakness in the current SEC Rules of Practice relates to the enforcement of subpoenas.

By statute, SEC subpoenas are enforced by the federal courts. As currently drafted, Commission rules and regulations provide for the Staff to seek enforcement in court. Thus, it is possible that the Staff, rather than respondent's counsel, will have control over the manner and extent to which enforcement of a subpoena is sought, even if it was issued at the request of the respondent. In appropriate circumstances, respondent's counsel should attempt to persuade the Commission to authorize counsel to make the argument in favor of enforcement of the subpoena. Alternatively, the respondent might be able to intervene in the subpoena enforcement action. Given the short period between service of the OIP and commencement of the hearing, it is unclear how discovery disputes can be resolved before the hearing concludes.

[10] Prehearing Conferences

The purposes of prehearing conferences include:

- "expediting the disposition of the proceeding,
- establishing early and continuing control of the proceeding by the hearing officer, and
- improving the quality of the hearing through more thorough preparation." n54

A prehearing conference must be held within 14 days of the service of an answer, unless the emergency nature of the proceeding makes such a conference "clearly inappropriate." n55 A prehearing conference is to be held as close to the start of the hearing as reasonable under the circumstances. n56 In addition, the ALJ is authorized to hold other prehearing conferences. n57

SEC Rule of Practice 221 provides considerable flexibility with respect to the format of the prehearing conferences. Conferences may be held with or without the hearing officer as he or she deems appropriate. n58 Conferences may be held with one or more persons participating by telephone. n59

Rule 222 authorizes the ALJ, on his or her own motion, or at the request of a party or other participant, to order any party, including the interested Division, to make a prehearing submission furnishing such information as deemed appropriate. Such information may include an outline or narrative summary of the party's case or defense; the legal theories upon which the party will rely; copies and a list of documents that the party intends to introduce at the hearing and the identity of witnesses who will testify on the party's behalf, including the witnesses' names, occupations, addresses, and a brief summary of their expected testimony. n60

Respondent's counsel should view the initial prehearing conference as an important opportunity to bring to the attention of the ALJ any issues relating to the Staff's turning over of documents pursuant to Rule 230. The timing of the initial prehearing conference dovetails with the requirement that the Staff make available investigative documents under Rule 230 within the 7 day period after filing the order instituting proceedings.

[11] Dispositive Motions

SEC Rule of Practice 250 authorizes the filing of motions for summary disposition prior to the hearing under certain circumstances. In the comment to Rule 250, the Commission noted that motions for summary disposition prior to the hearing would rarely be appropriate in an administrative enforcement proceeding. The SEC explained that, in light of the review process that precedes filing of an order instituting proceedings, "[t]ypically, Commission proceedings that reach litigation involve basic disagreement as to material facts. Based on past experience, the circumstances when summary disposition prior to hearing could be appropriately sought or granted will be comparatively rare." n61 Indeed, even in circumstances where the question presented is purely a matter of law, the Commission disfavors the use of summary disposition. n62

[a] Standard for Granting a Motion

For the purpose of a motion for summary disposition, the facts alleged in the pleadings of the party against whom the motion is made shall be taken as true, except as modified by stipulations or admissions made by that party, by uncontested affidavits, or by facts officially noted. An ALJ may grant a motion for summary disposition "if there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law." n63

Extensive prehearing discovery is not contemplated under Rule 250. "Nothing in Rule 250 should be construed to create a right to prehearing depositions or other discovery not otherwise provided for by the rules in order to support or oppose such a motion." n64 The rule provides that if it appears that a party, for good cause shown, cannot present (by affidavit) prior to the hearing facts essential to justify opposition to the motion, the ALJ shall deny or defer the motion. n65 Because a respondent is not authorized to take depositions and cross-examine witnesses prior to the hearing, this provision should effectively protect against the possibility that the Staff might obtain a summary disposition based on investigative testimony taken without the respondent being present and with which the respondent disagrees.

Comment

However, in light of the Staff's power to take investigative testimony, a strong argument can be made that the protection provided to the Staff by this provision is much more limited.

[b] Procedure

Rule 250 provides that a motion for summary disposition may be made only after a respondent has been given access to the Staff's investigative documents for inspection and copying pursuant to Rule 230. n66 There is a 35-page limit on the motion and any supporting documents. n67 Significantly, if the Division of Enforcement has not completed presentation of its case in chief, a motion for summary disposition may be made only with leave of the hearing officer. The SEC commented that "leave shall be granted only for good cause shown, and if consideration of the motion will not delay the scheduled start of the hearing." n68

Rule 250 can provide an important mechanism for the efficient disposition of cases, or portions of cases in certain circumstances. For example, a motion for summary disposition can be appropriate if the Commission instituted proceedings based on overlooked or misapprehended evidence, and the respondent is able to present a fuller view of the facts after having obtained access to the investigative record. Such a motion may also be appropriate if the respondent disputes the Commission's authority or jurisdiction. Partial summary disposition may also be appropriate if the doctrine of res judicata bars either the Commission or the respondent from contesting the facts.

[12] Miscellaneous Rules Governing Motions and Other Filings

[a] Motions

Procedural requirements governing motions are set forth in SEC Rule of Practice 154. The Rule provides that a motion be made in writing unless it is made during a hearing or conference. n69 Rule 154 provides that a brief in support of or in opposition to a motion may not exceed 15 pages and that requests for leave to file briefs in excess of 15 pages are disfavored. n70 An original and three copies of motions and all other papers shall be filed. n71

[b] Signature Requirement and Effect

Rule 153 serves as a partial counterpart to *Rule 11 of the Federal Rules of Civil Procedure*. Rule 153 provides that "[f]ollowing the issuance of an order instituting proceedings, every filing of a party represented by counsel shall be signed by at least one counsel of record in his or her name..." n72 The Rule provides that the signature constitutes a certification that the signer has read the filing, reasonably believes that it is grounded in fact and filed in good faith, and is not made for any improper purpose. n73 Rule 153 also provides that if a filing is not signed, then the ALJ may strike it unless it is signed promptly after the omission is called to the attention of the person who made the filing. n74 If it is determined that the signing does not comply with Rule 153, then the person(s) signing the filing is subject to the same sanctions available against persons making any other deficient filing. n75

[c] Filing of Papers; Record Index

Rule 151 provides that all papers required to be served on a party must be filed with the Office of the Secretary, unless otherwise ordered by the ALJ. The comment to the rule explains that "[s]ince hearing officers frequently preside at locations away from the Commission's Headquarters in Washington, D.C., persons are permitted to make filings with the hearing officer, who can then forward the filings to the Secretary." n76

The Office of the Secretary serves only some of the functions of a clerk's office in a federal court. Persons filing papers with the Office of the Secretary are required to provide a copy of the filing to the ALJ as well. n77 After the hearing, the Secretary prepares an index of the record and serves a copy of the record index on each party. n78 Respondent's counsel should carefully review the record index in order to confirm whether it properly reflects all filings, transcripts, and exhibits. The parties have 15 days from service of the index to file proposed corrections with the hearing officer. n79

[d] Service of Papers Filed by the Parties

Rule 150 authorizes service of papers by overnight delivery service and (under certain circumstances) facsimile transmission, as well as by mail or personal service.

[13] Offers of Settlement

A substantial percentage of cases settle after institution of proceedings, but prior to hearing. Rule 240 sets forth procedures for making a settlement offer. Under the rule, a person may propose to the applicable Division, at any time during the course of the proceedings, a written offer of settlement. n80

Rule 240 provides that offers of settlement should be signed by the person making the offer, not by counsel, and should be submitted to the interested Division. n81 Significant negotiation with the Staff is usually necessary so that a settlement offer can be drafted that both the respondent and the Staff consider acceptable. The Staff, however, does not have the power to bind the SEC to a settlement. The Division of Enforcement is authorized to present the offer to the Commission with its recommendation. n82 All settlements are subject to the approval of the Commission.

Comment

It is very rare for the SEC to accept a settlement that is opposed by the Division. Accordingly, Rule 240(c) provides that the Division must inform the respondent if it plans to oppose a settlement offer, and shall not present the offer unless the party making the offer so requests.

Rule 240(c) authorizes the ALJ, upon the request of the parties, to express his or her views regarding the appropriateness of a settlement offer. It specifies that such a request waives any right to claim prejudgment by the ALJ based on his or her view. n83 Although rarely used, this process might sometimes facilitate settlement by providing a neutral assessment regarding the likely outcome of the proceedings.

Settlement offers submitted to the Commission are subject to review by the Office of the General Counsel and any Division or Office interested in the subject matter of the proceedings. For example, the Office of the Chief Accountant will ordinarily review proposed orders addressing matters relating to accountants.

If the SEC rejects the settlement offer, then the respondent is notified of the rejection, the settlement offer is deemed withdrawn, and any documents relating thereto are deemed not to constitute a part of the record. n84

Due to the lengthy, uphill nature of an administrative proceeding, the prospect of settlement is very tempting to a respondent. Despite this temptation, respondents and practitioners alike should keep in mind that the Commission has become increasingly aggressive in demanding more severe settlement terms; thus, respondents have more incentive to litigate. A respondent who decides to litigate may be assigned to an ALJ whose interpretation of the respondent's case may lead to a lighter sanction than the sanctions proposed by the Division Staff.

In its June 11, 2003 release amending the SEC Rules of Practice to provide for rapid resolution of administrative proceedings, the Commission provided a limited exception for settlement offers:

Staff have been instructed to adopt new procedures to ensure that settlement negotiations do not delay the hearing process. These procedures are consistent with those described in Rule 161(c)(2). Under that rule, if the Commission Staff and one or more respondents in the proceeding file a joint motion notifying the hearing officer that they have agreed in principle to a settlement on all major terms, then the hearing officer shall stay the proceeding as to the settling respondent(s), or in the discretion of the hearing officer as to all respondents, pending completion of Commission consideration of the settlement offer. Any such stay will be contingent upon: (1) the settling respondent(s) submitting to the Commission Staff, within fifteen business days of the stay, a signed offer of settlement in conformance with Rule 240, and (2) within twenty business days of receipt of the signed offer, the staff submitting the settlement offer and accompanying recommendation to the Commission for consideration. If the parties fail to meet either of these deadlines, or if the Commission rejects the offer of settlement, the hearing officer must be promptly notified and, upon notification of the hearing officer, the stay shall lapse and the proceeding will continue. n85

FOOTNOTES:

(n1)Footnote 1. Under certain circumstances, *ex parte* orders are authorized when a temporary cease-and-desist order is sought. *See, e.g.*, Exchange Act; 17 C.F.R. § 201.500 (*et seq.*), § 21C(c) and Rules 500 *et seq.*

(n2)Footnote 2. Rule 200(b), 17 C.F.R. § 201.200(b), provides that the order shall:

(1) state the nature of any hearing; (2) state the legal authority and jurisdiction under which the hearing is to be held; (3) contain a short and plain statement of the matters of fact and law to be considered and determined ...; and (4) state the nature of any relief or action sought or taken.

(n3)Footnote 3. Rule 110, 17 C.F.R. § 201.110 (2005) (specifying procedures when the hearing officer selected is an ALJ).

(n4)Footnote 4. GAO Rep.No. GAO/GGD-96-27, Administrative Law Judges -- Comparison of SEC and CFTC

Programs 10 (Nov. 14, 1995) at 7.

(n5)Footnote 5. *In re Melson, AP Ruling Release No. 404, Admin. Pro. File No. 3-7998, 1994 SEC LEXIS 263* (Jan. 21, 1994) (A motion to dismiss was remanded on the grounds that the adjudication of the "constitutional claim is inextricably intertwined with the evidentiary issues"). *See also In re Stuart-James Co., Admin. Pro. File No. 3-7164, 1990 SEC LEXIS 3793* (Dec. 19, 1990); *In re Carl I. Shipley, 1974 SEC LEXIS 3113, 45 S.E.C. 589, 591 n.4 (1974)*.

(n6)Footnote 6. Rule 250, *17 C.F.R. § 201.250*.

(n7)Footnote 7. Final Rule: Rule of Practice, File No. S7-04-03 (June 11, 2003).

(n8)Footnote 8. *17 C.F.R. § 201.360*.

(n9)Footnote 9. *17 C.F.R. § 201.360*.

(n10)Footnote 10. *17 C.F.R. § 201.360*. Inexplicably, the proposed timelines do not include time for an actual hearing.

(n11)Footnote 11. Rule 161(b)(1), *17 C.F.R. § 201.161(b)(1) (2005)*.

(n12)Footnote 12. *17 C.F.R. § 201.232 (2003)*.

(n13)Footnote 13. The SEC Rules of Practice contain regulations concerning *ex parte* contacts and the separation of prosecutorial and adjudicatory functions by the Staff. Under the current rules, the former informal practice of *ex parte* requests to an ALJ for issuance of a subpoena is no longer allowed *See* Rule 232 and Cmt. (a); *17 C.F.R. § 201.232 (2005)*.

(n14)Footnote 14. Rule 200(a)(1), *17 C.F.R. § 201.200(a)(1)*.

(n15)Footnote 15. Rule 200(e), *17 C.F.R. § 201.200(e)* (noting that such release entails publication "in the *SEC News Digest* and, where directed, by publication in the *Federal Register*"). The *SEC News Digest* is published electronically, and is available at the Commission's website at www.sec.gov.

(n16)Footnote 16. Rule 141(a), *17 C.F.R. § 201.141(a)*.

(n17)Footnote 17. Rule 141(a)(2)(ii), *17 C.F.R. § 201.141(a)(2)(ii)*.

(n18)Footnote 18. Rule 220, *17 C.F.R. § 201.220*.

(n19)Footnote 19. Rule 230, *17 C.F.R. § 201.230*.

(n20)Footnote 20. Rule 230, *17 C.F.R. § 201.230*. Typically, when a Commission hearing room is not available or convenient to the witness, the hearing will take place at another governmental facility.

(n21)Footnote 21. Rule 220(c), *17 C.F.R. § 201.220(c)*.

(n22)Footnote 22. Rule 220(b), *17 C.F.R. § 201.220(b)*. Under Rule 7(c), only 15 days were allowed to file an answer.

(n23)Footnote 23. Rule 220(c), *17 C.F.R. § 201.220(c)*.

(n24)Footnote 24. *See* former Rule 7(c).

(n25)Footnote 25. Rule 220(e), *17 C.F.R. § 201.220(e)*.

(n26)Footnote 26. Rule 220(f), 17 C.F.R. § 201.220(f).

(n27)Footnote 27. Rule 220(d), 17 C.F.R. § 201.220(d).

(n28)Footnote 28. See, e.g., *In re Parker, Admin. Pro. File No. 3-5052, 1997 SEC LEXIS 2753, 52 SEC Docket (CCH) P 266* (Jan. 19, 1977) (Order on Motions to Dismiss and for Production of Documents) (noting that the Division of Enforcement has made available for respondents' inspection all files compiled during the Staff investigation).

(n29)Footnote 29. Final Rule: *Rules of Practice, File No. S7-04-03, 2003 SEC LEXIS 1404* (June 11, 2003) .

(n30)Footnote 30. 18 U.S.C.S. § 3500. Although the Jencks Act is a statute which, by its terms, applies in criminal proceedings, the SEC has imported its basic principles to administrative proceedings.

(n31)Footnote 31. Rule 231, 17 C.F.R. § 201.231.

(n32)Footnote 32. *Brady v. Maryland, 373 U.S. 83 (1963)* .

(n33)Footnote 33. Rule 232, 17 C.F.R. § 201.232. See also former Rule 14.

(n34)Footnote 34. 5 U.S.C.S. § 552 (2005). See also 17 C.F.R. § 200 (2005) (the Commission's confidential treatment procedures under the Freedom of Information Act). Generally, because of a broad statutory exemption from disclosure of information obtained for law enforcement purposes, 5 U.S.C.S. § 552(b)(7) or because of the applicability of other exemptions, FOIA requests are not successful in providing access to information related to a pending enforcement matter. See, e.g., *In re Request of Anton and Hirsheimer for Access to Investigatory Records, FOIA Release No. 20 (July 22, 1975), 1975 SEC LEXIS 1175* (denying request and noting that the rules of practice permit respondents to subpoena documents).

(n35)Footnote 35. 17 C.F.R. § 200.80e.

(n36)Footnote 36. Rule 230, cmt. (a)(3), 17 C.F.R. § 201.230 (2005). ("The Division of Enforcement's obligation under this rule relates to documents obtained by the Division of Enforcement. Documents located only in the files of other Divisions or Offices are beyond the scope of the rule").

(n37)Footnote 37. See *In re Upton, Admin. Pro. File No. 3-7604, 1992 SEC LEXIS 2378, 52 SEC Docket (CCH) P 550* (Jan. 14, 1992) (Order Regarding Production of Documents) (under former rules, ALJ ordered the Division to request responsive documents from other Offices).

(n38)Footnote 38. See Rule 221(c)(13), 17 C.F.R. § 201.221(c)(13).

(n39)Footnote 39. See, e.g., *In re Steinhardt Partners, L.P., 9 F.3d 230 (2d Cir. 1993)* .

(n40)Footnote 40. But see, *In re Allied Stores, Admin. Pro. File No. 3-6869, 1988 SEC LEXIS 5247, 52 SEC Docket (CCH) P 451* (Mar. 21, 1988) (Order Affirming Denial of Admission of Respondent's Wells Submission) (Wells statement not admissible because, inter alia, it was submitted for purposes of settlement).

(n41)Footnote 41. See, e.g., *Berliner, Zisser, Walter & Gallegos, P.C. v. SEC, 962 F. Supp. 1348 (D. Colo. 1997)* .

(n42)Footnote 42. Rule 230 cmt. (a) (July 2003), 17 C.F.R. § 201.230 (2003), 60 Fed. Reg. 46498, 46499 (Sept. 7, 1995) .

(n43)Footnote 43. On at least one occasion an ALJ granted a protective order for a confidential examination report under the former rules, even though there was no explicit provision authorizing such protective orders. See *In re Bank of Boston Corp., Admin. Pro. File No. 3-8270, 1994 SEC LEXIS 1558, 56 SEC Docket (CCH) P 1573* (Apr. 19, 1994)

(allowing introduction of comptroller of the currency's confidential examination report).

(n44)Footnote 44. *See* Informal Procedures and Supplementary Information Concerning Adjudicatory Proceedings, Rule 900, *17 C.F.R. § 201.900*.

(n45)Footnote 45. *Brady v. Maryland*, 373 U.S. at 87 .

(n46)Footnote 46. Rule 230(c), *17 C.F.R. § 201.230(c)*.

(n47)Footnote 47. Rule 232, *17 C.F.R. § 201.232*.

(n48)Footnote 48. Division of Enforcement trial counsel, as well as respondents, are likely to avail themselves of this opportunity since counsel typically do not participate in gathering evidence during the investigation and may wish to obtain information that the investigating Staff did not seek.

Prehearing depositions may be taken only for the purpose of preserving testimony. A deposition to preserve testimony may be taken only if it appears likely that the prospective witness may be unable to attend or testify in person at the hearing, that his or her testimony will be material, and that taking his or her deposition will serve the interests of justice. Depositions are not permitted for the purpose of discovering in advance what a witness will testify to at hearing. *See* Rule 233(a), (b), *17 C.F.R. § 201.233(a), (b)*.

(n49)Footnote 49. *See, e.g., In re Upton, Admin. Pro. File No. 3-7604, 1992 SEC LEXIS 2378, 52 SEC Docket (CCH) P 550* (Jan. 14, 1992).

(n50)Footnote 50. Rule 400(c)(1), *17 C.F.R. § 201.400(c)(1)*.

(n51)Footnote 51. *See* Rule 232, revision cmt., *60 Fed. Reg. 32763 -65* (June 23, 1995).

(n52)Footnote 52. *See* Rule 221(a), *17 C.F.R. § 201.221(a)*.

(N53)Footnote 53. *See* Informal Procedures and Supplementary Information Concerning Adjudicatory Proceedings, Rule 900, *17 C.F.R. § 201.900 (1995)*.

(n54)Footnote 54. Rule 221(a), *17 C.F.R. § 201.221(a)*.

(n55)Footnote 55. Rule 221(d), *17 C.F.R. § 201.221(d)*.

(n56)Footnote 56. Rule 221(d), *17 C.F.R. § 201.221(d)*.

(n57)Footnote 57. Rule 221(b), *17 C.F.R. § 201.221(b)*.

(n58)Footnote 58. Rule 221(b), *17 C.F.R. § 201.221(b)*.

(n59)Footnote 59. Rule 221(b), *17 C.F.R. § 201.221(b)*.

(n60)Footnote 60. Rule 222(a), *17 C.F.R. § 201.222(a)*.

(n61)Footnote 61. Rule 250, cmt., *60 Fed. Reg. 32738 (1995)* . As the Commission noted, the greater utility of the summary disposition procedures may be in proceedings that deal with regulatory, instead of enforcement issues.

(n62)Footnote 62. *In re Jean-Paul Bolduc, Admin. Proc. File No. 3-9793, 2002 SEC LEXIS 2571, 78 SEC Docket 1698-32* (Oct. 9, 2002).

(n63)Footnote 63. Rule 250, *17 C.F.R. § 201.250 (2005)*.

(n64)Footnote 64. Rule 250, cmt., *60 Fed. Reg. 32738 (1995)* .

(n65)Footnote 65. Rule 250(b), *17 C.F.R. § 201.250(b) (2005)*.

(n66)Footnote 66. Rule 250(a), *17 C.F.R. § 201.250(a) (2005)*.

(n67)Footnote 67. Rule 250(c), *17 C.F.R. § 201.250(c) (2005)*.

(n68)Footnote 68. Rule 250, revision cmt., *60 Fed. Reg. 32738, 32768 (June 23, 1995)* .

(n69)Footnote 69. Rule 154(a), *17 C.F.R. § 201.154(a)*.

(n70)Footnote 70. Rule 154(c), *17 C.F.R. § 201.154(c)*.

(n71)Footnote 71. Rule 152(d), *17 C.F.R. § 201.152(d)*.

(n72)Footnote 72. Rule 153(a), *17 C.F.R. § 201.153(a)*.

(n73)Footnote 73. Rule 153(b), *17 C.F.R. § 201.153(b)*. Examples of improper purpose include harassment, delay, and increased expense of adjudication. Rule 153(b), *17 C.F.R. § 201.153(b)*.

(n74)Footnote 74. Rule 153(b)(2), *17 C.F.R. § 201.153(b)(2)*.

(n75)Footnote 75. Rule 180, *17 C.F.R. § 201.180*.

(n76)Footnote 76. Rule 151 cmt. (July 2003), *17 C.F.R. § 201.151 (2003)*.

(n77)Footnote 77. Rule 151(c), *17 C.F.R. § 201.151(c)*.

(n78)Footnote 78. Rule 351(b), *17 C.F.R. § 201.351(b)*.

(n79)Footnote 79. Rule 351, *17 C.F.R. § 201.351*.

(n80)Footnote 80. Rule 240(a), *17 C.F.R. § 201.240(a)*.

(n81)Footnote 81. Rule 240(b), *17 C.F.R. § 201.240(b)*.

(n82)Footnote 82. Rule 240(c)(3), *17 C.F.R. § 201.240(c)(3)*.

(n83)Footnote 83. Rule 240(c)(2), *17 C.F.R. § 201.240(c)(2)*.

(n84)Footnote 84. Rule 240(c)(6), *17 C.F.R. § 201.240(c)(6)*.

(n85)Footnote 85. *Administrative Proceedings -- Timeliness, Securities and Exchange Commission, Securities Act Release No. 8240, 2003 SEC LEXIS 1404, [2003 Transfer Binder], Fed. Sec. L. Rep. (CCH) P 86,926 (June 11, 2003)*.



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CHAPTER 19 SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

1-19 Securities Enforcement: Counseling and Defense § 19.05

AUTHOR: Marc B. Dorfman Kenneth B. Winer

§ 19.05 The Evidentiary Hearing

The rules governing the evidentiary hearing are set forth in the 300 series of the SEC Rules of Practice. The ALJ presides over the hearing. Rule 301 generally provides that hearings shall be public unless otherwise ordered by the Commission. n1 Rule 302 provides that, unless otherwise ordered by the ALJ or the Commission, all hearings shall be recorded and transcribed, and the transcripts shall be available to the public.

Rule 200(c) provides that the location of the hearing will be "fixed with due regard for the public interest and the convenience and necessity of the parties, other participants, or their representatives." n2 In determining the location of the hearing, ALJs consider a number of factors, including the convenience of the parties and of the witnesses. ALJs can adjourn a hearing in order to later reconvene it in another city in order to accommodate witnesses who are not located in the city where the hearing was initially held.

The Federal Rules of Evidence do not govern the hearings. The SEC Rules provide that "the hearing officer may receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious." n3 The rules further provide a significant limitation on the introduction of prior sworn statements of witnesses other than the respondents. n4

Typically, the Staff presents its case first, with the respondents having the right to cross-examine its witnesses. In general, the respondent calls its witnesses after the Staff has completed its case-in-chief. When the hearing is held in more than one location, however, the respondent will often be given the opportunity to call witnesses to testify at each location even though this may result in witnesses testifying out of order.

Aspects of the Jencks Act are incorporated into Rule 231. The Rule provides that a respondent may move for the Staff to "produce for inspection and copying any statement of any person called or to be called as a witness by the Division of Enforcement that pertains, or is expected to pertain, to his or her direct testimony and that would be required to be produced pursuant to the Jencks Act, 18 U.S.C.S. 3500." n5 The ALJ fixes the time and place for such production. In the comments to the rule, the Commission indicates that the statement should be produced prior to the start of the hearing, unless the Staff shows that there is an improper use of such statement (e.g., intimidation of the witness). n6 Typically, the ALJ requires that a Staff member maintain custody of all the exhibits.

Each party has an opportunity to file proposed findings and conclusions before the ALJ issues the initial decision. n7 Rule 340 sets forth the procedural requirements applicable to such filings.

Unless the Commission directs otherwise, the ALJ must file an initial decision, unless it is waived by all the parties with the ALJ's consent, or the Commission has ordered that no initial decision be filed. n8 Rule 360(b) describes the content of initial decisions:

An initial decision shall include: findings and conclusions, and the reasons or basis therefor, as to all the material issues of fact, law or discretion presented on the record and the appropriate order, sanction, relief, or denial thereof. The initial decision shall also state the time period ... within which a petition for review of the initial decision may be filed. The reasons for any extension of time shall be stated in the initial decision. n9 The initial decision shall also include a statement that ...: (1) [t]he Commission will enter an order of finality as to each party unless a party or an aggrieved person entitled to review timely files a petition for review of the initial decision or a motion to correct a manifest error of fact in the initial decision with the hearing officer, or the Commission determines on its own initiative to review the initial decision; and (2) [i]f a party or an aggrieved person entitled to review timely files a petition for review or a motion to correct a manifest error of facts in the initial decision with the hearing officer, or if the Commission takes action to review as to a party or an aggrieved person entitled to review, the initial decision shall not become final as to that party or person. n10

The ALJ must file the initial decision with the Secretary of the Commission, who publishes the decision and serves copies on the parties. n11 This service begins the time period during which the parties may request review.

An initial decision does not become final, and sanctions set forth in the decision do not take effect, if a timely petition for review is filed. n12

FOOTNOTES:

(n1)Footnote 1. Rule 301 provides that hearings will be public, except on an application for confidential treatment, on a motion for a protective order, and on an *ex parte* application for a temporary cease-and-desist order. At one time, hearings against professionals for alleged violations of former Rule 2(e) were closed to the public. The presumption in favor of closed hearings in such proceedings was ended in 1988. Rule 301 still provides that the SEC, on its own motion, or the motion of a party, may close a hearing. As a practical matter, however, the Commission's policy is that all hearings will be public.

(n2)Footnote 2. Rule 200(c), *17 C.F.R. § 201.200(c)*.

(n3)Footnote 3. Rule 320, *17 C.F.R. § 201.320*.

(n4)Footnote 4. Rule 235, *17 C.F.R. § 201.235*.

(n5)Footnote 5. Rule 231(a), *17 C.F.R. § 201.231(a)*.

(n6)Footnote 6. Rule 231 cmt. (July 2003), *17 C.F.R. § 201.231 (2003)*.

(n7)Footnote 7. Rule 340(a), *17 C.F.R. § 201.340(a)*.

(n8)Footnote 8. Rule 360(a), *17 C.F.R. § 201.360(a)*.

(n9)Footnote 9. Rule 360(b), *17 C.F.R. § 201.360(b)*.

(n10)Footnote 10. Rule 360(b), *17 C.F.R. § 201.360(b)*.

(n11)Footnote 11. Rule 360(c), *17 C.F.R. § 201.360(c)*. In a nonpublic hearing, the decision would not be published unless the Commission ordered otherwise. Rule 360(c), *17 C.F.R. § 201.360(c)*.

(n12)Footnote 12. Rule 360(d), *17 C.F.R. § 201.360*.



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CHAPTER 19 SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

1-19 Securities Enforcement: Counseling and Defense § 19.06

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§ 19.06 Petition for Review by the SEC

Appeals to the Commission and its review are governed by the 400 series of the SEC Rules of Practice.

[1] Interlocutory Review

Rule 400 governs interlocutory review. In general, interlocutory review of interim procedural orders is not favored. The Commission only grants interlocutory review in "extraordinary circumstances." n1 The Commission has the discretion to decline to review a ruling certified by a hearing officer if it decides that interlocutory review is unwarranted or inappropriate given the particular circumstances of the proceeding. n2

Rule 400 states that the hearing officer shall not certify a ruling unless:

(1) his or her ruling would compel testimony of Commission members, officers or employees or the production of documentary evidence in their custody; or (2)...the hearing officer is of the opinion that: (i) the ruling involves a controlling question of law as to which there is substantial ground for difference of opinion; and (ii) an immediate review of the order may materially advance the completion of the proceeding. n3

Comment

In practice, the decision to grant interlocutory review seems as if it is decided on a more arbitrary basis than Rule 400 and the Commission's general disfavor of such review suggests. A petition for interlocutory review does not stay the administrative proceeding. n4

The Commission's informal guidelines set 45 days as the appropriate length of time for the Commission to decide interlocutory rulings. n5

[2] Review of an Initial Decision

Rule 410 provides that any party to the proceeding, and any person who would have been entitled to judicial review of

the final order entered in the proceedings if the Commission itself had made the initial decision, may file a petition for review of the initial decision. n6 The petition for Commission review should be filed with the SEC within the time period set forth in the initial decision. n7 Three copies should be filed along with the original. n8

Rule 410 specifies that the petition should specifically indicate the findings and conclusions as to which exceptions are taken, together with supporting reasons for such exceptions. The Rule provides that the reasons may be stated in summary form. The Rules of Practice provide that the Commission, in its discretion, may deem waived any objections to an initial decision not saved by written objection or set forth in the proposed findings.

The initial decision becomes final if no appeal is filed, and the Commission does not order review on its own initiative. n9 If a party timely petitions for review or the Commission timely orders review as to a party, the decision does not become final as to that party. n10

Under certain circumstances, the SEC may decline to review the initial decision. n11 There is a 21-day period after the end of the period for filing a petition for review during which the Commission may determine whether to grant the review. n12 The Commission has the power to review *de novo* the findings of fact and law of the ALJ, n13 and customarily reviews issues of law and public policy *de novo*.

After review is granted, the SEC issues a briefing schedule directing the party or parties to file opening briefs and specifying the issues, if any, as to which the briefing should be limited or directed. n14 Rule 450 states that, unless otherwise provided, opening briefs should be filed within 30 days of the date of the briefing schedule order, opposition briefs should be filed 30 days thereafter, and reply briefs should be filed 14 days after the opposition brief is due. n15 Rules 152 and 450 set forth requirements governing the briefs.

Comment

The Commission may deny a request for oral argument if exceptional circumstances make such argument impractical or inadvisable. n16 In practice, the Commission almost always grants timely requests for oral argument.

The SEC Commissioners receive copies of the parties' briefs and have access to the complete record. In addition, the adjudication section of the Office of the General Counsel usually distributes to each Commissioner shortly before the oral argument a summary pre-argument memorandum describing the facts of the case and analyzing the issues. The Rules of Practice provide one-half hour per side, unless ordered otherwise by the Commission. n17 If there are multiple respondents, "[t]he Commission may, in its discretion, determine that several persons have a common interest, and that the interests represented will be considered a single side for purposes of allotting time for oral argument." n18 In such a case, the time is to be divided equally among the participants on the side, unless they agree otherwise. n19

Requests for extensions of time and additional pages for briefs are handled by the Office of the Secretary pursuant to delegated authority. n20 Typically, this office rules on such requests without consultation with the Commission.

After oral argument, the Commission typically discusses the case in executive session. The adjudication group section then writes a proposed majority opinion based on the Commission's guidance, and circulates the draft opinion among the Commissioners for review. The proposed draft opinion and any separate concurrences and dissents are usually commented upon, changed as appropriate, and voted on by each Commissioner. Sometimes, the Commissioners review the draft opinion *seriatim*. Sometimes, they discuss the opinion at a closed meeting.

The respondent may appeal an adverse decision to a federal appeals court, as provided by the applicable federal securities law. n21 If the SEC decides in favor of the respondent, the Staff cannot appeal.

FOOTNOTES:

(n1)Footnote 1. Rule 400(a), *17 C.F.R. § 201.400(a)*.

(n2)Footnote 2. Rule 400(a), *17 C.F.R. § 201.400(a)*.

(n3)Footnote 3. Rule 410(c), *17 C.F.R. § 201.410(c)*.

(n4)Footnote 4. Rule 410(d), *17 C.F.R. § 201.410(d)*.

(n5)Footnote 5. Rule 900(a)(ii), *17 C.F.R. § 201.900(a)(ii)*.

(n6)Footnote 6. Rule 410(a), *17 C.F.R. § 201.410(a)*.

(n7)Footnote 7. Rule 410(b), *17 C.F.R. § 201.410(b)*.

(n8)Footnote 8. Rule 152(d), *17 C.F.R. § 201.152(d)*.

(n9)Footnote 9. Rule 360(d)(2), *17 C.F.R. § 201.360(d)(2)*. The SEC may, on its own initiative, order review of any initial decision within 21 days after the end of the period in which a petition for review may be filed. Rule 411(c), *17 C.F.R. § 201.411(c)*.

(n10)Footnote 10. Rule 360(d)(2), *17 C.F.R. § 201.360(d)(2)*.

(n11)Footnote 11. Rule 411(b)(2), *17 C.F.R. § 201.411(b)(2)*.

(n12)Footnote 12. Rule 411(c), *17 C.F.R. § 200*.

(n13)Footnote 13. *See* Rule 411(a), *17 C.F.R. § 201.411(a)* (setting forth the scope of the Commission's review and noting that, "[t]he Commission may affirm, reverse, modify, set aside or remand ... an initial decision by a hearing officer and may make any findings or conclusions that in its judgment are proper and on the basis of the record.").

(n14)Footnote 14. Rule 450(a), *17 C.F.R. § 201.450(a)*.

(n15)Footnote 15. Rule 450(a), *17 C.F.R. § 201.450(a)*.

(n16)Footnote 16. Rule 451(a), *17 C.F.R. § 201.451(a)* (noting that such requests will be granted "unless *exceptional circumstances* make oral argument impractical or inadvisable") (emphasis added).

(n17)Footnote 17. Rule 451(c), *17 C.F.R. § 201.451(c)*.

(n18)Footnote 18. Rule 451(c), *17 C.F.R. § 201.451(c)*.

(n19)Footnote 19. Rule 451(c), *17 C.F.R. § 201.451(c)*.

(n20)Footnote 20. *See 17 C.F.R. § 200.30-7(a)(2)-(5)*.

(n21)Footnote 21. *See* Securities Act § 9(a); Exchange Act § 25; Investment Company Act § 43; and Investment Advisers Act § 213.



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CHAPTER 19 SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

1-19 Securities Enforcement: Counseling and Defense § 19.07

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§ 19.07 SEC Guidelines for the Timely Completion of Adjudicatory Proceedings

On the same day that the SEC adopted the current rules of practice, it issued a statement entitled: *Informal Procedures and Supplementary Information Concerning Adjudicatory Proceedings*, n1 which put in place nonbinding policies and procedures in order to implement recommendations of the Schapiro task force that were designed to result in timely completion of administrative proceedings. These guidelines are of interest to practitioners because they provide insights into the perspective of the ALJs.

FOOTNOTES:

(n1)Footnote 1. Rule 900, *17 C.F.R. § 201.900*.



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CHAPTER 19 SEC ADMINISTRATIVE ENFORCEMENT PROCEEDINGS

1-19 Securities Enforcement: Counseling and Defense § 19.08

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§ 19.08 Respondent's Success May Depend on Which ALJ Is Assigned to the Proceeding

In a proceeding where both liability and remedy are at issue, a respondent faces a 26% chance, on average, of avoiding any sanction at the initial decision level. n1 Having avoided that pitfall, a successful respondent has a 73% chance that the dismissal will be upheld, for a "blended" success rate (26% [Left normal factor semidirect product] 73%) of 19%. n2

If the respondent foregoes settlement negotiations until after the proceeding has been assigned to a particular ALJ, he or she will be in a much better position to determine the most likely outcome with some precision. n3

FOOTNOTES:

(n1)Footnote 1. Rule 900, *17 C.F.R. § 201.900*.

(n2)Footnote 2. Rule 900, *17 C.F.R. § 201.900*.

(n3)Footnote 3. Rule 900, *17 C.F.R. § 201.900*. at 15.



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CHAPTER 20 COLLATERAL CONSEQUENCES OF SEC ENFORCEMENT

1-20 Securities Enforcement: Counseling and Defense 20.syn

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CHAPTER 20 COLLATERAL CONSEQUENCES OF SEC ENFORCEMENT

*1-20 Securities Enforcement: Counseling and Defense § 20.01***AUTHOR:** Joseph D. Edmondson Jr. Kenneth B. Winer**§ 20.01 Introduction**

This chapter addresses certain statutory and regulatory disqualifications, certain disclosure obligations, and other collateral consequences that might be triggered as a result of the entry of an injunction or other order in connection with an enforcement proceeding brought by the Securities and Exchange Commission ("SEC" or "Commission"). It is divided into five parts. The first three parts, respectively, address the impact under the federal securities laws of an SEC enforcement proceeding on: (a) companies that are issuers of securities or persons affiliated with issuers; (b) investment companies and investment advisers or persons affiliated with investment companies or investment advisers; and (c) securities broker-dealers and persons associated with broker-dealers. The fourth part addresses the impact under state securities laws of an SEC enforcement proceeding on securities broker-dealers and investment advisers, and persons affiliated or associated with such firms, as they are also regulated under state law. The fifth part addresses miscellaneous federal and state laws under which an SEC enforcement proceeding may have an impact.

When analyzing the potential impact of statutory and regulatory collateral consequences on a particular respondent, it is essential to begin the inquiry with an understanding of three key facts. First, one must know the nature of the sanction being entered against the firm, as the collateral consequences that potentially are triggered vary by the type of action taken by the Commission, and sometimes by the substantive provision of the securities laws that the respondent is deemed to have violated. For example, the consequences of an injunction entered by a court are different from the consequences of sanctions entered administratively pursuant to the SEC's authority under Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), or from a cease-and-desist order entered pursuant to the SEC's authority under various statutes. n1 In addition, certain consequences are triggered solely because the respondent has been found to have violated the "antifraud" provisions of the securities laws. Second, one must know the relationships between the respondent that is the subject of the SEC action, and any affiliated entities to which it may be related. In some cases, for example, collateral consequences are limited to the specific respondent who is the subject of the action, while in other cases, the consequences are, or could arguably be, applicable to affiliates. Similarly, for example, issuers may be disqualified from certain exemptions because of SEC enforcement actions brought against one of their officers, their underwriter or their investment advisor. Third, in order to determine whether a particular consequence is applicable, it is essential that one understand the nature of the current and future business operations of the respondent and the respondent's affiliates. While in some cases there may be consequences that attach upon entry of the SEC's order, such consequences may be of no concern because they will not have an effect on the respondent's business. This is especially

important with respect to certain collateral consequences, the effect of which can be waived or exempted by the SEC or, in some cases, by the Staff acting pursuant to delegated authority, as the time and effort associated with obtaining such a waiver or exemption from the SEC may be unnecessary.

It should be emphasized that, in addition to the statutory and regulatory implications discussed in this section, an SEC injunction or enforcement proceeding can have other substantial practical consequences for a person or firm. For example, the publicity surrounding the initiation of SEC administrative proceedings, the filing of an action in federal district court, and the entry of orders in such proceedings can have substantial adverse consequences for the career prospects and social standing of an individual. Similarly, the injunction can impair the reputation of a public company and undermine the morale of its employees.

Comment

A court or SEC order may also have litigation consequences for a company or individual. In some circumstances, the issuance of the order, or the findings contained in the order, may be admissible in litigation involving the company or individual. In a litigated matter, an order could give rise to collateral estoppel.

FOOTNOTES:

(n1)Footnote 1. For a discussion of various remedies available to the SEC in enforcement proceedings, see Chapter 18, *above*.



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CHAPTER 20 COLLATERAL CONSEQUENCES OF SEC ENFORCEMENT

1-20 Securities Enforcement: Counseling and Defense § 20.02

AUTHOR: Joseph D. Edmondson Jr. Kenneth B. Winer

§ 20.02 Impact on Issuers

[1] Disclosure Obligations

It is often the case that an issuer of securities might have to disclose in its registration statements and periodic filings the initiation of an SEC enforcement proceeding or the entry of an order against the issuer in connection with such a proceeding. Regulation S-K of the Exchange Act, that governs registration statements and periodic statements (such as annual reports on Form 10-K and quarterly reports on Form 10-Q), requires that issuers disclose any "material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party." n1 It is likely that an issuer will have to disclose the existence of an SEC administrative or judicial enforcement proceeding while the proceeding is pending. In recent cases, prominent issuers have disclosed the existence of otherwise confidential SEC investigations, n2 even before any government decision to charge the subject of the inquiry. Additionally, Regulation S-K requires that issuers describe any order that:

- was issued by a court of competent jurisdiction,
- enjoins any director or executive officer from engaging in any type of business practice or from engaging in any activity in connection with the purchase or sale of any security or commodity or in connection with any violation of any federal or state securities or commodities laws,
- is material to an evaluation of the ability or integrity of such person, and
- was not subsequently reversed or suspended. n3

Such disclosure may be required in an issuer's proxy statement, annual report on Form 10-K, or registration statement in connection with the public offering of securities.

A company should also carefully consider whether the existence of an SEC injunction against it should be disclosed. n4 In *Freschi v. Grand Coal Venture*, n5 a defendant falsely stated that an offering had been withdrawn because of tax problems, when it had actually been withdrawn because the SEC had obtained a temporary restraining order barring the

offering. The court rejected the defendant's argument that this misrepresentation was immaterial as a matter of law, stating that "[a]ny reasonable investor would be interested in knowing that the SEC was concerned about possible fraud in connection with a securities offering which the offeror himself described as 'basically similar' to the one under consideration for investment." n6 This discussion, of course, is not exhaustive. Given the SEC's vigorous enforcement of Section 10(b) of the Exchange Act and *Rule 10b-5* promulgated thereunder, public companies are well-advised to consider disclosure of all SEC enforcement developments with the assistance of experienced disclosure counsel. Notably, in recent years some companies have also adopted a practice of giving the Staff of the Division of Enforcement advance notice of the planned public disclosure.

[2] Public Company Exemptions

[a] Safe Harbor for Forward-Looking Statements

The safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995 (the "Litigation Reform Act") n7 is not available to an issuer for three years after it has been made the subject of a judicial or administrative decree arising out of a governmental action prohibiting future violations of the anti-fraud provisions of the securities laws, requiring the issuer to cease-and-desist from violating the anti-fraud provisions of the federal securities laws, or determining that it violated the anti-fraud provisions of the federal securities laws. n8 By its terms, however, the revocation of the safe harbor is subject to waiver by order of the Commission. The current procedure is to apply for such a waiver by letter directed to the senior Staff member in the Division of Enforcement who is responsible for the enforcement case. While waivers are theoretically available in litigated cases and may be sought even after the order against the respondent has been entered, it is more common for the waiver to be sought as part of a settlement. In such a case, the Staff should be informed of a respondent's intention to seek a waiver during settlement negotiations. Proper coordination with the Staff will ensure that the waiver order is presented to the Commission in conjunction with the order to be entered against the respondent, thereby ensuring that there is no gap in time during which the safe harbor might be deemed unavailable to the issuer.

Although the appropriate predicate for granting such a waiver has never been formally established, the Commission has granted a number of waivers on a case-by-case basis. n9 Companies seeking a waiver have argued that the relief was appropriate because, among other things: the conduct at issue in the enforcement proceeding was not related to the making of any forward-looking statements or public disclosures, the personnel of the respondent had no responsibility for making public statements or disclosures, and that the disqualification was not necessary for the public interest or the protection of investors.

One difficulty in applying for a waiver lies in the fact that the language of the safe harbor disqualification provision is arguably ambiguous as to whether the disqualification applies only to issuers who are themselves respondents, or whether the disqualification applies to issuer affiliates of respondents that are not themselves issuers. Specifically, the phrase "with respect to the business operations of the issuer" has caused concern that an SEC enforcement proceeding against a private subsidiary may be deemed to be related to the "business operations" of the issuer parent. Accordingly, counsel have, out of an abundance of caution, sought waivers that apply broadly to publicly traded affiliates, including parent corporations. In at least one instance, the SEC Staff has recommended, and the Commission has approved, a waiver of the disqualification provision as it applied to the parent corporation of a respondent that was a privately held subsidiary. n10 In such an instance, the fact that the private affiliate company, and not the publicly-traded issuer, committed the violation that is the subject of the underlying action is another ground that should be cited in support of the waiver request.

A further source of difficulty is that the disqualification provision is only triggered if the respondent violated an "anti-fraud" provision of the federal securities laws, but the term "anti-fraud" is not defined in the Litigation Reform Act, resulting in considerable debate as to its meaning. The issue is further complicated by the fact that the determination of whether the issuer has been disqualified from utilizing the safe harbor is a matter that will be

ultimately decided not by the SEC, but by a judge in future litigation brought by plaintiffs' lawyers who are likely to make aggressive arguments that the issuer has been disqualified for utilizing the safe harbor. Accordingly, care should be taken in determining whether the disqualification applies, and if so, if a waiver should be sought.

[b] Well-Known Seasoned Issuer

Effective December 1, 2005, the SEC adopted newly-amended rules, promulgated under the Securities Act, which provide benefits to certain issuers who meet the criteria for classification as a "well-known seasoned issuer" ("WKSI"). These benefits include a streamlined automatic registration process and exemptions from certain other restrictions ordinarily applicable to securities registrations. n11 However, these benefits are unavailable to issuers defined as "ineligible issuers" pursuant to Rule 405. n12 An issuer is deemed to be an "ineligible issuer" under Rule 405 if, among other things,

[w]ithin the past three years... the issuer or any entity that at the time was subsidiary of the issuer was made the subject of any judicial or administrative decree or order arising out of a governmental action that: (A) Prohibits certain conduct or activities regarding, including future violations of, the anti-fraud provisions of the federal securities laws; (B) Requires that the person cease and desist from violating the anti-fraud provisions of the federal securities laws; or (C) Determines that the person violated the anti-fraud provisions of the federal securities laws. n13

Ineligible issuer status may be waived if "the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the issuer be considered an ineligible issuer." n14 The Commission has delegated to the Division of Corporation Finance the authority to determine, based on an application submitted on behalf of the issuer, that the issuer not be considered an ineligible issuer as defined in Rule 405. n15 The grounds and reasons that might constitute good cause will be established as the Division of Corporation Finance begins to grant or deny application for WKSI waivers. Such decisions are on the Division's website. n16

[3] Private Placement Exemptions

[a] Federal Exemptions

Various rules promulgated under the Securities Act of 1933 ("Securities Act") provide safe harbors from the registration requirements set forth in § 5 of that statute. Certain of these safe harbors are not available to persons who are subject to SEC enforcement actions in various respects.

Regulation A, n17 promulgated under § 3(b) of the Securities Act, is one of the safe harbors from the registration requirements of § 5 that provides an exemption for certain offerings up to \$1.5 million. The Regulation A exemption may not be available for the issuance of securities, if the issuer, or any of its predecessors or any affiliated issuer, is, among other things, either subject to a temporary or preliminary injunction by a court, or has been, within the last five years, subject to an order, judgment, or decree of a court convicting it of criminal violations, enjoining it from engaging in any conduct or practice in connection with a purchase or sale of a security or involving the making of a false filing with the SEC. n18 Regulation A is also not available to exempt an issue of securities from registration if any officers, directors, or general partners of the issuer, or beneficial owners of more than 10 percent of its equity securities, the issuer's current promoters, underwriters of the securities to be offered, or any of such underwriter's officers, partners, or directors has been either so convicted (within ten years), enjoined (within 5 years) or is at any time subject to an order of the Commission entered pursuant to §§ 15(b), 15B(a), or 15B(c) of the Exchange Act or §§ 203(e) or 203(f) of the Investment Advisers Act. n19 The SEC can waive these Regulation A disqualifications upon a proper showing of good cause. n20

Regulation D, n21 under which most private placements and limited offerings occur, was promulgated under §§ 3(b) and 4(2) of the Securities Act. Specific exemptions from registration are set forth in Rules 504 through 506. n22 The

exemption under Rule 505 is not available to issuers who would be disqualified under the same terms as Rule 262 of Regulation A, i.e., issuers subject to criminal convictions or injunctions or whose insiders, promoters or underwriters are subject to orders of the Commission as specified in that rule. n23 Like Regulation A, the disqualification provisions of Rule 505 of Regulation D can be waived if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied. n24

In addition, Rule 507(a) of Regulation D provides that none of the safe harbors under Rules 504 through 506 may be available to an issuer if the issuer or any of its predecessors or affiliates have been subject to a court order enjoining it for failure to comply with the notice and filing requirements set forth in Rule 503. n25 This disqualification is also subject to a waiver if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances for the exemption to be denied. n26

Regulation E, n27 promulgated under § 3(c) of the Securities Act, provides a safe harbor for the offer of securities of small business investment companies that do not comply with the registration requirements of § 5, but meet other requirements. The safe harbor of Regulation E is not available for the securities of an issuer, if the issuer or any of its affiliates that has been convicted of any crime involving the purchase or sale of securities or has been subject within the last five years or subject to an injunction enjoining such person from engaging in any conduct in connection with the purchase or sales of securities. n28 The Regulation E disqualification can be waived by Commission order "upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." n29

As mentioned above, the disqualifications from using the safe harbors under Regulations A, D, and E, are all subject to waiver by the SEC, provided the respondent has made a proper showing of good cause under the particular provision of the Regulations. n30 Waivers of Regulations A and D are granted pursuant to delegated authority by the SEC Staff. Specifically, such waivers are granted in the form of no-action letters issued by the Staff of the Division of Corporation Finance. n31 While once available under the Staff's delegated authority, n32 a waiver under Regulation E can now be granted only by order of the Commission. n33 Requests for such relief continue, however, to be directed to the Staff of the Division of Investment Management and the grounds for such relief are parallel to those described in the no-action letter requests. n34

[b] State Exemptions

Many state exemptions from securities registration for private or limited offerings may be unavailable if the issuer is subject to an SEC injunction barring conduct in connection with the purchase or sale of a security. n35 Affected issuers should investigate this consequence further.

FOOTNOTES:

(n1)Footnote 1. Item 103 of Regulation S-K, *17 C.F.R. § 229.103*.

(n2)Footnote 2. *See, e.g., SEC Investigating Huron for Accounting Errors*, Reuters, August 11, 2009, reprinted at <http://www.cnbc.com/id/32369865/for/cnbc>; *SEC Probing Cablevision Unit's Accounting*, Newsday.com, July 4, 2003; *SEC Opens Formal Probe of Qwest*, Omaha World Herald, April 5, 2002.

(n3)Footnote 3. Item 401(f) of Regulation S-K, *17 C.F.R. § 229.401(f)(3)*.

(n4)Footnote 4. *See Freschi v. Grand Coal Venture*, 767 F.2d 1041 (2d Cir. 1985) (holding that information regarding a possible injunction is material).

(n5)Footnote 5. *Freschi*, 767 F.2d 1041 .

(n6)Footnote 6. *Freschi*, 767 F.2d at 1048 .

(n7)Footnote 7. Pub. L. 104-167.

(n8)Footnote 8. Securities Act § 27A(b) and Exchange Act § 21E(b), as amended by Litigation Reform Act § 102. The text of the provision is as follows:

Except to the extent otherwise specifically provided by rule, regulation, or order of the Commission, this section shall not apply to a forward looking statement--that is made with respect to the business or operations of the issuer, if the issuer--during the 3-year period preceding the date on which the statement was first made ... has been made the subject of a judicial or administrative decree or order arising out of a governmental action that--prohibits future violations of the antifraud provisions of the securities laws; requires that the issuer cease-and-desist from violating the antifraud provisions of the securities laws; or determines that the issuer violated the antifraud provisions of the securities laws.

(n9)Footnote 9. *See, e.g., In re Morgan Stanley & Co., Sec. Act. Rel. No. 9055, 2009 SEC LEXIS 2395* (July 20, 2009) ; *In re Banc of America Securities, LLC and Banc of America Investment Services, Inc., Sec. Act. Rel. No. 9043A, 2009 SEC LEXIS 2105* (June 9, 2009) ; *In re RBC Capital Markets Corp., Sec. Act. Rel. No. 9042, 2009 SEC LEXIS 1925* (June 9, 2009) ; *In re CSK Auto Corp., Sec. Act. Rel. No. 9034, 2009 SEC LEXIS 1753* (May 29, 2009) ; *In re Merrill Lynch & Co., Sec. Act. Rel. No. 8206, 2003 SEC LEXIS 619* (March 17, 2003) ; *In re Royal Bank of Canada, Sec. Act. Rel. No. 8015, 2001 SEC LEXIS 2000* (Sept. 27, 2001) ; *In re Warburg Dillon Read LLC, Sec. Act. Rel. No. 7822, 2000 SEC LEXIS 639* (April 6, 2000) ; *In re Goldman, Sachs & Co., Sec. Act. Rel. No. 7834, 2000 SEC LEXIS 640* (April 6, 2000) ; *In re Lehman Brothers, Inc., Sec. Act. Rel. No. 7837, 2000 SEC LEXIS 642* (April 6, 2000) ; *In re Salomon Smith Barney, Inc., Sec. Act. Rel. No. 7831, 2000 SEC LEXIS 653* (April 6, 2000) ; *In re Prudential Securities Inc., Sec. Act. Rel. No. 7819, 2000 SEC LEXIS 657* (April 6, 2000) ; *In re Rauscher Pierce Refsnes, Inc., Dain Rauscher Inc., and James Feltham, Sec. Act. Rel. No. 7846, 2000 SEC LEXIS 658* (April 6, 2000) ; *In re Morgan Stanley & Co. Inc., Sec. Act. Rel. No. 7843, 2000 SEC LEXIS 667* (April 6, 2000) ; *In re Paine Webber Inc., Sec. Act. Rel. No. 7825, 2000 SEC LEXIS 665* (April 6, 2000) ; *In re Merrill Lynch, Pierce, Fenner & Smith Inc., Sec. Act. Rel. No. 7840, 2000 SEC LEXIS 668* (April 6, 2000) ; *Bear, Stearns Securities Corp., Sec. Act. Rel. No. 7720, 1999 SEC LEXIS 1547* (Aug. 5, 1999) ; *In re Certain Market Making Activities on NASDAQ, Sec. Act. Rel. No. 7624, 1999 SEC LEXIS 30* (Jan. 11, 1999) .

(n10)Footnote 10. *See In re Royal Bank of Canada, Sec. Act. Rel. No. 8015, 2001 SEC LEXIS 2000* (Sept. 27, 2001) . The waiver was granted in connection with the issuance of an Order Instituting Proceedings, Making Findings and Imposing Sanctions against the company's subsidiary, Dain Rauscher Inc.. *In re Rauscher Pierce Refsnes, Inc., now known as Dain Rauscher Inc., Sec. Act. Rel. No. 8013, 2001 SEC LEXIS 2005* (Sept. 27, 2001) .

(n11)Footnote 11. *See Rule 163, 17 C.F.R. § 230.163.*

(n12)Footnote 12. *See Rule 405, 17 C.F.R. § 230.405.*

(n13)Footnote 13. Rule 405 (definition of "Ineligible Issuer," para. (1)(vi)).

(n14)Footnote 14. Rule 405 (definition of "Ineligible Issuer," para. (2)).

(n15)Footnote 15. Securities Offering Reform, *70 Fed. Reg. 44,722, 44,798-799* (Aug. 3, 2005) (to be codified at *17 C.F.R. § 200.30-1*).

(n16)Footnote 16. Available at <http://www.sec.gov/divisions/corpfin/cf-noaction.shtml>. *See also In re RenaissanceRe Holdings, Ltd., 2007 SEC No.-Act LEXIS 462* (April 27, 2007); *In re New England Securities Corp., 2006 SEC No-Act. LEXIS 239* (Feb. 21, 2006) (determining ineligible issuer status was not necessary with respect to the broker-dealer's parent, MetLife, Inc. based on the fact that the agreement with the SEC by which the broker-dealer settled the enforcement action was entered into before December 1, 2005, the effective date of the WSKI rule).

(n17)Footnote 17. *17 C.F.R. §§ 230.251 to 230.263.*

(n18)Footnote 18. *See Securities Act Rule 262(a)(4), 17 C.F.R. § 230.262(a)(4).*

(n19)Footnote 19. *See Securities Act Rule 262(b)(2), 17 C.F.R. § 230.262(b)(2).*

(n20)Footnote 20. *See Securities Act Rule 262, 17 C.F.R. § 230.262.*

(n21)Footnote 21. *17 C.F.R. §§ 230.501 to 230.508.*

(n22)Footnote 22. *17 C.F.R. §§ 230.504 to 230.506.*

(n23)Footnote 23. *See Securities Act Rule 505(b)(2)(iii), 17 C.F.R. § 230.505(b)(2)(iii) (1994).*

(n24)Footnote 24. *See Securities Act Rule 505(b)(2)(iii)(C), 17 C.F.R. § 230.505(b)(2)(iii)(C).*

(n25)Footnote 25. *17 C.F.R. § 230.507(a).*

(n26)Footnote 26. *Securities Act Rule 507(b), 17 C.F.R. § 230.507(b).*

(n27)Footnote 27. *17 C.F.R. §§ 230.601 to 230.610.*

(n28)Footnote 28. *See Securities Act Rule 602(b)(3)-(b)(4), 17 C.F.R. § 230.602(b)(3)-(b)(4).* An issuer may also lose access to the Regulation E exemption due to other provisions of Rule 602(b). Since they are not technically related to SEC enforcement actions, they are not discussed here. The exemption is likewise not available to an issuer if any of its directors, officers, principal security holders, investment adviser or underwriter (including any partner, director or officer of such investment adviser or underwriter) is subject to certain convictions, injunctions, and other SEC sanctions, discussed below. *See Sec. Act Rule 602(c), 17 C.F.R. § 230.602(c).*

(n29)Footnote 29. *Securities Act Rule 602(e), 17 C.F.R. § 230.602(e).*

(n30)Footnote 30. *See Sec. Act Rule 262, 17 C.F.R. § 230.262 (Regulation A); Sec. Act Rules 505(b)(iii)(C) and 507(b), 17 C.F.R. §§ 230.505(b)(iii)(C) and 230.507(b) (Regulation D); and Sec. Act Rule 602(e), 17 C.F.R. § 230.602(e) (Regulation E).*

(n31)Footnote 31. *See, e.g., Merrill Lynch & Co., 2003 SEC No-Act. LEXIS 566 (March 17, 2003); North East Insurance Company, 1996 SEC No-Act. LEXIS 598 (July 10, 1996); Sybaris Clubs Int'l, Inc., 1996 SEC No-Act. LEXIS 577 (July 1, 1996); The Cooper Companies, Inc., 1994 SEC No-Act. LEXIS 907 (Dec. 20, 1994); Michigan Nat'l Corp., 1993 SEC No-Act. LEXIS 1186 (Dec. 17, 1993); General Aluminum Forgings (U.S.), Inc., 1989 SEC No-Act. LEXIS 1084 (Nov. 3, 1989). *See also* General Electric Company, 1988 SEC No-Act. LEXIS 754 (May 24, 1988) (parent company seeking waiver due to effect of SEC action against wholly-owned subsidiary Kidder, Peabody & Co.).*

(n32)Footnote 32. *See, e.g., Donaldson, Lufkin & Jenrette Securities Corporation, 1992 SEC No-Act. LEXIS 827 (July 13, 1992); Salomon Brothers, Inc., 1992 SEC No-Act. LEXIS 655 & 1992 SEC No-Act. LEXIS 667 (May 20, 1992); Dain Bosworth Inc., 1992 SEC No-Act. LEXIS 562 (March 30, 1992); Morgan Stanley & Co., 1991 SEC No-Act. LEXIS 1042 (Aug. 28, 1991).* Many of these letters also seek waivers of disqualifications relating to Regulation B, an exemption relating to securities offering by oil and gas ventures. Regulation B was removed after a determination by the Commission that it was no longer necessary. *See Exch. Act Rel. No. 7300, 1996 SEC LEXIS 1489 (May 31, 1996)*, reprinted at *61 Fed. Reg. 30397* (effective July 15, 1996).

(n33)Footnote 33. *See, e.g., In re Merrill Lynch & Co., Inc., Sec. Act Rel. No. 338205, 2003 SEC LEXIS 618, 79 SEC Docket 2351-2353 (March 17, 2003).*

(n34)Footnote 34. Commission Orders granting the exemptive relief are available on the SEC's website at: <http://www.sec.gov/rules/other.shtml>. *See, e.g.*, Merrill Lynch & Co., 2003 SEC No-Act. LEXIS 566 (March 17, 2003); North East Insurance Co., 1996 SEC No-Act. LEXIS 598 (July 10, 1996); Sybaris Clubs Int'l, Inc., 1996 SEC No-Act. LEXIS 577 (July 1, 1996); The Cooper Cos., Inc., 1994 SEC No-Act. LEXIS 907 (Dec. 20, 1994); Michigan Nat'l Corp., 1993 SEC No-Act. LEXIS 1186 (Dec. 17, 1993); General Aluminum Forgings (U.S.), Inc., 1989 SEC No-Act. LEXIS 1084 (Nov. 3, 1989). *See also* General Electric Co., 1988 SEC No-Act. LEXIS 754 (May 24, 1988) (parent company seeking waiver due to effect of SEC action against wholly-owned subsidiary Kidder, Peabody & Co.).

(n35)Footnote 35. *E.g.*, Uniform Limited Offering Exemption § B5.



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CHAPTER 20 COLLATERAL CONSEQUENCES OF SEC ENFORCEMENT

1-20 Securities Enforcement: Counseling and Defense § 20.03

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§ 20.03 Impact on Investment Companies and Investment Advisers

[1] Generally

Under the Investment Advisers Act, the SEC may place limitations on the activities of an investment adviser or suspend or bar a broker-dealer from engaging in investment advisory activities. n1

[2] Section 9(a) of the Investment Company Act

Section 9(a) of the Investment Company Act prohibits any person who is enjoined by a court of competent jurisdiction from engaging in conduct in connection with a purchase or sale of a security from serving as an employee, officer, director, or investment adviser or depository of any registered investment company or as a principal underwriter for any registered open end-company, registered unit investment trust, or registered face-amount certificate company. n2 Further, any company affiliated with the ineligible person is equally barred from serving in the capacity described in § 9(a). n3 Under Section 9(a)(3) of the Investment Company Act, the definition of an "affiliated person" includes any person directly or indirectly controlling, controlled by, or under common control with the ineligible person. The SEC will often give complete or partial relief from the disqualifying effect of an injunction upon a showing "that the prohibitions of subsection (a), as applied to such person, are unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors to grant such application." n4

Section 9(a) only applies to injunctions. A cease-and-desist order, by contrast, does not trigger an automatic bar under Section 9(a). Nevertheless, the SEC may, in a "follow-on" proceeding under Section 9(b) of the Investment Company Act, seek to prohibit a person who has "willfully violated" (or aided and abetted a violation of) the securities laws from serving as an investment adviser, underwriter or depositor of an investment company under Section 9(b) of the Investment Company Act. Indeed, most SEC administrative orders, including cease-and-desist orders, are based on "willful violations" and are accompanied by findings of fact supporting the conclusion that violations have occurred. The existence of such an order could potentially make it easier for the Commission to seek to impose a Section 9(b) sanction at a later time. The Commission might also seek a remedial sanction against the firm under Sections 203(e)(4) and 203(f) of the Investment Advisers Act, based on the theory that it is against the public interest for a firm that is the subject of an injunction, particularly an anti-fraud injunction, to continue as a registered investment adviser. n5

[3] Restrictions on Paying Cash Fees to Solicitors of Investment Advisory Business

SEC Rule 206(4)3(a)(1)(ii) n6 prohibits an investment adviser from paying a cash fee, directly or indirectly, to any solicitor that, among other restrictions, has been found by the Commission to have engaged in "conduct specified in paragraphs (1), (5), or (6) of section 203(e) of the [Investment Advisers] Act" or who "is subject to an order, judgment or decree described in section 203(e)(4) of the Act." n7 As such, if an investment adviser has solicitation relationships with other firms, including most likely broker-dealers, it would be effectively prohibited from paying fees to such firms, absent no-action relief from the SEC Staff. Such relief has been routinely granted. n8 Over the years, the SEC Staff has revised its position concerning the necessary undertakings. The current position, as expressed in a no-action letter dated July 3, 2003, is that the following undertakings are the necessary predicate for no-action relief:

(1) the cash solicitation arrangement is conducted in compliance with the terms of Rule 206(4)3, except for the investment adviser's payment of cash solicitation fees to a solicitor who is subject to a Disqualifying Order;

(2) no Disqualifying Order bars or suspends the solicitor from acting in any capacity under the federal securities laws;

(3) the solicitor has complied with the terms of each Disqualifying Order, including, but not limited to, the payment of disgorgement, pre-judgment interest, civil or administrative penalties and fines; and

(4) for ten years from the date of the entry of each Disqualifying Order, the solicitor or any investment adviser with which it has a solicitation arrangement subject to rule 206(4)3 discloses the Disqualifying Order in a written document that is delivered to each person whom the solicitor solicits (a) not less than 48 hours before the person enters into a written or oral investment advisory contract with the investment adviser or (b) at the time the person enters into such a contract, if the person has the right to terminate such contract without penalty within 5 business days after entering into the contract. n9

In light of the SEC's current position, the Staff has decided that in many circumstances it will no longer respond to requests for no-action relief regarding Rule 206(4)3 unless the matters present "novel or unusual" issues. n10 In many cases, therefore, firms will be able to continue receiving cash solicitation payments provided they adhere to the undertaking prescribed by the no-action letter. The argument can be made that unless the disqualifying order against the soliciting firm involves investment advisory violations or fraud, it should not be deemed novel or unusual. It is unclear whether practitioners will feel comfortable with the Staff's attempt to offer this limited no-action relief of general applicability, but it is likely that many will continue to file no-action letter requests in order to seek adequate comfort, to ensure that their clients' situations are deemed to be not "novel" or "unusual," or to seek approval of different undertakings.

[4] Disclosure Obligations

SEC enforcement proceedings against investment companies and investment advisers may also trigger disclosure obligations. The rules governing advertisements by investment advisers provide that:

[i]t shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) of the [Investment Advisers] Act for any investment adviser registered or required to be registered under Section 203 of the Act to fail to disclose to any client or prospective client all material facts with respect to ... [a] legal or disciplinary event that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients. n11

Rule 206(4)4 creates a rebuttable presumption that the following constitute disclosable events:

- the entry of an SEC injunction within the last 10 years barring or limiting investment-related activity of the investment adviser or its management person and,
- the conduct within the last 10 years of an SEC proceeding or certain other administrative proceedings in which the investment adviser or management person was subject to certain adverse findings.

Rule 206(4)(d)(1) defines "management person" as one who has the "power to exercise, directly or indirectly, a controlling influence over the management or policies of an adviser... ." The rule defines "investment-related activity" to include activity involving securities, commodities, banking, insurance, real estate, or being associated with a broker-dealer.

Investment Company Act Rule 20a1 requires disclosure in proxy statements of investment companies of all the information normally required to be disclosed in proxy statements under § 14 of the Exchange Act, as well as detailed disclosure about the applicable investment adviser. n12 Exchange Act Rule 14a9 prohibits disclosure in a proxy statement that would be materially inaccurate or incomplete. The existence of an SEC injunction against a member of management or a director of the investment company or its investment adviser, for example, notwithstanding an SEC grant of relief under § 9(c) of the Investment Company Act, often has to be disclosed in the company's proxy statement. Similar disclosure in the investment company's prospectus might well be required.

A person filing a Form ADV, the uniform application for investment advisor registration, must disclose, among other things, whether any court has "in the past ten years, enjoined the applicant or an advisory affiliate in connection with any investment activity." n13 Furthermore, if the applicant or an advisory affiliate is so enjoined after filing the Form ADV, the applicant must amend the form to reflect this injunction. n14

FOOTNOTES:

(n1)Footnote 1. For a further discussion of this provision, see *Revocation or Suspension of Registration, below § 20.04[5][a]*. Investment Advisers Act § 203(e)(3), 15 U.S.C.S. § 80b-3(e)(3).

(n2)Footnote 2. 15 U.S.C.S. § 80a-9(a). Specifically, § 9(a) provides:

(a) It shall be unlawful for any of the following persons to serve or act in the capacity of employee, officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company, registered unit investment trust, or registered face-amount certificate company:

* * *

(2) any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or degree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, investment adviser, municipal securities dealer, government securities broker, government securities dealer, bank, transfer agent, or entity or person required to be registered under the Commodity Exchange Act, or as an affiliated person, salesman, or employee of any investment company, bank, insurance company, or entity or person required to be registered under the Commodity Exchange Act, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security; or

(3) a company any affiliated person of which is ineligible by reason of paragraph (1) or (2), to serve or act in the foregoing capabilities.

For the purposes of paragraphs (1), (2), and (3) of this subsection, the term "investment adviser"

shall include an investment adviser as defined in title II of this Act.

(n3)Footnote 3. *See* Investment Company Act § 9(a)(3), 15 U.S.C.S. § 809(a)(3).

(n4)Footnote 4. Investment Company Act § 9(c), 15 U.S.C.S. § 809(c). *See, e.g., Merrill Lynch Investment Mangers, L.P., et al., Temporary Order and Notice of Application, Investment Company Rel. No. 25964, 2003 SEC LEXIS 630* (March 17, 2003), reprinted at, 68 *Fed. Reg.* 14267-14269 (March 24, 2003) (noting that no officers or employees who were engaged in the provision of investment advisory or principal underwriting services to investment companies participated in any way in the conduct that was the subject of the injunction, that the advisers had policies and procedures in place, that the inability of the advisers and underwriter to serve the investment companies would result in potentially severe hardships for the investment companies and their shareholders); *Credit Suisse First Boston Corp., Investment Company Rel. No. 25406, 2002 SEC LEXIS 248, 76 SEC DOCKET 1986-54* (Jan. 30, 2002) (noting that the matters involving the disqualifying action did not involve any of the registered investment companies, that none of the employees of the applicants who would be involved in providing advisory or underwriting services to registered investment companies were involved in the disqualifying action, and that the firm adopted procedures regarding the disqualifying conduct); *Gabelli & Co., Inc./GAMCO Investors, Inc., Sec. Exchange Act Release No. 35057, 1994 SEC LEXIS 3744* [1994-1995 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 76,951, at 78,750* (Dec. 8, 1994) (noting the cooperation of the parties involved, the lack of scienter, and the exemplary compliance record in agreeing to grant the requested relief). In the two most recent examples, the Staff has required that the applicant provide information to the boards of the registered investment companies regarding the nature of the disqualifying action.

(n5)Footnote 5. Inv. Adv. Act, §§ 203(e)(4) and 203(f), 15 U.S.C.S. §§ 80b-3(e)(4) and (f).

(n6)Footnote 6. 17 C.F.R. § 275.206(4)3(a)(1)(ii).

(n7)Footnote 7. Section § 203(e) of the Investment Advisers Act provides that the Commission shall censure or otherwise impose limitations on the activities of an investment adviser if it finds that he or she:

(1) willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.

* * *

(4) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction, including any foreign court of competent jurisdiction, from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation, or as an affiliated person or employee of any investment company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(5) has willfully violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, [the Investment Advisers Act], the Commodity Exchange Act, or the rules or regulations under any such statutes or any rule of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(6) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, this title, the Commodity Exchange Act, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.

(n8)Footnote 8. *See, e.g.*, Prime Advisors, Inc., 2001 SEC No-Act. LEXIS 788 (Nov. 8, 2001); Legg Mason Wood Walker, Inc., 2001 SEC No-Act. LEXIS 632 (June 11, 2001); Dreyfus Corp., SEC No-Action Letter (pub. avail. March 9, 2001); Prudential Securities Inc., 2001 SEC No-Act. LEXIS 138 (Feb. 7, 2001); Tucker Anthony Inc., 2000 SEC No-Act. LEXIS 1010 (Dec. 21, 2000); J.B. Hanauer & Co., 2000 SEC No-Act. LEXIS 998 (Dec. 12, 2000); Founders Asset Management LLC, 2000 SEC No-Act. LEXIS 933 (Nov. 8, 2000); Credit Suisse First Boston Corp., 2000 SEC No-Act. LEXIS 813 (Aug. 24, 2000); Janney Montgomery Scott LLC, 2000 SEC No-Act. LEXIS 744 (July 18, 2000); Aeltus Investment Management, Inc., 2000 SEC No-Act. LEXIS 735 (July 17, 2000); William R. Hough & Co., 2000 SEC No-Act. LEXIS 484 (Apr. 13, 2000); *In re* Certain Municipal Bond Refundings, 2000 SEC No-Act. LEXIS 485 (Apr. 13, 2000); *In re* Certain Market Making Activities on Nasdaq, 1999 SEC No-Act. LEXIS 26 (Jan. 11, 1999); Paine Webber, Inc., 1998 SEC No-Act. LEXIS 1079 (Dec. 22, 1998); NationsBanc Investments, Inc., 1998 SEC No-Act. LEXIS 573 (May 6, 1998); Morgan Keegan & Co., Inc., 1998 SEC No-Act. LEXIS 14 (Jan. 9, 1998); Merrill Lynch, Pierce, Fenner & Smith, Inc., 1997 SEC No-Act. LEXIS 806 (Aug. 7, 1997); Gruntal & Co., 1996 SEC No-Act. LEXIS 635 (July 17, 1996); Carnegie Asset Management, 1994 SEC No-Act. LEXIS 614 (July 11, 1994); Salomon Brothers Inc., 1994 SEC No-Act. LEXIS 238 (Jan. 26, 1994); BT Securities Corporation, 1992 SEC No-Act. LEXIS 563 (Mar. 30, 1992); Kidder Peabody & Co. Inc., 1990 SEC No-Act. LEXIS 1191 (Oct. 11, 1990); First City Capital Corp., 1990 SEC No-Act. LEXIS 214 (Feb. 9, 1990); RNC Capital Management Co., 1989 SEC No-Act. LEXIS 175 (Feb. 7, 1989); and Stein Roe & Farnham, Inc., 1988 SEC No-Act. LEXIS 1326 (Aug. 25, 1988).

(n9)Footnote 9. Dougherty & Company LLC, 2003 SEC No-Act. LEXIS 598 (July 3, 2003), revising position stated in Dougherty & Company LLC, 2003 SEC No-Act. LEXIS 436 (March 26, 2003).

(n10)Footnote 10. Dougherty & Company LLC, 2003 SEC No-Act. LEXIS 598 (July 3, 2003). In that letter, the Staff stated:

We no longer will respond to requests for no-action relief under section 206(4) and rule 206(4)3 with respect to any cash solicitation arrangement under which an investment adviser proposes to pay cash solicitation fees to a solicitor that is subject to a Disqualifying Order under the foregoing circumstances, unless the requests present novel or unusual issues. We will continue to consider on a case-by-case basis, however, requests for no-action relief under section 206(4) and rule 206(4)3 with respect to any cash solicitation arrangement that is proposed to be conducted in a different manner. We also will continue to consider on a case-by-case basis requests for no-action relief under section 206(4) and rule 206(4)3 with respect to any cash solicitation arrangement involving a solicitor that:

has been subject to a Disqualifying Order that suspends or bars the solicitor from acting in any capacity under the federal securities laws;

has been convicted within the previous ten years of any felony or misdemeanor involving conduct described in section 203(e)(2)(A) through (D) of the Advisers Act but that is not subject to a Disqualifying Order relating to such conviction or order, judgment or decree;

is subject to an order, judgment or decree described in section 203(e)(4) of the Advisers Act, but that is not subject to a Disqualifying Order relating to such conviction or order, judgment or decree.

(n11)Footnote 11. Rule 206(4)4, 17 C.F.R. § 275.206(4)4 (promulgated under Investment Advisers Act § 206). For a further discussion, see § 20.05[1] below.

(n12)Footnote 12. See Investment Company Act Rule 20a1, 17 C.F.R. § 270.20a1.

(n13)Footnote 13. See Form ADV, Part IA, Page 13, item 11(B)(2), reprinted in 6 Fed. Sec. L. Rep. (CCH) P 57,101.

(n14)Footnote 14. Rule 2041(b)(1), 17 C.F.R. § 275.2041(b)(1).



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Securities Enforcement: Counseling and Defense

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CHAPTER 20 COLLATERAL CONSEQUENCES OF SEC ENFORCEMENT

1-20 Securities Enforcement: Counseling and Defense § 20.04

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§ 20.04 Impact on Broker-Dealers

An SEC enforcement proceeding can trigger important and far-reaching collateral consequences for broker-dealers. This is not surprising given that broker-dealers are among the most heavily regulated entities that fall within the jurisdiction of the SEC. In addition, as noted above, if a broker-dealer is an affiliate of an issuer or an investment adviser, it should also consider the collateral consequences applicable to such affiliates.

[1] Collateral and Statutory Bars

Once a broker or dealer has been enjoined in an SEC enforcement proceeding from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities dealer, transfer agent, or in a number of other activities or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security, the SEC may deny a new application for registration as a broker dealer or may proceed against an existing broker or dealer under § 15(b)(4)(C) of the Exchange Act. n1 Under that provision, the SEC may, after notice and hearing, "censure, place limitations on the activities, functions or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any broker or dealer" so enjoined, if such censure or limitation is in the public interest. Under § 15(b)(6) of the Exchange Act, the Commission may bar any individual from associating with a broker or dealer or otherwise sanction that person upon a finding that he or she:

- engaged in certain willful misconduct as described in § 15(b)(4)(A), (D), and (E);
- was convicted of certain crimes enumerated in § 15(b)(4)(C) within the last 10 years; or
- was enjoined from engaging in any conduct in connection with the purchase or sale of a security.

The Commission may also deny such person's application for registration as a municipal securities dealer. n2

A Commission order suspending or barring an individual from association with a broker-dealer or suspending or revoking a broker-dealer's registration constitutes a "statutory disqualification" under §§ 3(a)(39)(A) and (B) of the Exchange Act. n3 Similarly, an individual or firm that has committed or omitted any act, or is subject to an order or

finding that it, among other things, willfully violated any of the federal securities laws or regulations or failed reasonably to supervise a person who commits such a violation, will also be deemed to be statutorily disqualified. n4 Both national securities exchanges and associations (such as FINRA) may bar anyone subject to a "statutory disqualification" from association with a member of that exchange. n5 Under the FINRA By-Laws, no member or person associated with a member shall be permitted to continue as a member or associated person once subject to a statutory disqualification. n6 For example, New York Stock Exchange Rule 346(f) prohibits member firms from having a statutorily disqualified person associated with that member and establishes a procedure for seeking permission to continue as a member or associated person notwithstanding the statutory disqualification. FINRA, for example, requires that a "Continuation Application" be filed, stating the grounds and reasons that justifies continued association of a firm or an individual with the Exchange. n7 Accordingly, it is advisable that the member firm contact FINRA and any exchanges of which it is a member prior to the issuance of the SEC order to negotiate the exchange's position on statutory disqualification. The SEC may also deny an application for a broker or dealer registration by any person subject to an order under § 15(b)(4).

Even an injunction entered into by consent rather than litigation can subject the firm to greater risk of remedial sanction in such a "follow-on" proceeding under Section 15(b)(4). Even though the underlying facts will not have been actually litigated, the Commission will not allow respondents to dispute the factual allegations of the complaint for injunctive relief in the subsequent follow-on remedial proceeding. n8 Typically, the respondent's decision to settle an injunctive action will be based on an understanding reached between the respondent and the SEC Staff that no "follow-on" proceeding will be brought immediately based on the specific conduct that is the subject of the settlement. The concern over the collateral effect of a consent injunction arises in the context of a subsequent "follow-on" proceeding that is based on subsequent conduct, but within which the Commission seeks to reach back to the consent injunction as evidence why the remedial sanction is in the public interest. n9

In addition, national securities exchanges and FINRA may (and if so ordered by the SEC, shall) deny membership to any broker, dealer, or natural person associated with a registered broker or dealer, and bar from becoming associated with a member any person who has been enjoined by a court of competent jurisdiction from acting as, among other activities, an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities dealer, transfer agent, or engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security. n10 As such, it is often advisable to determine whether an exchange or FINRA will take such a position prior to agreeing to a settled injunctive proceeding with then SEC.

[2] Restrictions on Investment Company and Advisory Activities

Many broker-dealers have close affiliations with investment companies and investment advisers. If the broker-dealer entity becomes the subject of an SEC enforcement action, it should consider the effects on its affiliated investment companies or investment advisers discussed above as well as its own ability to participate in certain related activities, including as an underwriter. Under the Investment Company Act, an injunction automatically bars a person from serving or acting in the capacity of "employee, officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company, registered unit investment trust, or registered face-amount certificate company." n11 The SEC may place limitations, under the Investment Advisers Act, on the investment adviser activities of a broker-dealer or suspend or bar a broker-dealer from engaging in such activities. n12

Rule 206(4)-3 under the Investment Advisers Act sets forth prohibitions against a solicitor from receiving cash payments from an investment adviser for solicitation of advisory services if such solicitor is subject to certain findings or Commission orders. n13 A broker-dealer that is engaged in solicitation arrangements for affiliated or unaffiliated investment advisers should determine whether the prohibitions apply and seek appropriate no-action relief if necessary.

[3] Private Placements

An SEC injunction or administrative proceeding can impair the ability of a securities broker-dealer or investment adviser to participate in private placements by limiting its ability to underwrite clients' securities offerings under certain exemptions from the costly registration requirements of the federal securities laws. n14

The exemptions under Regulation A and Rule 505 of Regulation D are lost if: "Any director, officer or general partner of the issuer, beneficial owner of 10 percent or more of any class of its equity securities, any promoter of the issuer presently connected with it in any capacity, any underwriter of the securities to be offered, or any partner, director or officer of any such underwriter" is, among other things:

- subject to "any order, judgment, or decree of any court of competent jurisdiction temporarily or preliminarily enjoining or restraining, or is subject to any order, judgment, or decree of any court of competent jurisdiction, entered within five years prior to the filing of such offering statement, permanently enjoining or restraining such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security, involving the making of a false filing with the Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser;" or
- "is subject to an order of the Commission entered pursuant to section 15(b), 15B(a), or 15B(c) of the Exchange Act, or section 203(f) of the Investment Advisers Act of 1940." n15

Similarly, the exemption under Regulation E is lost if any of the issuer's "directors, officers or principal security holders, any investment adviser or any underwriter of the securities to be offered, or any partner, director or officer of any such investment adviser or underwriter" is, among other things:

- "temporarily or permanently restrained or enjoined by any court from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer or investment adviser;" or
- "subject to an order of the Commission entered pursuant to section 15(b) ... ; has been found by the Commission to be a cause of any such order which is still in effect; or is subject to an order of the Commission entered pursuant to section 203(d) or (e) of the Investment Advisers Act of 1940;" n16

Although with respect to all three exemptions the issuer itself may request a waiver of the disqualification, n17 the more common practice is for the underwriter or investment adviser to apply for an advance waiver of the disqualification as it may apply to any future offerings. n18 There exist numerous examples of waiver requests of the Regulation A and D exemptions granted by the Staff pursuant to delegated authority, n19 as well as Commission orders granting waivers of the Regulation E exemption.

The Staff of the Division of Corporation Finance has recently begun evaluating requests for exemptive relief from the disqualifying effects of Regulation A and D by broker dealers under a 1977 interpretation, which states:

Rule 505 is not available to any issuer that falls within any of the disqualifications for the use of Regulation A. *See* Rule 505(b)(2)(iii). One such disqualification arises where the issuer or any of its directors, officers, general partners or underwriters is subject to an order of the Commission entered under Section 15(b) of the Exchange Act, which deals with broker/dealer registration and regulation. *See* Rule 262(d)(3). The issuer in the case presented was a broker-dealer that was censured four years ago pursuant to a Commission order. Because that censure has no continuing force, the issuer is not "subject to an order of the Commission" and is thus not disqualified from using Rule 505. n20

Accordingly, if an order involves only a censure and a fine, without a sanction with "continuing force," such an order to comply with an undertaking, exemptive relief may not be necessary. The Staff of the Division of Investment Management is likely to follow the guidance as well, with respect to its determination of the disqualifying effect of an order on the Regulation E exemption, given the similarity in the rules. In any event, the appropriate Division Staff should be consulted for assurance that the terms of any specific order fit the guidance. If there is doubt, exemptive relief should always be sought.

Comment

Among other equitable arguments in support of a good cause determination, underwriters and investment advisers typically argue that the disqualification of the issuer from using the regulatory exemptions, due to the enforcement action against the underwriter or adviser and not the issuer itself, would have an adverse impact on the third-party issuers that have retained or will retain such firms.

[4] Reporting to Regulatory Authorities

The most current Form BD, the uniform application for broker-dealer registration with the SEC, requires the broker-dealer applicant to disclose, among other things, whether it or any "control affiliate" has been enjoined in the past 10 years in connection with any investment-related activity or if the SEC or any other regulatory agency has made certain findings with respect to the control affiliate. n21 The Form BD information must be amended whenever the information on file changes.

NASD member firms are required to report certain information pursuant to NASD Rule 3070, unless their reporting requirements are satisfied by reporting obligations to another self-regulatory organization, such as the New York Stock Exchange ("NYSE"). Reportable events under Rule 3070 include situations in which the member firm:

- "has been found to have violated any provision of any securities law or regulation, any rule or standards of conduct of any governmental agency, self-regulatory organization, or financial business or professional organization, or engaged in conduct which is inconsistent with just and equitable principles of trade"
- "is named as a defendant or respondent in any proceeding brought by a regulatory or self-regulatory body alleging the violation of any provision of the Act, or of any other federal or state securities, insurance, or commodities statute, or of any rule or regulation thereunder, or of any provision of the By-laws, rules or similar governing instruments of any securities, insurance or commodities regulatory or self-regulatory organization." n22

The NYSE has its own reporting requirements under Rule 351 and on Form RE-3.

FINRA Form U-4 of an individual affiliated with a broker-dealer must reflect, among other things, whether the applicant has ever been enjoined "in connection with any investment related activity." n23 Investors and other members of the public are able to perform an online background search to check whether a broker or other brokerage employee has been a subject of disciplinary action. n24 Other SROs may have reporting requirements. For example, the Depository Trust and Clearing Corporation ("DTCC"), through its subsidiaries, National Securities Clearing Corporation ("NSCC") and Fixed Income Clearing Corporation ("FICC"), requires disclosure of any event that would result in a statutory disqualification, including SEC orders and injunctions. n25 In addition, firms that are members of FICC's Government Securities and Mortgage-Backed Securities Divisions also must make notification within two business days of becoming aware that they are subject to a proceeding that could result in a statutory disqualification. n26

[5] State Regulation of Broker-Dealers and Investment Advisers

[a] Revocation or Suspension of Registration

An SEC injunction can lead to state regulators denying, suspending, or revoking the registration of an investment adviser or broker-dealer. Most of the states have adopted, with only minor variations, the 1956 version of the Uniform Securities Act ("1956 Uniform Act"). Under the act, a state regulator may deny, suspend, or revoke the registration of an investment adviser or a broker-dealer if it is found that the denial, suspension, or revocation of the registration is in the public interest and a court of competent jurisdiction has permanently or temporarily enjoined the registrant/applicant, or any partner, officer, or director thereof, or any person occupying a similar status or performing similar functions or any person directly or indirectly controlling the broker-dealer or investment adviser from engaging or continuing any conduct or practice involving any aspect of the securities business. The 1956 Uniform Act provides that while the state regulator may issue an order summarily postponing or suspending registration, the applicant/registrator shall be given prompt notice of such order and the right to a hearing.

A number of states have adopted the version of the Uniform Securities Act that was adopted in 1985 (the "1985 Uniform Act"). Under the 1985 Uniform Act, a state regulator may by order deny, suspend, or revoke a license, limit the securities activities that the applicant/registrator may perform in the state, or take other actions, if it is found that such order is:

- in the public interest; and
- a court of competent jurisdiction has enjoined the applicant/registrator or a person affiliated with it from acting as "an investment adviser, underwriter, broker-dealer, or as an affiliated person or employee of an investment company, depository institution, or insurance company, or from engaging in or continuing a conduct or practice in connection with any of the foregoing activities, or in connection with the purchase or sale of a security."

The 1985 Uniform Act does not explicitly provide for notice and a hearing. Some of the states that have adopted the act have altered it to provide for notice and hearing. Other states have enacted legislation that differs significantly from both the 1956 and 1985 acts.

[b] Notification of State Securities Regulators

Most states require broker-dealers and investment advisers to notify the appropriate state securities regulator of SEC injunctions and various other regulatory actions against the entity.

[c] Insurance and Banking Activities

Many securities broker-dealers sell certain insurance products and annuities that are treated as insurance under state law. Accordingly, many broker-dealers maintain state insurance licenses. An injunction could subject these licenses to revocation. n27 An injunction or other regulatory action may also be reportable in license renewal applications or at other times. In addition, many broker-dealers are also not affiliated with banks that are regulated by state and federal law. Disclosure requirements under applicable banking regulations should also be considered.

[d] Blue Sky Laws

Numerous states disqualify firms that have been enjoined from acting as underwriters in transactions pursuant to limited offering provisions in their blue sky laws. n28

[e] Public Finance

Through their public finance departments, many securities broker-dealers respond to the numerous requests for proposals from state and local governments and related authorities in connection with the prospective underwriting of municipal securities or the provision of services as a financial adviser to the issuer of such securities. Disclosure of an injunction or other disciplinary action might be required by the "RFP" and could impair the ability of a broker-dealer to compete for such business.

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C.S. § 78o(b)(4)(C)*. Specifically, § 15(b)(4)(C) provides:

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated ...

(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act, or any substantially equivalent foreign statute or regulation, or as an affiliated person or employee of any Investment Company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent foreign statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

The SEC has similar authority with respect to government securities dealers, Exchange Act § 15C(c)(1)(A), *15 U.S.C.S. § 78o5(c)(1)(A)*, and municipal securities dealers, Exchange Act § 15B(c)(4), *15 U.S.C.S. § 78o4(c)(4)*.

(n2)Footnote 2. *See Exchange Act § 15(b)(2)(B), 15 U.S.C.S. § 78o(b)(2)(B)*.

(n3)Footnote 3. *See Exchange Act §§ 3(a)(39)(A), (B), 15 U.S.C.S. §§ 78c(a)(39)(A), (B)*.

(n4)Footnote 4. *See Exchange Act § 3(a)(39)(F), 15 U.S.C.S. § 78(c)(a)(39)(F)*.

(n5)Footnote 5. *See Exchange Act § 6(c)(2), (3), 15 U.S.C.S. § 78f(c)(2), (3)*.

(n6)Footnote 6. *See FINRA By-Laws, Art. III, Sec. 3.*

(n7)Footnote 7. *See FINRA Rule 9270. As another example, Rule 1, Section 18 of Article III of the Rules of the Fixed Income Clearing Corporation Mortgage-Backed Securities Division provided that a member must notify FICC in writing if it no longer will be able to meet applicable membership requirements. The staff of the FICC take the position that under Rule 3, Section 18 of Article III, the membership requirements include that the member be free of a "Statutory Disqualification" as defined in Section 3(a)(39)(F) of the Exchange Act. Notably, notification within two business days is also required if the member learns "of an investigation or proceeding to which it is or is becoming subject that would cause the [member] to fall out of compliance with any of the relevant qualifications and standards for membership set forth in Rule 2 and 3." See Rule 1, Section 18 of Article III.*

(n8)Footnote 8. *In re Marshall E. Melton and Asset Management & Research, Inc., Inv. Adv. Act Rel. No. 2151,*

2003 SEC NEWS LEXIS 1701 (July 28, 2003).

(n9)Footnote 9. *See In re Marshall E. Melton and Asset Management & Research, Inc., Inv. Adv. Act Rel. No. 2151, 2003 SEC NEWS LEXIS 1701 (July 28, 2003).*

(n10)Footnote 10. Exchange Act § 6(c)(2), *15 U.S.C.S. § 78f(c)(2)* (national securities exchange); Exchange Act § 15A(g)(2), *15 U.S.C.S. § 78o-3(g)(2)* (registered securities association).

(n11)Footnote 11. For a further discussion of this provision, see Chapters 16 and 17. Investment Company Act § 9(a), *15 U.S.C.S. § 80a-9(a)*.

(n12)Footnote 12. For a further discussion of this provision, see § 20.04[5][a]. Investment Advisers Act § 203(e)(3), *15 U.S.C.S. § 80b-3(e)(3)*.

(n13)Footnote 13. See discussion, *above*, § 20.01[2][c].

(n14)Footnote 14. *See Regulations A, D, and E under the Securities Act, 17 C.F.R. §§ 230.262(b)(2), 230.505(b)(2)(iii), and 230.602(c)(2) (1995).*

(n15)Footnote 15. Securities Act Rule 262(b); *17 C.F.R. § 230.262(b)*.

(n16)Footnote 16. Securities Act Rule 602(c); *17 C.F.R. § 230.602(c)*.

(n17)Footnote 17. See discussion, *above*, § 20.01[1][b].

(n18)Footnote 18. *See, e.g., Dain Rauscher, Inc., 2001 SEC No-Act. LEXIS 743 (Sept. 27, 2001); Legg Mason Wood Walker, Inc., 2001 SEC No-Act. LEXIS 614 (June 11, 2001); Dain Rauscher, Inc., Goldman Sachs & Co., Lehman Brothers Inc., Merrill Lynch, Pierce, Fenner & Smith Inc., Morgan Stanley & Co. Inc., PaineWebber Inc., Prudential Securities Inc., Salomon Smith Barney Inc., as successor to Smith Barney, Inc., Warburg Dillon Read LLD, 2000 SEC No-Act. LEXIS 650 (April 6, 2000); In re Certain Market-Making Activities, 1999 SEC No-Act. LEXIS 26 (pub. avail. Jan. 11, 1999); Stephens Inc., 1998 SEC No-Act. LEXIS 1006 (Nov. 23, 1998).*

(n19)Footnote 19. *See, e.g., In re Prudential Securities, Inc., Sec. Act Rel. No. 8247, 2003 SEC LEXIS 1622 (July 10, 2003); In re Credit Suisse First Boston Corporation, Sec. Act Rel. No. 8064, 2002 SEC LEXIS 347 (Feb. 12, 2002); In re Dain Rauscher Pierce Refsnes, Inc., Sec. Act Rel. No. 8014, 2001 SEC LEXIS 1999 (Sept. 27, 2001); In re Legg Mason Wood Walker, Inc., Sec. Act Rel. No. 7984, 2001 SEC LEXIS 1121 (June 11, 2001); In re Prudential Securities Inc., Sec. Act Rel. No. 7947, 2001 SEC LEXIS 161 (Jan. 30, 2001); In re Vincent Deuschel and Tucker Anthony, Inc., Sec. Act Rel. No. 7930, 2000 SEC LEXIS 2816 (Dec. 21, 2000); In re E-INVEST, INC., Sec. Act Rel. No. 7893, 2000 SEC LEXIS 1965 (Sept. 21, 2000); In re Janney Montgomery Scott LLC, Sec. Act Rel. No. 7875, 2000 SEC LEXIS 1613 (July 18, 2000); In re Rauscher Pierce Refsnes, Inc., Dain Rauscher Inc. and James R. Feltham, Sec. Act Rel. No. 7845, 2000 SEC LEXIS 643 (April 6, 2000); In re Morgan Stanley & Co. Inc., Sec. Act Rel. No. 7842, 2000 SEC LEXIS 651 (April 6, 2000); In re Merrill Lynch, Pierce, Fenner & Smith Inc., Sec. Act Rel. No. 7839, 2000 SEC LEXIS 652 (April 6, 2000); In re Lehman Brothers Inc., Sec. Act Rel. No. 7836, 2000 SEC LEXIS 644 (April 6, 2000); In re Goldman, Sachs & Co., Sec. Act Rel. No. 7833, 2000 SEC LEXIS 656 (April 6, 2000); In re Salomon Smith Barney, Inc., Sec. Act Rel. No. 7830, 2000 SEC LEXIS 654 (April 3, 2000); In re PaineWebber Inc., Sec. Act Rel. No. 7824, 2000 SEC LEXIS 670 (April 6, 2000); In re Warburg Dillon Read LLC, Sec. Act Rel. No. 7821, 2000 SEC LEXIS 655 (April 6, 2000); In re Prudential Securities Inc., Sec. Act Rel. No. 7818, 2000 SEC LEXIS 664 (April 6, 2000); In re BT Alex. Brown Inc., Sec. Act Rel. No. 7778, 1999 SEC LEXIS 2428 (Nov. 17, 1999); In re Bear, Stearns Securities Corp., Sec. Act Rel. No. 7721, 1999 SEC LEXIS 1548 (Aug. 5, 1999); In re Lazard Freres & Co., LLC, Sec. Act Rel. No. 7670, 1999 SEC LEXIS 805 (April 21, 1999); In re Certain Market Making Activities on NASDAQ, Sec. Act Rel. No. 7623, 1999 SEC LEXIS 31 (Jan. 11, 1999); In re Stephens Inc., Sec. Act Rel. No. 7613, 1998 SEC LEXIS 2523 (Nov. 23, 1998).*

(n20)Footnote 20. Manual of Publicly Available Telephone Interpretations, Section E (Regulation D and Rule 701), Item 37 (July 1997).

(n21)Footnote 21. *See* Form BD, page 4, item 11(H)(1)(a). A copy of the form may be downloaded at www.finra.com.

(n22)Footnote 22. NASD Rule 3070(a).

(n23)Footnote 23. *See* Form U-4, item 14(H). A copy of the form may be downloaded at www.nasdr.com. Item 14 contains numerous disclosure questions that relate to actions by the SEC, other regulators, customers and other private parties, and the individual's employer.

(n24)Footnote 24. pdpi.nasdr.com/PDPI.

(n25)Footnote 25. *See* NSCC Rules, Sec. 2(B)(a)(i); FICC Government Securities Division Rulebook, Rule 2, Sec. 3; FICC Mortgage-Backed Securities Division Rules, Rule 1, Sec. 3.

(n26)Footnote 26. *See* FICC Government Securities Division Rulebook, Rule 3, Sec. 7; FICC Mortgage-Back Securities Division Rules, Rule 1, Sec. 18.

(n27)Footnote 27. *See, e.g., Ohio Rev. Code § 3905.14.*

(n28)Footnote 28. *See, e.g., N.J. Rev. Code Stat. §§ 49:3-50, 49:3-58(2)(iv); Tex. Admin. Code § 109.13(k)(2).*



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CHAPTER 20 COLLATERAL CONSEQUENCES OF SEC ENFORCEMENT

1-20 Securities Enforcement: Counseling and Defense § 20.05

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§ 20.05 Other Collateral Consequences

[1] Schedule 13D Disclosure Obligations

A person filing a Schedule 13D must disclose whether such person has, within the past five years, been a party to a civil proceeding of a judicial or administrative nature that resulted in a judgment, decree, or final order enjoining violations of the federal securities laws. n1 The same disclosure must be made in tender offer statements. n2

[2] Government Contractors

An SEC injunction can impair the ability of a company to act as a federal government contractor. A government contractor may be temporarily suspended for up to 18 months upon "adequate evidence" of among, other things, the making of false statements or the falsification of records. n3 A government contractor can be debarred for a period "commensurate with the seriousness of the cause(s)," generally not to exceed three years, if the contractor has been the subject of a civil judgment for, among other things, the making of false statements or the falsification of records. n4

Comment

The consequences of an SEC enforcement proceeding to a company that engaged in significant government contracts is poignantly demonstrated in the case of Worldcom. n5 In that case, which involved settlement of SEC charges of accounting fraud, Worldcom was reportedly the subject of a "notice of disbarment" from the General Services Administration, rendering the company ineligible from bidding on any new federal contracts. n6

[3] Employment and Professions

An SEC enforcement proceeding can have severe implications for individuals in their careers and professions. Such a proceeding against an attorney might trigger an inquiry by the bar, especially if the proceeding involves allegations of fraud. Similarly, an SEC action against an accountant might trigger an inquiry by the state accountancy board and by the American Institute of Certified Public Accountants. If the employer is regulated by state or federal authorities, it might be under regulatory or statutory pressure not to employ individuals who are the subject of sanctions imposed by

the SEC, especially if an injunction or cease-and-desist order involves allegations of fraud.

An SEC enforcement action can also have collateral consequences for an individual if the individual either works in an area that is regulated by a state or subsequently seeks to work in such an area. For example, certain insurance commissioners have the power to revoke a license for "fraudulent" or "dishonest" behavior or conduct demonstrating untrustworthiness. n7

Rule 102(e)(3) of the SEC Rules of Practice allows the SEC to temporarily suspend any attorney, accountant, or engineer from practicing before it if that professional has been permanently enjoined from violation of the federal securities laws. This temporary suspension may become permanent, since it requires the subject to petition for dissolution of the suspension. Upon such petition, the SEC may grant the request or hold a hearing. After such a hearing, the Commission has the authority to censure and temporarily or permanently suspend the person. Should the person fail to file the required petition within 30 days, the suspension automatically becomes permanent. n8

[4] Overseas Private Investment Corporation

A person convicted of violating the FCPA in relation to a project insured or otherwise supported by OPIC can be suspended for up to five years from participating in an OPIC program. n9

[5] Export Licenses

Persons convicted of violating the anti-bribery provisions of the FCPA can be barred from receiving an export license from the Department of State. n10

FOOTNOTES:

(n1)Footnote 1. Item 2(e), *17 C.F.R. § 240.13d-101*.

(n2)Footnote 2. Item 2(f), *17 C.F.R. § 240.14d-100*.

(n3)Footnote 3. *48 C.F.R. § 9.407-2*.

(n4)Footnote 4. *48 C.F.R. § 9.406-4*.

(n5)Footnote 5. *SEC v. WorldCom Inc.*, Civil Action No. 02-CV-4963 (S.D.N.Y.) (*JSR*), *Litig. Rel. No. 18219*, 2003 *SEC LEXIS 1590* (July 7, 2003) .

(n6)Footnote 6. *WorldCom Can't Get New U.S. Work; GSA Says Phone Firm Has to Improve Accounting, Ethical Practices*, Washington Post, August 1, 2003 at p. E01.

(n7)Footnote 7. *See, e.g., N.Y. Ins. Law § 2110(a)*.

(n8)Footnote 8. For a more detailed discussion of Rule 102(e) of the SEC Rules of Practice, see Chapter 18, *above*.

(n9)Footnote 9. *22 C.F.R. pt 709.1*.

(n10)Footnote 10. *22 C.F.R. 120.a(b)*.



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CHAPTER 21 PRIVATE LITIGATION AND SEC ENFORCEMENT

2-21 Securities Enforcement: Counseling and Defense 21.syn

AUTHOR: Kenneth B. Winer

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CHAPTER 21 PRIVATE LITIGATION AND SEC ENFORCEMENT

2-21 Securities Enforcement: Counseling and Defense § 21.01

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§ 21.01 Introduction

The same circumstances that give rise to a Securities and Exchange Commission ("SEC" or "Commission") investigation frequently trigger the filing of private litigation by shareholders. Because the two often co-exist, they affect each other. Strategies that develop in one may help develop strategies in the defense of the other. This chapter addresses how the pendency of an SEC enforcement investigation or proceeding may affect the defense of private litigation. First, Section 21.02 reviews the most common types of private securities litigation. Section 21.03 addresses the use and admissibility in private litigation of documents from the SEC proceeding. Section 21.04 discusses some strategic choices and issues that counsel defending parallel proceedings may face.



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CHAPTER 21 PRIVATE LITIGATION AND SEC ENFORCEMENT

2-21 Securities Enforcement: Counseling and Defense § 21.02

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§ 21.02 Private Securities Litigation

There are many species of shareholder litigation. The two primary types of shareholder litigation are: (1) class actions brought under the federal securities laws and (2) derivative actions brought under state fiduciary duty law. n1

[1] Shareholder Class Actions Under Federal Law

Shareholder class actions arise from a range of circumstances as broad as the ways in which one can mislead investors in connection with the purchase and sale of securities. Common causes include financial restatements, discovery of accounting irregularities, regulatory problems and investigations, misleading statements concerning mergers and acquisitions, missed earnings or revenue expectations, delays or flaws in key products, and lost sources of revenues, such as the cancellation of important contracts. Another potential trigger of a shareholder class action is the disclosure of the fact that a company is being investigated by the SEC.

The federal securities laws provide two broad categories of civil liabilities that plaintiffs frequently plead in shareholder class actions. First, Sections 11 and 12 of the Securities Act of 1933 ("1933 Act") provide specific private remedies against a narrow group of potential defendants in the context of securities offerings. n2 In these cases, plaintiffs can recover without the need to prove "scienter" or the state of mind of reckless or knowing deception. n3

The second source of civil liability is *Rule 10b-5*, n4 a broad anti-fraud rule enacted by the SEC pursuant to its authority under the Securities Exchange Act of 1934 ("1934 Act"). *Rule 10b-5* is the most common basis for fraud claims found in shareholder class actions. *Rule 10b-5* liability is more generalized than liability under the 1933 Act, in the sense that *Rule 10b-5* claims can be based on any type of material misrepresentation or omission in connection with the purchase or sale of securities, however or wherever made. Thus, *Rule 10b-5* liability can result from the usual types of statements that public companies make to investors, such as press releases and periodic SEC filings, but can also result, for example, from a drug company's discussion of its products in an obscure medical journal. n5 While liabilities under the 1933 Act arise in the context of specific types of securities offerings, claims under *Rule 10b-5* can arise at any stage in a company's history, as it communicates with the world about itself.

In shareholder class actions in the context of public company disclosures, common defendants include the company

itself, its top officers and others who made public statements about the company, and any directors who sold stock during the class period. If the case involves allegations of inaccurate historical accounting, the company's auditors also may be sued. Where the case arises from a securities offering, members of the company's board of directors and the underwriters of the offering may also be named as defendants.

In the broker-dealer context, *Rule 10b-5* again represents a broader liability threat. Stockbrokers can be held liable under *Rule 10b-5*, for example, for misrepresenting securities that they are recommending to their customers or for recommending unsuitable securities.

In 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA"), which regulates shareholder class actions in a variety of ways. Among its key provisions are:

- Provisions for the selection of a lead plaintiff, with the presumption that the class member who suffered the largest loss will be selected; n6
- A stay of discovery while defendants test the sufficiency of the pleadings with a motion to dismiss; n7
- The requirement that plaintiffs plead with particularity the basis for a "strong inference" of scienter, which is frequently contested in a motion to dismiss; n8 The PSLRA also requires that the misleading statements -- and why they are misleading -- be pleaded with particularity; n9
- A "safe harbor" for forward-looking statements. Forward-looking statements are protected from liability if (a) they are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the forward-looking statement," or (b) plaintiffs do not plead a strong inference that the statement was knowingly false; and n10
- Proportionate liability provisions that limit liability of certain defendants to their proportionate share of the fault, except in cases of "knowing" violators. n11

One of the consequences of the procedural aspects of the PSLRA is that the cases do not typically proceed on a fast track and usually do not proceed into discovery on the merits until at least a year after the case is filed. Defense counsel facing both a shareholder class action and an SEC investigation should be aware of the timing of the class action as they consider how the class action will impact the SEC proceedings and vice versa.

Timeline of a Typical Shareholder Class Action

| Event | Time from Case Filing |
|--|-----------------------|
| Consolidation of cases and selection of lead plaintiff and lead counsel | 3 to 5 months |
| Filing of consolidated complaint, which typically includes expanded allegations from initial complaints | 5 to 7 months |
| Briefing and resolution of motion to dismiss | 9 to 12 months |
| Briefing and resolution of motion for class certification, together with discovery on class certification issues | 11 to 15 months |
| Discovery on the merits | 12 to 36 months |
| Expert witness discovery | 24 to 40 months |

| | |
|--|-----------------|
| Briefing and resolution of motion for summary judgment | 30 to 50 months |
| Trial | 30 to 60 months |

The vast majority of shareholder class actions are settled well before trial. While there are no limits on when a case can settle, few cases settle in the early stages. Before a lead plaintiff and lead counsel are selected, settlement is difficult because defense counsel will not be able to negotiate with a duly-appointed representative of the class. Most defendants will attempt to win a motion to dismiss before serious settlement negotiations begin.

In many cases, the time after a motion to dismiss is denied but before extensive deposition discovery has begun presents an opportune time to consider the possibility of settlement. At this time, settlement is attractive to the plaintiffs who may wish to settle before they invest substantial resources in discovery. For defendants, settlement at this juncture may avoid both defense expenses (which reduce the D & O insurance coverage available to pay toward a later settlement) n12 and the disruption to the defendants that discovery inevitably causes. Counsel facing a simultaneous SEC investigation or enforcement action may wish to settle with the plaintiffs before the plaintiffs develop evidence that may be useful to the SEC. n13

[2] Shareholder Derivative Actions Under State Law

A derivative lawsuit seeks to pursue the corporation's own cause of action against persons who have liability to the corporation. In the securities context, derivative suits are usually brought against officers and directors of the company, where the board fails to act to pursue those claims and/or is conflicted in determining whether to pursue those claims. Where a board is not conflicted, the directors, rather than the derivative plaintiff, have the prerogative to decide whether to pursue the company's claims against the alleged wrongdoers. Typically, the shareholder derivatively suing a board will not make a pre-suit demand that the board of directors act to bring the proposed litigation, and will argue that such a demand is excused because the directors are conflicted. The derivative lawsuit seeks to recover for the company its damages as a result of alleged breaches of duty by directors or officers.

The following is an example of a typical derivative claim in the securities context. Shareholders have sued the corporation and others in a class action for the direct damages suffered by purchasing shareholders, under the federal securities laws. A derivative plaintiff will then sue the entire board of directors for allegedly breaching duties of oversight of the corporation's financial reporting, which breaches allegedly caused the company to incur liability to the shareholder class in the first case. Thus, the derivative lawsuit attempts to piggyback on the shareholder class action to hold directors liable for the harm suffered by the corporation as a result of its liability under the federal securities laws.

Sometimes, there will be merit to the claim that the board is responsible and the derivative action serves a useful purpose in seeking to reduce the net cost of the shareholder class action to the corporation and to hold the board accountable. In other cases, the derivative action will serve no useful purpose and will simply add to the costs to the corporation, inasmuch as (1) the corporation will suffer costs to defend and indemnify the directors and officers named as defendants in the derivative action, and (2) the cost to defend or settle the derivative action will reduce the D&O insurance proceeds available to the corporation to defend and settle the shareholder class action. Law firms in the shareholder plaintiffs' bar who routinely bring shareholder class actions typically file derivative actions as well, leading to special concerns that the derivative action in fact seeks to aid the prosecution of the shareholder class action or at least complicates the defense of the class action. n14

Derivative actions against directors and officers are almost always brought under state fiduciary duty law. That body of law includes duties of care and loyalty to the corporation. The most common claim against directors is that they failed to exercise proper oversight over the corporation's financial reporting or compliance functions. The leading case on this

issue is *In re Caremark International Derivative Litigation*.¹⁵ Most derivative lawsuits are litigated in state court.

There are two concepts that have developed under state law that limit the ability of a shareholder to use the derivative action to pursue causes of action that belong to the corporation. The board of directors can exercise their prerogative to determine whether litigation is in the best interests of the corporation through these two concepts: the demand requirement and the special litigation committee.

The Demand Requirement. Most derivative actions under Delaware law are filed without a pre-suit demand on the board of directors, based on the notion that the board is conflicted due to its own liability exposure and thus that a demand on the board would be futile. As a result, companies often move to dismiss the complaint on the ground that a pre-suit demand was not excused, seeking to place the control of the litigation in the hands of the board in the first instance. Whether such a motion will succeed depends on whether the directors can convince the court (based on a limited record) that a majority of the board is independent and disinterested, i.e., that the outside directors were uninvolved in the underlying fraud and face no meaningful exposure for breach of duties to the company.¹⁶

In many states, there is a statutory demand requirement. Thus, a shareholder must initially make a pre-suit demand on the board to pursue the proposed causes of action. If the board determines that the litigation should not be pursued, the derivative plaintiff will often proceed to file the derivative action, alleging that the demand was wrongfully refused. Again, the directors will typically respond by filing motions to dismiss the derivative complaint on grounds that the refusal of the demand was a proper exercise of the board's judgment.

If the court grants the company's motion to dismiss on the grounds that demand was not excused or was not wrongfully refused, the suit is terminated. Additionally, the shareholder plaintiff is barred from re-litigating the issue that the board is not capable of properly determining whether the litigation should be pursued, subject only to the possibility of later review of the board's determination under the business judgment rule.

Special Litigation Committees. A special litigation committee ("SLC") is a committee of one or more independent directors who are appointed by the board to review and make a binding determination with respect to whether the company should seek dismissal of a pending derivative action against or involving a majority of the board of directors. The purpose of the SLC is to act on behalf of the corporation when the full board is incapable of acting in a disinterested or independent fashion. A director is considered independent and disinterested -- and thus qualifies to serve on an SLC -- when he or she can base a decision on the merits of the case rather than on extraneous considerations or influences.

Normally, the SLC retains independent counsel and then commences a thorough investigation of the matters raised in the shareholder's complaint. Counsel defending the company or its officers in the SEC investigation will usually not qualify as independent counsel for the SLC. If the Audit Committee has retained independent counsel to conduct an internal investigation on behalf of the Audit Committee, the Audit Committee counsel likely will not qualify as independent counsel to the SLC if members of the Audit Committee are conflicted. The defendants in the derivative action typically move to stay the derivative lawsuit pending completion of the SLC process. While courts often grant such motions, the plaintiff is likely to oppose the motion and argue that, because the SLC members are themselves not independent and disinterested, the court should not stay the derivative lawsuit pending the SLC's determination. After the SLC completes its investigation, it typically prepares a written report containing both the factual results of its investigation and its conclusions with respect to whether litigation against the alleged wrongdoers is prudent. If the SLC determines that the derivative claims are without merit or for some other reason are not in the best interests of the company,¹⁷ the SLC instructs the company to seek a dismissal of the suit based on the SLC's determination. Alternatively, the SLC can determine to pursue the claims proposed by the derivative plaintiff or to settle those claims in exchange for some relief in favor of the corporation.

The courts developed the SLC process to give companies a meaningful way to use a body of duly elected or appointed

directors to determine whether litigation proposed in the derivative suit is in the best interests of the company, rather than leaving that determination to an un-elected dissident or gadfly shareholder and his or her self-interested counsel. One way to look at it is that the SLC process is really a corporate governance tool to address situations where some of the directors are conflicted but others can legitimately make the company's determination with respect to the litigation. Because of the possibility that the SLC process can be nothing more than a whitewash for fellow directors or management, however, courts exercise judicial review to determine whether the committee members are independent and whether the process that they used to make the company's determination was objective and thorough.

The Delaware Supreme Court established a two-step test in *Zapata v. Maldonado*ⁿ¹⁸ to decide whether or not a derivative suit should be dismissed pursuant to the determination of a special litigation committee. In the first step of the *Zapata* analysis, the court must examine the conduct and activities of the SLC to determine whether the SLC acted independent of the corporation, and in good faith conducted a reasonable investigation upon which the SLC based its conclusions. Because the good faith and reasonable investigation element looks closely at the thoroughness of the process, special committee investigations are often disruptive and expensive.

If the court determines that the SLC did not act in accordance with these standards, then the court will deny the corporation's motion to dismiss the derivative lawsuit. If the court, however, determines that the SLC has demonstrated that it was independent and that its decisions were made in good faith after reasonable investigation, the court moves on to the second prong of the *Zapata* two-step test. Under the second step, the court may choose to apply its own business judgment to determine whether the company's motion to dismiss should be granted. This second step is intended to strike a balance between the power of the board to get rid of meritless or harmful litigation, and, on the other hand, constraining that power when it is used to eliminate legitimate derivative claims.

If the SLC recommends termination of the derivative litigation, there is frequently a skirmish over whether the derivative plaintiff can obtain discovery of the record of the SLC's investigation, including interview notes and documents related to the SLC's deliberations. There is conflicting case law on the right to discovery, so it is usually difficult to predict whether discovery would be allowed. However, it is safe to say that if discovery is permitted, it could be problematic because the SLC process frequently elicits unflattering facts that will likely be used by the plaintiff to argue that the SLC's conclusions were unreasonable. The factual record of the SLC investigation, therefore, will sometimes be dangerous if it falls into the hands of either the SEC or the shareholder class action plaintiffs who would seek to use those very facts to hold the company liable.

Special litigation committees have become a common way of dealing with derivative lawsuits. However, they are most appropriate when either a majority of the board is implicated in the wrongdoing or the facts are particularly aggravated and call for a review of the actions of management or others. There are significant costs to the SLC process and no guarantees that it will cut off the derivative litigation.

Against the backdrop of an SEC investigation or enforcement proceeding, the work of the SLC can complicate matters. First and foremost, as discussed elsewhere in this book,ⁿ¹⁹ the SEC often pressures companies to waive the attorney-client privilege. Thus, the SEC may ask to see the record of the SLC investigation, even though that record would ordinarily be considered attorney-client privileged or immune from discovery under the work product doctrine. If the company relents and provides the SEC with that record, the derivative plaintiff as well as the class action plaintiff will seek discovery of that record on the ground that applicable privileges have been waived. Second, key witnesses, who may themselves face personal liability, will be subject to requests for interviews or testimony from multiple sources and may retain separate counsel with whom SEC defense counsel will have to work. Third, witnesses who face exposure to SEC sanctions may decline to be interviewed by the SLC, in light of the risk that the record of that interview will become discoverable.

FOOTNOTES:

(n1)Footnote 1. Shareholder class actions can also be brought under state law. However, following the 1998 enactment

of the Securities Litigation Uniform Standards Act ("SLUSA") 15 U.S.C.S. § 78bb(f), many state law shareholder class actions are preempted by federal law. The preempted causes of action generally include claims that the defendants' misrepresentations or omissions violated state securities statutes or common law misrepresentation principles. However, pursuant to an exception in SLUSA, 15 U.S.C.S. § 78bb(f)(3)(A)(i), class actions for breach of fiduciary duty under the law of the company's state of incorporation have generally survived after SLUSA.

(n2)Footnote 2. 15 U.S.C.S. §§ 77k and 77l.

(n3)Footnote 3. *E.g., Kaplan v. Rose*, 49 F.3d 1363 (9th Cir. 1994) , cert. denied, 116 S. Ct. 58 (1995) .

(n4)Footnote 4. 17 C.F.R. § 240.10b-5.

(n5)Footnote 5. *In re Carter-Wallace, Inc. Secs. Litig.*, 150 F.3d 153 (2d Cir. 1998) .

(n6)Footnote 6. 15 U.S.C.S. § 78u-4(a)(3)(B).

(n7)Footnote 7. 15 U.S.C.S. § 78u-4(b)(3). Plaintiffs often argue that defendants should be required to produce documents that they have already provided to the SEC, on the grounds that there is no additional burden to providing the same documents to the plaintiffs. Such arguments have met with varying results. *Compare Faulkner v. Verizon Communications, Inc.*, 156 F. Supp. 2d 384 (S.D.N.Y. 2001) (denying plaintiffs' motion seeking production of documents already produced by defendants); *In re Pinnacle Holdings Secs. Litig.*, slip op., Case No. 8:01-CV-624-T-27-MSS (M.D. Fla. May 24, 2002), with, *In re Enron Sec. Corp. Sec. 2002 U.S. Dist. LEXIS 26261* (S.D. Tex. Aug. 16, 2002) (lifting discovery stay as to materials already produced to various government agencies, including the SEC); *In re LaBranche Sec. Litig.*, 333 F. Supp 2d 178 (S.D.N.Y. 2004) (same).

(n8)Footnote 8. 15 U.S.C.S. § 78u-4(b)(2).

(n9)Footnote 9. 15 U.S.C.S. § 78u-4(b)(1).

(n10)Footnote 10. 15 U.S.C.S. §§ 77z-2(c) and 78u-5(c). Where the safe harbor does not apply, the defendants may nevertheless defend on the ground that the alleged misrepresentations fall within the protections of the "bespeaks caution" doctrine. This doctrine treats optimistic statements as immaterial or incapable of reasonable reliance where the optimistic statements are qualified by adequate risk warnings. *E.g., EP MedSystems, Inc. v. EchoCath, Inc.*, 235 F.3d 865 (3d Cir. 2000) .

(n11)Footnote 11. 15 U.S.C.S. § 78u-4(f).

(n12)Footnote 12. See Chapter 26 for a discussion of D&O insurance issues.

(n13)Footnote 13. Similarly, counsel may wish to resolve the SEC investigation before the SEC develops evidence useful to the plaintiffs. On the other hand, where the SEC investigation is viewed as a far greater threat than the private litigation, the ability of private litigation to provide defense counsel with an opportunity to obtain discovery of evidence that can assist in defending the SEC investigation or a resulting administrative proceeding may be a factor counseling against settlement of the private action.

(n14)Footnote 14. These parallel derivative actions create perverse incentives for the derivative plaintiff's counsel. On the one hand, the derivative plaintiff purports to represent the interests of the corporation. Thus, the derivative plaintiff should be pleased to see the direct action fail and result in no significant cost to the corporation. Such a result, however, would obviate the need to sue directors and officers to recover the harm suffered by the corporation through its liability in the direct action. If the derivative plaintiff's counsel is motivated by a desire to earn a fee through the pursuit of a derivative claim, that counsel will wish to see the corporation exposed to significant liability in the direct action. Thus, in many instances, corporations will view the motives of the derivative plaintiff warily and will want to

prevent the derivative action from aiding the direct action. Tactics to achieve this objective include insistence on a demand on the board of directors (discussed below) and moving to stay derivative litigation unless and until it is determined that the corporation faces meaningful exposure to liability.

(n15)Footnote 15. *698 A.2d 959 (Del. Ch. 1996)* ; *see also McCall v. Scott, 239 F.3d 808 (6th Cir. 2001)* .

(n16)Footnote 16. The seminal Delaware case on the demand requirement is *Aronson v. Lewis, 473 A.2d 805 (Del. 1984)* ; *see also McCall, 239 F.3d 808* .

(n17)Footnote 17. The SLC can determine that there is merit to the claims made in the litigation, but that pursuing those claims is not in the best interests of the company, based on factors such as (1) exhaustion of the D&O policy as a result of the litigation, (2) collectibility from the defendants, (3) distraction of management, and (4) adverse publicity or internal morale as a result of the company pursuing the claims.

(n18)Footnote 18. *430 A.2d 779 (1981)* .

(n19)Footnote 19. See Chapter 19.



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Securities Enforcement: Counseling and Defense

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CHAPTER 21 PRIVATE LITIGATION AND SEC ENFORCEMENT

2-21 Securities Enforcement: Counseling and Defense § 21.03

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§ 21.03 Admissibility and Use in Private Litigation of Materials from SEC Proceedings

[1] Transcripts of SEC Testimony

As discussed elsewhere in this treatise, ⁿ¹ it is possible for plaintiffs to obtain discovery via a subpoena or via the Freedom of Information Act of transcripts of testimony taken by the SEC in the course of its investigation or litigation. Defense counsel should anticipate that plaintiffs will seek such discovery and will make use of it. Plaintiffs benefit from possession of transcripts in several ways. Such transcripts may be used to impeach any contrary testimony, to educate plaintiffs' counsel about what a variety of witnesses have already said before beginning to take depositions in the private action, to assess the merits of the case before taking costly discovery, and so forth. At a practical level, this reality impacts everything from how witnesses are prepared for their SEC testimony to decisions regarding the timing and content of settlements with the SEC.

[2] Wells Submissions

While a strong argument can be made that a Wells Submission should be treated as a document entitled to the protection from admission into evidence accorded statements made in connection with settlement negotiations under *Federal Rule of Evidence 408*, ⁿ² there is a risk that shareholder plaintiffs will attempt to introduce the Wells Submission into evidence. It must be noted, however, that a defendant is permitted to offer into evidence the Wells Submission that he submitted in connection with SEC administrative proceedings. ⁿ³

Even if the Wells Submission is not admissible in the private litigation, it is likely to be discoverable and may be useable as impeachment material. ⁿ⁴ Thus, counsel drafting a Wells Submission will be torn between a desire to concede some points or candidly to acknowledge failings (and corresponding contrition) to make a more effective argument to the SEC and the possibility that any concessions will be used by shareholder plaintiffs to develop their case for civil liability.

[3] SEC Settlements

One of the possible consequences of reaching a settlement in an SEC enforcement proceeding is that the settlement may be admitted into evidence in private litigation such as a shareholder class action. For example, a private plaintiff

bringing a claim against a defendant for alleged violations of the federal securities laws might attempt to introduce into evidence documents that show the SEC brought enforcement proceedings for the same alleged misconduct and any documents relating to a settlement of such proceedings. Defendants contemplating a settlement with the SEC need to worry about the admissibility of the settlement in private litigation, given the fact that a jury is likely to assume that a defendant who settled with the government deserves a finding of liability.

Where the SEC has charged a defendant, plaintiffs frequently recite the SEC charges in their complaint to attempt to satisfy the rigorous pleading standards applicable to shareholder class actions after the PSLRA. n5 Some courts may consider allegations regarding SEC charges against a defendant at the pleading stage of private litigation. Moreover, the fact that the agency with expertise in spotting securities law violations has decided to pursue a case lends significant credibility to the plaintiff's allegations and makes it unlikely that the case will be viewed as a strike suit.

Some courts, however, may decline to consider allegations that are based on allegations asserted by the SEC. In one case, n6 the private complaint listed at length facts and conclusions from a complaint filed by the SEC against the same defendants. The defendants argued that these imported allegations were improper and should be ignored in determining whether the private complaint measured up to the PSLRA pleading standard. The court noted that *Fed. R. Civ. P. 11* "conveys a non-delegable duty upon the signing attorney to conduct his own independent analysis of the facts and law which form the basis of a pleading or motion." n7 Ruling that the allegations were hearsay and improper and thus would not be considered, the court found it to be a "pervasive defect" that the plaintiffs might be merely asserting that "someone else" has alleged the facts quoted from the SEC complaint. n8

[a] Federal Rule of Evidence 803(8)(c)

While a defendant is likely to object to evidence related to a settlement on hearsay grounds, a plaintiff may argue that the settlement documents are admissible under *Federal Rule of Evidence 803(8)(c)*. Rule 803(8) provides, in part, that

Records, reports, statements, or data compilations in any form, of public offices or agencies setting forth

* * *

(C) in civil actions and proceedings and against the Government in criminal cases, factual findings resulting from an investigation made pursuant to authority granted by law, unless the sources of information or other circumstances indicate lack of trustworthiness.

The United States Supreme Court noted that Rule 803(8)(c) permits "admissibility in the first instance" absent circumstances that indicate a lack of trustworthiness. n9

Courts have considered the following factors suggested by the Advisory Committee to assist in passing upon the admissibility of evaluative reports under Rule 803(8)(c): (1) the timeliness of the investigation; (2) the investigator's skill or experience; (3) whether a hearing was held and the level at which it was conducted; and (4) possible bias when reports are prepared with a view to possible litigation. n10

Several courts have applied these factors to determine if a report of an administrative agency should be admitted into evidence. Applying these factors, the Tenth Circuit in *Denny v. Hutchinson Sales Corp.* determined that the report prepared by an administrative agency was inadmissible under *Federal Rule of Evidence 803(8)(c)* for "lack of trustworthiness." n11 The court noted that the "findings ... were made pursuant to an *ex parte* investigation" and "(t)he lack of formal procedures and an opportunity to cross-examine witnesses are proper factors in determining the trustworthiness of the finding." n12 The court referred to an earlier opinion in *Franklin v. Skelly Oil Co.*, n13 and said: "[W]e noted that the trustworthiness of a report is particularly questionable when its conclusion would not be admissible

by the direct testimony of the maker or the opportunity to cross-examination had been denied." n14 In *Strobl v. New York Mercantile Exchange*, n15 the court considered the admissibility of a decision from an administrative law judge of the Commodity Futures Trading Commission after hearings in which the respondents had not participated. After considering the source of the information and the circumstances under which that information was transformed into "findings of fact," the court concluded that the evidence lacked "sufficient indicia of trustworthiness to qualify for admission under 803(8)(c)." n16 The court stated further, "the proffered 'findings' are 'findings' in name only." n17

The Second Circuit considered the admissibility of a consent decree resulting from a settled SEC injunctive action in *Lipsky v. Commonwealth United Corp.* n18 In *Lipsky*, the Second Circuit found that consent decrees involving the SEC should be excluded from evidence because they result from private bargaining and do not reflect a decision on the merits by a trier of fact. Citing *Federal Rule of Evidence 410*, which prohibits a plea of *nolo contendere* from being used later against the party who so pleaded, the Second Circuit observed that "a consent judgment between a federal agency and a private corporation which is not the result of an actual adjudication of any of the issues ... can not be used as evidence in subsequent litigation between that corporation and another party." n19 The Second Circuit explained that an SEC consent decree and a *nolo contendere* plea are comparable in that they "are not true adjudications of the underlying issues." n20 The court explained that "[t]he consent decree ... was the result of private bargaining, and there was no hearing or rulings or any form of decision on the merits by the [trier of fact]." n21

In settled SEC enforcement matters, it is typical for portions of the charging document to set forth legal conclusions in addition to factual conclusions. Thus, it could be argued that even if an SEC order in a settled case were admissible under *Federal Rule of Evidence 803(8)(c)* insofar as it set forth certain facts (e.g., a factual description of a person's conduct), the order would be inadmissible insofar as it set forth legal conclusions (e.g., a statement that a person willfully aided and abetted certain violations of the federal securities laws). n22

It could be argued further that the admission of settlement papers reflecting legal conclusions of the SEC pose a danger that the jury may believe that the SEC knows more than the judge regarding the securities laws. In *Marx & Co. v. Diners' Club, Inc.*, the Second Circuit held that an expert should not be permitted to testify regarding "the legal effect [of a document] when there is a knowledgeable gentleman in a robe whose exclusive province it is to instruct the jury on the law. The danger is that the jury may think that the 'expert' in the particular branch of the law knows more than the judge -- surely an inadmissible inference in our system of law." n23 The Second Circuit further recognized that "care must be taken lest, in the field of securities law, he [the expert] be allowed to usurp the function of the judge." n24 Similarly, a strong argument can be made that admission of papers relating to an SEC settlement is inappropriate insofar as the settlement papers would usurp "the court's duty to set forth the law and the jury's ability to apply this law to the evidence." n25

Defendants should be mindful that the party opposing the introduction bears the burden of coming forward with enough "negative factors" to persuade a court that a report should not be admitted because of lack of trustworthiness under Rule 803(8)(c). n26 The defendants in *Option Resource Group v. Chambers Dev. Co.* n27 failed to meet this burden. The defendants vigorously contended:

the factual findings and conclusions of the SEC are untrustworthy and inadmissible for a number of reasons, including the lack of formal hearings and opportunity of these parties to cross-examine the witnesses to the SEC proceedings and otherwise fully participate therein, and the fact they were issued as an integral part of the Releases announcing the settlement of the SEC administrative proceedings. n28

The district court rejected the defendants' contention and allowed the SEC's factual findings, including its opinions and conclusions, to be admitted under Rule 803(8)(c). n29

[b] Federal Rule of Evidence 408

Notwithstanding Rule 803(8)(c), district courts may exercise discretion under *Federal Rule of Evidence 408* to determine whether the evidence should still be excluded.

Rule 408 provides:

Evidence of (1) furnishing or offering or promising to furnish, or (2) accepting or offering or promising to accept, a valuable consideration in compromising or attempting to compromise a claim which was disputed as to either validity or amount, is not admissible to prove liability for or invalidity of the claim or its amount. Evidence of conduct or statements made in compromise negotiations is likewise not admissible.

Rule 408 "codifies the general practice of the federal courts that compromise agreements are inadmissible." n30 In *Fidelity*, the court explained that the refusal to infer an admission of liability from a compromise or settlement "lies both in the policy of the law to encourage settlement of litigation and in the realization that it is often more advantageous, economical and desirable for a party to 'buy his peace' than to go through litigation even when his chances of prevailing are great." n31 The court further explained that the federal policy "encourages negotiation of settlements by preventing the parties to the compromise from being tied elsewhere to the concessions they made *inter sese*." n32

Applying this in SEC settings, courts have excluded consent decrees in SEC enforcement proceedings as evidence in private securities litigation. In *Beck v. Cantor, Fitzgerald & Co.*, n33 the court excluded all evidence of an SEC investigation, an SEC opinion, and the plaintiff's acquiescence in the SEC opinion as "irrelevant and immaterial for several reasons," including the court's view that plaintiff's acquiescence in an SEC opinion was inadmissible pursuant to Rules 408 and 410. Similarly, in *Option Resource Group*, n34 the district court granted a motion in limine filed by the defendants in a securities fraud action seeking to exclude evidence of and references to the compromise and settlement of SEC proceedings. The court held that the evidence of conduct of the parties or statements made in the course of the settlement negotiations clearly were excluded by the language of Rule 408. n35 In *In re Cenco, Inc. Securities Litigation*, n36 the court granted a motion to strike references to an SEC Release. Drawing an analogy to a consent decree issued by the SEC in a settled enforcement proceeding, the court determined that the Release was a settlement within the meaning of *Fed. R. Evid. 408* and not within the hearsay exception of *Fed. R. Evid. 803(8)*. n37 The *Cenco* court was not persuaded that the Release was offered to prove any facts other than the defendant's possible liability in the private litigation. n38 Moreover, the Court found that the facts that the plaintiff sought to prove were "not based on formal findings of the SEC following a hearing on the record. The [Release] recited unproven allegations developed by the SEC's staff, plus some comments by the Commission." n39

Further, in most instances, the defendant will have a strong argument that the order resulting from the settlement of the administrative proceeding should be excluded from evidence based on the language of the order. The SEC will typically agree to include in such orders a statement that the findings are made solely for the purpose of these proceedings and are not binding on any other person or entity in this or any other proceeding. This statement may support the argument that the order should not be admitted into evidence in private litigation because the Commission expressly states that its findings were not made for that purpose. n40

It is important to keep in mind that Rule 408 does not require exclusion of settlement evidence where it is offered for some legitimate purpose other than to establish liability. n41

[c] Lack of Probative Value and Prejudice

Independent of Rule 408 and the public interest in encouraging settlements, a defendant may argue that the settlement papers should be excluded as hearsay because they lack probative value and have the potential to mislead the jury. n42 Courts will likely exclude administrative agency reports when the evidence could be presented in some other form because the only purpose to be served by admitting the evidence "would be to suggest to the jury that it should reach the

same conclusion" as the agency. n43 Settlement documents may also be excluded when there is a concern that the evidence may open "large areas of proof on collateral matters." n44 Settlement materials will also be excluded when it is determined that the documents serve no purpose except to inflame the reader. n45

Comment

Excluding the consent decree from evidence is particularly appropriate where plaintiffs have access to all the evidence that was available to the SEC.

[4] Judgments in Favor of the SEC and Collateral Estoppel in Private Litigation

A party who has had issues of fact adjudicated against him or her by a court in an action brought by the SEC is likely to be collaterally estopped from relitigating the same issues in a parallel lawsuit brought by a shareholder plaintiff. Although it used to be that a party could only invoke collateral estoppel where both parties were bound by the same judgment, the United States Supreme Court also listed to be a requirement of mutuality of parties in 1979. In *Parklane Hosiery Co. v. Shore*, n46 the United States Supreme Court held that defendants in a shareholder class action were collaterally estopped from relitigating the question of whether a proxy statement was materially false and misleading as they had a full and fair opportunity to litigate their claims and those issues had been fully and fairly adjudicated in the prior proceeding brought by the SEC. The Supreme Court explained, however, that collateral estoppel should not be used when the application would be unfair to a defendant. n47 The *Parklane* Court found that none of the factors were present that would suggest unfairness to the defendant-petitioners:

The application of offensive collateral estoppel will not here reward a private plaintiff who could have joined in the previous action, since the [plaintiff] probably could not have joined in the injunctive action brought by the SEC even had he so desired ... [t]here is no unfairness to the petitioners in applying offensive collateral estoppel because in light of the serious allegations made in the SEC's complaint against the petitioners as well as the foreseeability of subsequent private suits that typically follow a successful Government judgment, the petitioners had every incentive to litigate the SEC lawsuit fully and vigorously ... [t]he judgment in the SEC action was not inconsistent with any previous decision ... [t]here will in the respondent's action be no procedural opportunities available to the petitioners that were unavailable to the petitioners in the first action of a kind that might be likely to cause a different result. n48

While *Parklane* involved an SEC injunctive action that had been litigated in court, collateral estoppel effect might also be given to the decision of an administrative law judge. n49 A strong argument can be made, however, that the decision of an Administrative Law Judge ("ALJ") should rarely, if ever, be given collateral estoppel effect, because a respondent in an administrative proceeding is not entitled to take pre-hearing discovery, and the rules of evidence do not apply in an SEC administrative hearing.

Thus, a company or individual faces heightened risk if it litigates against both the SEC and private litigants. n50 Because courts do not give collateral estoppel effect against persons who were not party to a litigation, if the defendant prevails in the first trial, the court in the second litigation will not estop the plaintiff from relitigating the issues in the second trial. In contrast, if the defendant loses in the first trial, there is a significant risk that the court will estop the defendant from relitigating the issue in the second trial. Thus, the defendant faces the daunting prospect of having to win two trials in order to prevail in the second action to go to trial.

FOOTNOTES:

(n1)Footnote 1. See Chapter 15.

(n2)Footnote 2. *In re Allied Stores Corp.*, 1988 SEC LEXIS 5247, 52 SEC Docket 451 (Mar. 21, 1988) (administrative law judge excluding Wells Submission and condemning the Division's argument that the Wells

Submission procedure is to inform the Commission, not to encourage settlement, as an unacceptably narrow view. The ALJ concluded that it is clear that the Commission's intention was "to encourage submissions in the interest of resolving or settling the basic question of whether enforcement action should be instituted.", *But see In re Initial Public Offering Litig.*, 2003 U.S. Dist. LEXIS 23102 (S.D.N.Y. Jan. 12, 2003) (holding that Wells Submissions were not settlement materials under *Fed. R. Evid. 408*).

(n3)Footnote 3. *McDaniel v. Bear Stearns & Co.*, 196 F. Supp. 2d 343, 365 (S.D.N.Y. 2002) (affirming arbitration panel's decision admitting the body of Wells Submission and most of the exhibits but not accepting attached trial testimony and deposition transcripts because much of that testimony was hearsay and witnesses could be called to testify if necessary).

(n4)Footnote 4. *E.g., In re Initial Public Offering Litig.*, 2003 U.S. Dist. LEXIS 23102 (S.D.N.Y. Jan. 12, 2003) . (holding that Wells Submission, even if not admissible, was nonetheless discoverable under *Fed. R. Civ. P. 26(b)(1)*).

(n5)Footnote 5. *E.g., Accelr8 Technology Corp. Sec. Litig.*, 147 F. Supp. 2d 1049, 1056 (D. Colo. 2001)

(n6)Footnote 6. *Geinko v. Padda*, No. 00-C-5070, 2002 U.S. Dist. LEXIS 3316 (N.D. Ill. Feb. 27, 2002) .

(n7)Footnote 7. *Geinko*, 2002 U.S. Dist. LEXIS 3316 .

(n8)Footnote 8. *Geinko*, 2002 U.S. Dist. LEXIS 3316 . See also *Lipsky*, 551 F.2d 887, 893-894 (upholding lower court order striking references in plaintiff's complaint to SEC injunctive complaint and Consent Decree).

(n9)Footnote 9. *Beech Aircraft Corp. v. Rainey*, 488 U.S. 153, 167 (1988) .

(n10)Footnote 10. *Denny v. Hutchinson Sales Corp.*, 649 F.2d 816, 821 (10th Cir. 1981) .

(n11)Footnote 11. *Denny*, 649 F.2d at 821 .

(n12)Footnote 12. *Denny*, 649 F.2d at 821 .

(n13)Footnote 13. *Franklin v. Skelly Oil Co.*, 141 F.2d 568 (10th Cir. 1944) .

(n14)Footnote 14. *Denny*, 649 F.2d at 822 .

(n15)Footnote 15. *Strobl v. New York Mercantile Exchange*, 590 F. Supp. 875, 878 (S.D.N.Y. 1984) .

(n16)Footnote 16. *Strobl*, 590 F. Supp. at 878-879 .

(n17)Footnote 17. *Strobl*, 590 F. Supp. at 880 .

(n18)Footnote 18. 551 F.2d 887, 893 (2d Cir. 1976) .

(n19)Footnote 19. *Lipsky*, 551 F.2d at 893 .

(n20)Footnote 20. *Lipsky*, 551 F.2d at 893-894 .

(n21)Footnote 21. *Lipsky*, 551 F.2d at 893 .

(n22)Footnote 22. *See, e.g., Hines v. Brandon Steel Decks, Inc.*, 886 F.2d 299, 302 (11th Cir. 1989) ("Rule 803(8)(c) does not provide for the admissibility of the legal conclusions contained within an otherwise admissible public report ... Legal conclusions are inadmissible because the jury would have no way of knowing whether the preparer of the report was cognizant of the requirements underlying the legal conclusion").

(n23)Footnote 23. *Marx & Co. v. Diners' Club, Inc.*, 550 F.2d 505, 512 (2d Cir. 1977) .

(n24)Footnote 24. *Marx & Co.*, 550 F.2d at 512 .

(n25)Footnote 25. *Specht v. Jensen*, 853 F.2d 805, 808 (10th Cir. 1988) , cert. denied, 488 U.S. 1008 (1989) .

(n26)Footnote 26. *Beech Aircraft Corp. v. Rainey*, 488 U.S. 153, 167 .

(n27)Footnote 27. *Option Resource Group v. Chambers Dev. Co.*, 967 F. Supp. 846 (W.D. Pa. 1996) .

(n28)Footnote 28. *Option Resource Group*, 967 F. Supp. at 851 .

(n29)Footnote 29. *Option Resource Group*, 967 F. Supp. at 851 . See also *Beech*, 488 U.S. at 171 ("We hold ... portions of investigatory reports otherwise admissible under Rule 803(8)(c) are not inadmissible merely because they state a conclusion or opinion."); *In re Japanese Elec. Prods. Antitrust Litig.*, 723 F.2d 238, 268 (3d Cir. 1983) ("Requiring that the government report of an investigation be based on an evidentiary hearing providing an opportunity for cross-examination would rob Rule 803(8)(c) of any practical utility. Most governmental investigations proceed without either evidentiary hearings or the opportunity for cross-examination. The indice of reliability for the governmental investigative report is the fact that it is prepared pursuant to a duty imposed by law.").

(n30)Footnote 30. *Fidelity & Deposit Co. v. Hudson United Bank*, 493 F. Supp. 434, 445 (D.N.J. 1980) , rev'd on other grounds, 653 F.2d 766 (3d Cir. 1981) .

(n31)Footnote 31. *Fidelity & Deposit Co.*, 493 F. Supp. at 445 .

(n32)Footnote 32. *Fidelity & Deposit Co.*, 493 F. Supp. at 445 . See *Fed. R. Evid. 408* Adv. Comm. Note (quoting *McShain, Inc. v. Cessna Aircraft*, 563 F.2d 632, 635 n.5 (3d Cir. 1977)) .

(n33)Footnote 33. *Beck v. Cantor, Fitzgerald & Co.*, 621 F. Supp. 1547, 1565 (N.D. Ill. 1985) .

(n34)Footnote 34. *Option Resource Group*, 967 F. Supp. at 849 .

(n35)Footnote 35. *Option Resource Group*, 967 F. Supp. at 849 . See also *Petruzzi's IGA Supermarkets v. Darling-Delaware Co.*, 998 F.2d 1224, 1247 (3d Cir. 1993) (evidence of settlements in two antitrust actions inadmissible under *Fed. R. Evid. 408*); *Kramas v. Security Gas & Oil, Inc.*, 672 F.2d 766, 772 (9th Cir. 1982) (affirming decision to exclude "evidence of a consent decree entered in a prior SEC enforcement proceeding ... under *Fed. R. Evid. 404(b)*"); *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887, 893 (2d Cir. 1976) ("[A] consent judgment between a federal agency and a private corporation which is not the result of an actual adjudication of any of the issues ... can not be used as evidence in subsequent litigation between that corporation and another party."); and *Shahzad v. Meyers & Co., Inc.*, 1997 U.S. Dist. LEXIS 1128, *39-42 (S.D.N.Y. 1997) (striking allegations in complaint referring to consent orders entered into between defendant and various state and federal agencies).

(n36)Footnote 36. 601 F. Supp. 336 (N.D. Ill. 1984) .

(n37)Footnote 37. *Cenco Inc.*, 601 F. Supp. at 337 n.3 .

(n38)Footnote 38. *Cenco Inc.*, 601 F. Supp. at 337 n.3 .

(n39)Footnote 39. *Cenco Inc.*, 601 F. Supp. at 337 n.3 .

(n40)Footnote 40. *Kramas*, 672 F.2d at 772 (The "consent decree involved no finding of culpability and no judgment of wrongdoing, and contained a recitation that it did not constitute evidence of wrongdoing in the enforcement proceeding or in any other proceeding."). See also *Option Resource Group*, 967 F. Supp. at 848 (each of the releases

contained "a proviso stating the findings of the investigation are solely for the SEC proceedings, and are not binding on any other person or entity").

(n41)Footnote 41. *See, e.g., Central Soya Co. v. Epstein Fisheries, Inc., 676 F.2d 939, 944-945 (7th Cir. 1982)* (settlement negotiations may be introduced for another purpose).

(n42)Footnote 42. *Fed. R. Evid. 403, 410(b)* and 303(b).

(n43)Footnote 43. *See, e.g., Hall v. Western Production Co., 988 F.2d 1050, 1058 (10th Cir. 1993)* (refusing to admit report of Wyoming Fair Employment Commission where other methods could be employed to present evidence, and the only purpose of WFEC report therefore, would be to suggest to the jury that it should reach the same conclusion as the WFEC).

(n44)Footnote 44. *Kramas, 672 F.2d at 772* (district court reasonably concluded that the balance favored exclusion).

(n45)Footnote 45. *Shahzad v. Meyers & Co., Inc., 1997 U.S. Dist. LEXIS 1128, *30-42 (S.D.N.Y. 1997)* (striking from complaint references to affidavit of SEC investigator describing false and misleading sales techniques employed by defendants because it was from a completely unrelated proceeding and could serve no purpose other than to inflame the reader).

(n46)Footnote 46. *Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979)* .

(n47)Footnote 47. *Parklane Hosiery Co., 439 U.S. 322* .

(n48)Footnote 48. *Parklane Hosiery Co., 439 U.S. 322* .

(n49)Footnote 49. *United States v. Utah Constr. & Mining Co., 384 U.S. 394, 422 (1966)* ("When an administrative agency is acting in a judicial capacity and resolves disputed issues of fact properly before it which the parties have had an adequate opportunity to litigate, the courts have not hesitated to apply res judicata to enforce repose.")

(n50)Footnote 50. *See Chapter 17.*



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CHAPTER 21 PRIVATE LITIGATION AND SEC ENFORCEMENT

2-21 Securities Enforcement: Counseling and Defense § 21.04

AUTHOR: Kenneth B. Winer

§ 21.04 Strategic and Practical Considerations

Defense counsel faced with both private shareholder litigation and an SEC proceeding need to address difficult strategy decisions throughout the defense effort. One fundamental driving force in this strategic decision tree will be which of the two proceedings poses a greater risk to the client, based on what is important to the client.

For example, a corporation may face liability exposure as a result of employee misconduct, but may have mitigated its exposure to the SEC by, for example, taking steps to adopt remedial measures to "clean house." Counsel for the corporation in this instance may prefer to base their strategy on minimization of the more ominous exposure to shareholder litigation. Counsel for an individual executive officer in the same situation may have little or no concern about the shareholder litigation (because the officer is protected by indemnification rights and D&O insurance), but may view the possibility of SEC sanctions as the prime concern because of its likely career-ending effect. Because there are so many variations of the situations that defendants will face, the calculus will be different in each case.

One thing is certain; fighting a two-front battle is more difficult than a one-front battle. The following paragraphs discuss some of the considerations that counsel should ponder.

[1] Privilege Waiver

Elsewhere, this treatise discusses situations in which the attorney-client privilege is deemed waived, such as the risk that disclosure to the SEC of the results of an internal investigation can waive the privilege, n1 and that the SEC will consider such a waiver as an indication of cooperation that could result in lesser sanctions. n2 Where private litigation is also pending, counsel must consider the impact of the waiver on both proceedings. Whereas it may be in the interest of a company to provide privileged materials to the SEC, it is rarely, if ever, in the interest of a company for private plaintiffs to be able to obtain discovery of materials prepared in the course of the company's internal investigation. Where there is private litigation to worry about, a company must carefully consider the potential impact on private litigation before agreeing to provide materials to the SEC that may result in a waiver.

[2] Joint Representation and the Proliferation of Separate Counsel

The interests of a corporation and its officers or directors are far more likely to diverge in an SEC enforcement case than

they are in private litigation. For example, the corporation may want to earn credit from the SEC by replacing key officers who were directly or indirectly responsible for the problem. Another example comes at the settlement stage, as the SEC may agree to lesser sanctions against the corporation if it can obtain more serious sanctions against officers or directors. Thus, multiple defendants are likely to need separate legal representation if there is a pending SEC investigation, which can deplete the D&O coverage limits otherwise available to satisfy the private litigation.

[3] Taking the Fifth

If the SEC proceeding spurs parties to invoke their *Fifth Amendment* privilege against self-incrimination, the judge in the private litigation may preclude the admission of evidence by those parties on the same subjects and may instruct the jury to draw an adverse inference from the refusal to answer on self-incrimination grounds. n3 A jury is likely to be prejudiced if it hears an individual defendant or an employee of a corporate defendant decline to answer questions on the ground that answering them truthfully may tend to incriminate them.

Counsel may seek to postpone discovery in civil proceedings where there is a parallel criminal proceeding or the threat thereof, or may seek a protective order sealing the civil testimony from use by criminal investigators or prosecutors.

[4] Settle to Focus on Defense of the SEC Proceeding

Some defendants (such as an officer of an issuer) may be relatively unconcerned about the private litigation, because, for example, they expect the matter to be resolved without their making a personal contribution. Such defendants may oppose the use of a limited pool of D&O insurance coverage to settle the private litigation, preferring to maintain that coverage to fund their defense of the SEC charges. Conversely, an issuer might be more forward on the private litigation, especially if the issuer has a new team of directors and senior officers. Some of the benefits of eliminating the exposure to private litigation and focussing on the SEC proceeding are:

- Eliminate the risk that the plaintiffs will develop evidence that will assist the SEC.
- Eliminate the risk that the SEC will develop evidence that will assist the plaintiffs and exacerbate the liability exposure.
- Eliminate the risk that a loss in the SEC enforcement proceeding will carry with it massive private liability in light of the possible use of collateral estoppel.
- Open the possibility of waiving privileges and providing privileged materials to the SEC without collateral consequences in the private litigation.
- Make appropriate concessions and accept responsibility vis-'a-vis the SEC (including a Wells Submission) in a way that is more likely to elicit SEC leniency, without liability consequences to shareholder plaintiffs.

The strategic decisions that fall upon defense counsel facing private shareholder litigation and SEC enforcement action are rarely uncomplicated and almost always involve unpleasant tradeoffs.

FOOTNOTES:

(n1)Footnote 1. *See* Chapter 12.

(n2)Footnote 2. *See* Chapter 17.

(n3)Footnote 3. *See* Chapter 13.



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CHAPTER 22 STATE SECURITIES ENFORCEMENT

2-22 Securities Enforcement: Counseling and Defense 22.syn

AUTHOR: Terry D. Nelson

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CHAPTER 22 STATE SECURITIES ENFORCEMENT

2-22 Securities Enforcement: Counseling and Defense § 22.01

AUTHOR: Terry D. Nelson

§ 22.01 Introduction

[1] Background

Enforcement action by the Massachusetts Securities Division under the authority of the Massachusetts state securities law against a major national investment "scam", in connection with alleged violations of such law is a dramatic example of a state securities regulator flexing its muscle against a major national figure in the United States securities industry. n1

Generally, securities regulatory enforcement actions against alleged securities law violators on a national level involving "national" securities issues are left by the state securities administrators (the "State Administrators") to the Securities and Exchange Commission ("SEC" or "Commission"), the Financial Industry Regulatory Authority ("FINRA", formerly the "NASD") and the other Supervisory Regulatory Organizations (the "SROs"). Some observers argue that it is necessary for State Administrators to take enforcement actions on national securities-type matters when it appears that the SEC and the various SROs have failed to take effective action to deal with such matters. Other observers note that such matters must be handled by the national cops on the beat, rather than the local cops (i.e., the State Administrators) for fear of having 50 different enforcement actions in such matters. n2

Regardless of where one stands on the subject of the appropriateness of the State Administrators acting on a "national cop" basis, many of the State Administrators apparently continue to believe there is a void in securities regulation over certain national securities matters and it is incumbent upon them to step in to protect their state investors. n3 Also, the SEC has long recognized the importance of the state securities laws as a supplement to federal law. n4

This chapter provides only a general summary of the enforcement capabilities under the state securities laws. In order to fully appreciate the enforcement capabilities of, and before pursuing or defending against any legal claims under, a state securities law, the reader needs to first fully review the applicable provisions of the particular state securities law(s) that have jurisdiction over the transactions in question and the securities professionals involved.

[2] Origin and Structure of State Securities Laws

The state securities laws are commonly known as the "Blue Sky Laws." That name apparently comes from a comment

by the United States Supreme Court in an early case where the Court upheld the constitutionality of the state securities law and stated that such state laws were enacted to prevent "speculative schemes which have no more basis than so many feet of "blue sky, ... " n5

The first securities act was passed by the State of Kansas in 1911. By 1929, nearly all the states had a securities law. Many of the states' securities laws pre-dated the federal securities laws.

State securities laws generally regulate: (i) the offer and sale of securities and the registration thereof; (ii) fraud in connection with offers and sales of securities; and (iii) the registration of securities professionals (e.g., broker-dealers, securities agents, investment advisers and investment adviser representatives). Many of the state securities law provisions are similar to those found under certain of the federal securities laws (e.g., the Securities Act of 1933 ("1933 Act"), n6 the Securities Exchange Act of 1934 ("1934 Act") n7 and the Investment Advisers Act of 1940 ("Investment Advisers Act")). n8

Enforcement of the state securities laws is conducted through: (i) criminal prosecutions, (ii) civil injunctions, (iii) administrative proceedings, and (iv) private civil suits.

Enforcement through criminal prosecution has been a part of state securities laws from the very beginning and has been widely used. Enforcement by civil injunction was also available in the early state laws but, historically, has not been widely used. The enforcement tools of administrative proceedings and private civil suits developed later on.

The National Securities Markets Improvement Act of 1996 ("NSMIA") preempted the authority of the State Administrators to require registration of most of the national securities offerings, but did not effect the State Administrators' authority to investigate and bring enforcement actions against those national securities offerings. n9 Since NSMIA, State Administrators have devoted an increasing amount of their time and resources to enforcement matters. Notwithstanding the noted efforts by the Massachusetts Securities Division, the State Administrators generally focus most of their enforcement efforts on those issuers of non federally registered securities and securities professionals that are not directly regulated by the SEC or the SRO's.

In spite of federal preemption and a general trend towards deregulation across the country, this chapter reveals that the State Administrators are equipped with an impressive and diverse arsenal for battling individuals and companies suspected of conducting unlawful securities activities in their states.

[3] The Uniform Securities Act

The Uniform Securities Act (the "Uniform Act") was adopted by the National Conference of Commissioners on Uniform State Laws (the "Commissioners") in 1956 and approved by the American Bar Association in 1956. n10 The Uniform Act has been adopted into law, all or in part, by 37 states. In 1985, the Commissioners adopted a new revised act (the "1985 Act"). n11 Only a few states have adopted parts of the 1985 Act. n12 The Commissioners approved a new act in 2002 (the "2002 Act") which is intended to modernize the Uniform Act by including, among other things, the regulatory changes imposed by Congress on the state securities laws through the enactment of NSMIA. n13

Now that the 2002 Act has been ratified by the Commissioners, it will be up to each state through its legislative process whether or not to adopt the 2002 Act. There can be no certainty if or when the 2002 Act will be adopted, in all or in part, by a significant number of states. However, it is believed that the Commissioners and the State Administrators will make a united effort to promote the adoption of the 2002 Act by most if not all of the states. n14

Noteworthy changes in the 2002 Act include:

- (1) a qualified immunity provision to protect a broker-dealer or investment adviser from defamation

claims based on information filed with the SEC, a State Administrator or SRO unless the broker-dealer or investment adviser knew or should have known at the time that the statement made was materially false or acted in a reckless disregard of the truth or falsity of the statement (this Section was primarily intended to protect broker-dealers and investment advisers while providing full disclosure with respect to the departure of employees); n15

(2) new subsections were added to recognize the Securities Litigation Uniform Standards Act of 1998 n16 and civil liability for investment advisers; n17

(3) two statute of limitations provisions: one year after the violation occurred for registration violations, n18 and two years after the discovery of the facts, or five years after the fraud violation n19 to follow the current federal securities law statutes of limitations; and

(4) a broad range of civil and administrative tools for the State Administration including: asset freezes, rescission orders, civil penalties n20 and cease and desist orders. n21

The enforcement provisions within the 2002 Act include both summary process and due process requirements.

Because it is not practical to discuss the enforcement process under the Blue Sky Laws of all 53 jurisdictions (i.e., the 50 states of the United States, the District of Columbia, the Commonwealth of Puerto Rico, and the Virgin Islands), this chapter deals exclusively with the enforcement process under the Uniform Act and without consideration of any revisions to the Uniform Act (either, within the 1985 Act or those of the 2002 Act). The Uniform Act has been preempted in part by NSMIA n22 and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). n23 This chapter will refer to such preemption provisions only in part and the reader needs to review both NSMIA and SLUSA to understand the full effect of their provisions on the Uniform Act.

All of the state securities laws, whether or not based on the Uniform Act, agree on a basic philosophy of regulating issuer offerings, the conduct of securities professionals, and the prohibition on fraudulent activity in connection with the offer and sale of securities.

In many instances, the state securities laws require a lesser showing for liability than their federal equivalents. In defending state securities matters, defense counsel should be alert to the significant distinctions between the federal securities law and state securities law(s) at issue.

[4] Scope of the Uniform Act and Service of Process

Section 414 of the Uniform Act (the "Scope of the Act ...") n24 is key to determining whether the Uniform Act applies to the securities activities in question. The activity that the administrator is alleging in any enforcement action or seeking generally to administrate over, or the activities alleged in a civil suit must have occurred "in this state" as described under Section 414 of the Uniform Act. The following is a summary of Section 414:

The provisions under Sections 101 (fraud provisions), n25 201(a) (broker-dealer and agent registration requirements), n26 301 (securities registration requirements), n27 405 (unlawful representations concerning registration or exemption) n28 and 410 (civil liability provisions) n29 apply to persons who sell or offer to sell securities when (i) an offer to sell is made in this state or (ii) an offer to buy is made and accepted in this state.

Sections 101, n30 201(a) n31 and 405 n32 apply to persons who buy or offer to buy when (i) an offer to buy is made in this state or (ii) an offer to sell is made and accepted in this state.

For the purposes of Section 414, n33 "an offer to sell or to buy is made in this state, whether or not

either party is present in this state, when the offer (1) originates from this state or (2) is directed by the offeror to this state and received at the place to which it is directed (or at any post office in this state in the case of a mailed offer)." n34 "For the purpose of this section, an offer to buy or to sell is accepted in this state when acceptance (1) is communicated to the offeror in this state and (2) has not previously been communicated to the offeror, orally or in writing, outside this state; and acceptance is communicated to the offeror in this state, whether or not either party is then present in this state, when the offeree directs it to the offeror in this state reasonably believing the offeror to be in this state and it is received at the place to which it is directed (or at any post office in this state in the case of a mailed acceptance)." n35

An offer to sell or to buy is *not* made in this state when (1) a publisher circulates or there is circulated on his behalf in this state in any *bona fide* newspaper or other publication of general, regular, and paid circulation which is not published in this state, or which is published in this state but has more than two-thirds of its circulation outside this state during the past twelve (12) months or (2) a radio or television program originated outside this state is received in this state. n36

Generally, if the transaction has some connection with a state, then such state's securities law will apply. It is not relevant whether either the purchaser or seller is a resident of the state, as long as the transaction, at least in part, takes place within this state. It is possible that laws of several states will apply to the same transaction. n37 Any type of contact or negotiation which takes place in a state will probably result in an offer being made in that state. Also, it is possible to have multiple offers in connection with a single sale of a security as offers may be extended on a number of different occasions before the investor agrees to accept.

Under Section 414, n38 Sections 102 n39 (unlawful advisory activities) 201(c) n40 (investment adviser registration requirements) and Section 405 n41 so far as investment advisers are concerned, apply when any act instrumental in effecting prohibited conduct is done in this state, whether or not either party is present in this state.

Defense counsel, prior to responding to an administrator's request for information concerning allegations of illegal activity under the Uniform Act, should first determine if the client's activities, which are the focus of the request, come within the "scope" of the administrator's authority under Section 414. n42

Section 414 of the Uniform Act n43 is intended to not only address illegal activities directed on the citizens of the state, but also to those activities of persons who use the state as a base to conduct illegal activities exclusively upon persons residing in other states.

For example, a person located in the state contacts prospective investors exclusively in other states for the purpose of soliciting securities transactions. Although all of the persons who received solicitations reside exclusively in other states, the administrator of the state in which the solicitations originated (assuming of course, that the solicitations constitute "offers" of "securities" as those terms are defined under the Uniform Act) has the authority to investigate and initiate enforcement action against such person. n44

Section 414 n45 also includes the following service of process procedures: Applicants for broker-dealer, agent and investment-adviser registration, and every issuer wishing to offer its securities in this state, are required to file with the administrator an irrevocable consent appointing the administrator or his successor to be such person's attorney to receive service of any lawful process in any non-criminal suit, action or proceeding against him or his successor executor or administrator which arises under the Uniform Act or any rule or order thereunder after the consent has been filed, with the same force and validity as if served personally on the person filing the consent.

When a person, including any non-resident of this state, engages in conduct prohibited or made actionable by the Uniform Act or any rule or order thereunder, and such person has not filed a consent to service of process under the Uniform Act and personal jurisdiction over such person cannot otherwise be obtained in this state, the conduct shall be

considered equivalent to such person's appointment of the administrator or his successor in office to be such person's attorney to receive service of any lawful process in any non-criminal suit, action or proceeding against such person or the person's successor, executor or administrator which grows out of that conduct and which is brought under the Uniform Act or any rule or order thereunder, with the same force and validity as if served on the person personally. n46

"When process is served under this section, n47 the court, or the [Administrator] in a proceeding before [him], shall order such continuance as may be necessary to afford the defendant or respondent reasonable opportunity to defend." n48

This service of process authority under Section 414 n49 provides an important opportunity for citizens of the state to obtain service in connection with alleged illegal activities under the Uniform Act, upon persons they may not otherwise be able to obtain such service.

[5] Administrators and Staff

All of the states and the District of Columbia have divisions or agencies that regulate the offers and sales of securities in their state. Some are "stand alone" agencies. Some are one of several consumer oriented divisions under an umbrella state consumer department. Most of the State Administrators are appointed by the Governor or by the administrator of the umbrella department (who is usually appointed by the Governor). When the Governor or department administrator leaves office, his successor is generally free to replace the incumbent administrator with his own appointee. The Governor, through the direct or indirect selection of the administrator, generally sets the "tone" for securities regulation in the state.

In the last 20 years or so, several of the states that were so-called "merit" states (i.e., states that review securities registration applications based upon whether the offering meets so-called "just, fair and equitable" standards) have been converted to "full disclosure" states (i.e., states that review securities registration applications based upon whether the offering document includes full disclosure), mainly due to deregulatory pressures placed on the Governor to make it easier for state-based issuers to have their securities offerings approved by the administrator. n50 Full disclosure is the standard imposed on issuers by the SEC under the 1933 Act. n51 By having the predominate number of states now conform to the SEC "full disclosure" standard, securities registration has generally been a smoother process for issuers under state securities laws. Oftentimes, the State Administrators and their staffs in the "full disclosure" states forgo a full review of such registration applications if the SEC is conducting a full review. This reliance, either wholly or in part by the State Administrators on the SEC's review, provides State Administrators with valuable time and resources for a more thorough review of securities registration applications not registered with the SEC and for enforcement matters.

Generally, the state securities division or agency consists of separate sections for securities registration, broker-dealer, investment adviser and agent registration and enforcement. Most of the divisions or agencies will have one or more attorneys, either serving as the administrator, deputy administrator and/or general counsel. n52 Also, it is common to have one or more attorneys in the enforcement section unless the state assigns an assistant attorney general to counsel the state securities division or agency on enforcement matters.

The trend in recent years, due to state budget shortfalls, is to eliminate staff and other resources within the state securities division or agency, either by offering early retirement or eliminating positions. With the uncovering of alleged corporate and securities fraud in the nation's investment markets within the last couple of years, the trend of cutting back on staff and resources in the office of the State Administrators may be reversed or at least put on hold by the states, for the near future. n53 Some defense lawyers believe that budget pressures might also increase the pressure on securities State Administrators to seek greater monetary fines and/or filing fees in order to demonstrate that their offices are not fiscal burdens on the state budgets. Consequently, through the increased fines and filing fee amounts, the nationally regulated securities industry is, in effect, covering the shortfall within the states' budgets to the extent necessary for State Administrators to continue to regulate both the regulated and non-regulated industry. Those State

Administrators lacking staff, resources or authority will oftentimes refer enforcement matters involving alleged violations of the Uniform Act to other securities regulators (i.e., the SEC and/or the SROs).

[6] North American Securities Administrators Association, Inc.

The North American Securities Administrators Association, Inc. ("NASAA") supports the efforts of the State Administrators and their staffs in enforcing the provisions of the state securities laws. n54 NASAA was organized in 1919 and consists of administrators of all 50 states, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Mexico and the provinces of Canada. n55 NASAA strives to promote uniformity among the states in developing, interpreting and applying the state securities laws. NASAA has formed several committees made up of administrators and their staffs to work on various projects and concerns common to the administrators. NASAA also forms task forces among the administrators and staffs to conduct inspections of problem broker-dealers, "boiler room" type activities or other regulatory concerns common to the administrators. n56 Information obtained by members of the task force is then passed on to the administrator of each state in which alleged violations occurred, for possible enforcement action.

Counsel for targets of a NASAA task force inspection should be mindful that it is the intent of the members of the task force to detect and document alleged violations of state securities laws and that such information collected will be dispersed to the administrators of the affected states who may seek administrative, civil or criminal action, where appropriate. It is generally prudent to be cooperative with the task force but only to the degree that the task force members are operating within their statutory authority. Also, a duplicate copy of all written documentation obtained by the task force should be retained by the target and its counsel. In addition, the target and its counsel should insist upon an exit interview by the task force supervisor before the task force completes its review. With a copy of the task force documentation collected and opportunity to determine possible findings and future enforcement actions through the exit interview, the target and its counsel will have the opportunity to prepare for, and possibly head off, possible actions by the administrators of the states in which alleged violations may have occurred.

The administrators remain in constant and direct contact with their counterparts in all of the jurisdictions, oftentimes sharing information about wrong doers' activities in multiple jurisdictions. NASAA oftentimes serves as the "voice" and advocate of the administrators and their authority on the national scene. n57

[7] Methods for Dealing with Violations

The Uniform Act provides four methods for dealing with violations or threatened violations of the Uniform Act: (1) civil liability, (2) criminal prosecution, (3) administrative action and (4) civil injunction. A violator of a provision of the Uniform Act may be subjected to civil liability under Section 410 of the Uniform Act, n58 to criminal liability under Section 409 of the Uniform Act, n59 to administrative action under Section 407 n60 of the Uniform Act for a person who has or is about to violate the Uniform Act, and to civil injunctive action, under Section 408 of the Uniform Act, n61 if the person is believed to have violated or may violate the Uniform Act.

The first two methods are not usually directly applied by the administrators as an enforcement tool. Oftentimes, however, the administrators will encourage or require by order violators to offer rescission to investors for transactions effected in violation of the Uniform Act. Also, the administrators may refer violations of the Uniform Act for criminal prosecution to the local district attorney or state attorney general.

FOOTNOTES:

(n1)Footnote 1. Complaint, *In re Fairfield Greenwich Advisors LLC*, No. 2009-0028 (Mass. Sec. Div. Apr. 1, 2009).

(n2)Footnote 2. Thomas G. Dolan, *Unwarranted Protection*, Barrons, Apr. 22, 2002, at 42.

(n3)Footnote 3. Sara Hansard, *State Regulators Defend their Authority Vigorously*, Investment News, March 26,

2007.

(n4)Footnote 4. The SEC noted with respect to broker-dealer regulation that the State Administrators "are well-positioned to quickly detect and respond to fraudulent and abusive practices in their individual states, as well as to prevent unscrupulous agents from effecting securities transactions with their citizens." SEC, *Study of State Licensing Requirements for Associated Persons of Broker-Dealers Pursuant to Section 510(d) of the National Securities Markets Improvement Act of 1996* 48 (Oct. 10, 1997).

(n5)Footnote 5. *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917) (quoting *Rast v. Van DeMan & Lewis Co.*, 240 U.S. 342, 36 S. Ct. 370, 60 L. Ed. 679 (1916)).

(n6)Footnote 6. 15 U.S.C. § 77a et seq. .

(n7)Footnote 7. 15 U.S.C. § 78a et seq. .

(n8)Footnote 8. 15 U.S.C. § 80b-1 et seq. .

(n9)Footnote 9. Title 1 of NSMIA Pub. L. 104-290, §§ 101-109, 110 Stat. 3416 designated the federal securities regulators as the exclusive regulator of national securities offerings, except that the states maintained their anti-fraud enforcement powers and the ability to collect notice filings and fees for certain of the "covered securities" offerings. See H.R. Rep. No. 104-622, at 3-5 (June 17, 1996).

(n10)Footnote 10. Unif. Sec. Act (1956).

(n11)Footnote 11. Unif. Sec. Act (1985).

(n12)Footnote 12. Colorado, District of Columbia, Montana, Nevada, New Mexico and Rhode Island enacted the 1985 Act with some alterations.

(n13)Footnote 13. Unif. Sec. Act (2002).

(n14)Footnote 14. As of June 2010, the jurisdictions of Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Mexico, Oklahoma, South Carolina, South Dakota, Vermont, U.S. Virgin Islands and Wisconsin have adopted the 2002 Act.

(n15)Footnote 15. Unif. Sec. Act (2002) § 507.

(n16)Footnote 16. Unif. Sec. Act (2002) § 509(a).

(n17)Footnote 17. Unif. Sec. Act (2002) §§ 509(e) and (f).

(n18)Footnote 18. Unif. Sec. Act (2002) § 509(j)(1).

(n19)Footnote 19. Unif. Sec. Act (2002) § 509(j)(2).

(n20)Footnote 20. Unif. Sec. Act (2002) § 603.

(n21)Footnote 21. Unif. Sec. Act (2002) § 604.

(n22)Footnote 22. NSMIA Pub. L. 104-290, § 102(a), 110 Stat. 3416.

(n23)Footnote 23. SLUSA Pub. L. 105-353, 112 Stat. 3227.

(n24)Footnote 24. Unif. Sec. Act § 414.

(n25)Footnote 25. Unif. Sec. Act § 101.

(n26)Footnote 26. Unif. Sec. Act § 201(a).

(n27)Footnote 27. Unif. Sec. Act § 301.

(n28)Footnote 28. Unif. Sec. Act § 405.

(n29)Footnote 29. Unif. Sec. Act § 410.

(n30)Footnote 30. Unif. Sec. Act § 101.

(n31)Footnote 31. Unif. Sec. Act § 201(a).

(n32)Footnote 32. Unif. Sec. Act § 405.

(n33)Footnote 33. Unif. Sec. Act § 414.

(n34)Footnote 34. Unif. Sec. Act § 414(c).

(n35)Footnote 35. Unif. Sec. Act § 414(d).

(n36)Footnote 36. *See* Unif. Sec. Act § 414(e) (emphasis added).

(n37)Footnote 37. *Klein v. Boyd, No. 95-5410, 1996 U.S. Dist. LEXIS 17153*, at **13-15 (E.D. Pa. Nov. 21, 1996) .

(n38)Footnote 38. Unif. Sec. Act § 414.

(n39)Footnote 39. Unif. Sec. Act § 102.

(n40)Footnote 40. Unif. Sec. Act § 201(c).

(n41)Footnote 41. Unif. Sec. Act § 405.

(n42)Footnote 42. Unif. Sec. Act § 414.

(n43)Footnote 43. *Id.*

(n44)Footnote 44. Unif. Sec. Act § 414(c).

(n45)Footnote 45. Unif. Sec. Act § 414(g).

(n46)Footnote 46. Unif. Sec. Act § 414(h).

(n47)Footnote 47. Unif. Sec. Act § 414.

(n48)Footnote 48. Unif. Sec. Act § 414(i).

(n49)Footnote 49. Unif. Sec. Act § 414.

(n50)Footnote 50. South Dakota is the most recent example of a state where the state securities law was revised to replace merit with full disclosure review of securities registration applications.

(n51)Footnote 51. *15 U.S.C. § 77a et seq.* .

(n52)Footnote 52. *Securities Administrators, 1 Blue Sky L. Rep. (CCH) P 6001 at 2101* .

(n53)Footnote 53. The states of Alaska, Idaho, Indiana and New York are notable examples of where the number of staff of the applicable agency regulating securities has increased over the last couple of years.

(n54)Footnote 54. See About NASAA, www.nasaa.org//About_NASAA/

(n55)Footnote 55. NASAA History, www.nasaa.org//About_NASAA/NASAA_History/

(n56)Footnote 56. NASAA Newsroom, *State Securities Regulators Coordinate Ongoing Auction-Rate Securities Investigations* (April 17, 2008), available at www.nasaa.org/NASAA_Newsroom/Current_NASAA_headlines/8627.cfm.

(n57)Footnote 57. NASAA Newsroom, *State Securities Regulators Continue to See Fraud and Abuse in the Life Settlement Market* (Apr. 29, 2009), available at www.nasaa.org/NASAA_Newsroom/current_NASAA_headlines/10691.cfm.

(n58)Footnote 58. Unif. Sec. Act § 410.

(n59)Footnote 59. Unif. Sec. Act § 409.

(n60)Footnote 60. Unif. Sec. Act § 407.

(n61)Footnote 61. Unif. Sec. Act § 408.



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Securities Enforcement: Counseling and Defense

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CHAPTER 22 STATE SECURITIES ENFORCEMENT

2-22 Securities Enforcement: Counseling and Defense § 22.02

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§ 22.02 Investigations

[1] Investigations Conducted by the Administrator

State Administrators often employ attorneys, investigators, accountants and other personnel who conduct investigations. In addition, personnel from other law enforcement agencies sometimes assist the administrator's staff in conducting investigations.

The Uniform Act grants broad investigative powers to the administrator. The Uniform Act authorizes the administrator to initiate an investigation and hold hearings under Section 407(a) of the Uniform Act: n1 (1) in connection with the promulgation of rules or forms under the Uniform Act; (2) to aid in the enforcement of the Uniform Act; and (3) to conduct an investigation to determine whether a particular person or group of people have violated or are about to violate the Uniform Act. In other words, like the SEC, the administrator may conduct an investigation without establishing probable cause and without instituting formal proceedings against the target, about whom the evidence is sought. n2

Most states do not have rules governing the conduct of securities investigations. The safeguards afforded in state securities investigations vary based on the subject matter of the investigation, the target's prior enforcement history, perceived urgency, historical practices followed by the administrator, the preferences of the relevant regulators, and applicable statutes and regulations. In many cases, the safeguards are less extensive than the practices afforded by the SEC and the SROs.

State securities investigations can be triggered by a number of factors including complaints by investors, media reports, and referrals from other state and federal agencies. Typical investigation topics include violation of the broker-dealer, agent or investment adviser registration requirements (including technical and unintentional violations), the sales practices of such securities professionals, offerings that fail to comply with the state's registration requirements, and fraud in connection with the offer or sale of securities. State Administrators typically explore claims against securities professionals and affiliated persons, issuers, and the issuer's officers.

A state securities investigation can have serious consequences. It can result in criminal prosecution, a temporary or

permanent injunction, appointment of a receiver, imposition of monetary penalties (including but not limited to payment of the state's costs of investigation), revocation or suspension of the licenses of broker-dealers, agents and investment advisers, and the revocation of securities registration or use of exemptions.

If a target learns that it is the subject of a state enforcement investigation, it should retain counsel experienced in handling such investigations. Defense counsel will ordinarily seek to gather documents, interview witnesses, and analyze the evidence in order to assess whether state securities laws have been violated and evaluate the client's potential exposure. Once defense counsel has reviewed and analyzed the evidence, defense counsel may want to meet with the administrator's enforcement staff to learn the focus of the staff's concerns and explore possible resolutions of the investigation.

The investigation may be either public or private under the Uniform Act pursuant to Section 407(a)(1).ⁿ³ Generally, the administrator will conduct an investigation in private. During the investigative phase, the investigation is held in private and there is no public press release or announcement by the administrator. If the investigation is in the "private" stage, the information obtained during the investigation is confidential subject to the right of discovery by a party in a civil, administrative or criminal proceeding that may result from the investigation. Investigative reports and other staff memoranda may be privileged under the attorney-client and work-product privileges, or common law privilege for law enforcement investigative files. Once an administrative order is issued, then the matter is public subject to media coverage and/or press release by the administrator.

During the private investigation, the target of the investigation has limited rights. Accordingly, the target has no right to know who his accusers are, whether subpoenas were issued to others and the content of such subpoenas, to cross-examine witnesses, or to obtain a transcript of witness testimony during this private investigative period. Generally, the courts have agreed that because the investigation is supposedly "nonadversarial" in nature during the investigation phase, it is proper to limit the target's due process rights.ⁿ⁴

Although the target lacks the usual rights during this investigative process, any witnesses called by the administrator in the gathering of information during the investigation are allowed certain rights. Such witnesses are allowed the opportunity to inspect and/or secure a copy of the transcript of their testimony and should be advised that they have the ability to invoke their *Fifth Amendment* rights against incriminating testimony.

After the investigative process has been completed, the administrator may decide to: initiate civil or criminal enforcement actions under Sections 408ⁿ⁵ or 409 of the Uniform Act,ⁿ⁶ respectively; initiate administrative adjudicative proceedings under Sections 204(c)ⁿ⁷ or 306(b);ⁿ⁸ issue a cease-and-desist order; hold a public investigative hearing under Section 407(a);ⁿ⁹ or determine that it is unlikely that any violations of the Uniform Act have occurred or will occur and close his file.

The public investigative hearing under Section 407(a)ⁿ¹⁰ is a public proceeding. Public hearings can inflict substantial damage on companies and individuals that are the subject of the hearing. However, the administrator and the parties involved may consent to a closed hearing pursuant to Section 412(f).ⁿ¹¹ Whether or not the hearing may be closed may be questionable based upon some of the states' open meeting laws. The administrator may publish his findings subsequent to the hearing. The public investigative hearings have been used by State Administrators primarily to broadcast to the public a potential problem in the securities area.

Targets of inquiries or administrative actions by State Administrators should be mindful that the State Administrators share information about possible wrongdoing of the targets and their activities with the State Administrators of the other states and with other state and federal regulators. Accordingly, a target who has activities in more than one state or contacts with persons located in more than one state may ultimately be the focus of investigations in several of the states due to this information sharing.

Defense counsel for a target of state securities enforcement investigations by multiple states should consider the possibility of coordinating the investigation and resolution of any enforcement actions with the affected state administrators so that the expense and time involved may be minimized. Sometimes, negotiating and agreeing to a resolution with a "lead enforcement" state will encourage the other states to "sign on" to the resolution agreed to by the lead state.

[2] Authority to Request Information

Under Section 407(a)(2) of the Uniform Act, n12 the administrator has the authority to require any person to file a written statement under oath in connection with any investigation. Generally, the administrator uses this authority upon information being received that an issuer or an unregistered professional is selling securities in the state. Upon initiating the investigation, the administrator will request a written statement from the issuer or professional with respect to their activities in the state pursuant to the authority under Section 407(a)(2) of the Uniform Act. n13 If the recipient of the request for information ignores the administrator's request for the written statement, it is typical for the administrator to issue a cease-and-desist order or an order of revocation of the exemption being relied upon by the issuer. Any sales of the securities subsequent to the date of the order could be then handled by injunction or criminal prosecution. A violation of the administrator's order is also a cause for injunctive action and/or criminal prosecution. n14

These matters are handled by the issuer or professional responding to the request for information and if an exemption is claimed and is available, then the administrator closes his file. If the issuer or professional responds and no exemption appears to be available (and it is the issuer's or professional's burden to show that the exemption is available), then the issuer or professional negotiates with the administrator to resolve the matter. Such negotiations can result in the administrator issuing a "consent" order where the respondent typically neither admits nor denies the administrator's allegations but consents to the order issued by the administrator prohibiting further offers or sales of securities in the state that are neither registered nor exempt or the order may also prohibit the further conduct of offering or selling unregistered securities. That is a typical settlement of a non-registration matter, but oftentimes, depending upon the number of purchasers and time period in which the sales occurred, the administrator may require offers of rescission, an administrative fine, revocation of exemption, denial of a registration application or some other more punitive-type actions to settle the matter.

Using the authority under Section 407 of the Uniform Act, n15 some State Administrators and their staff conduct "routine" examinations of the books, records and sales practice on-site at the offices of registered broker-dealers and investment advisers located within or without the state. n16 Information obtained during these examinations may be used by the State Administrators to formulate enforcement cases against the registrant. Also, State Administrators will share information discovered during these examinations about alleged unlawful activities with the State Administrators of other affected states and with other federal and state regulators. n17

During such "routine" examinations, the registrant and its counsel should take steps to determine from the administrator's staff the nature and scope of the examination. The registrant should insist upon an exit interview to ascertain the initial findings by the staff during the examination and obtain a duplicate copy of all documentation that the staff has obtained and will retain subsequent to the examination. The registrant and its counsel should determine that the information requested during the examination is within the administrator's authority to obtain under Section 407 of the Uniform Act. n18

[3] Subpoena Authority

The administrator has the authority, under Section 407(b) of the Uniform Act, n19 to issue subpoenas. The administrator is authorized to issue subpoenas in connection with investigations and in connection with any administrative hearing authorized by the provisions of the Uniform Act. Section 407(b) n20 allows the administrator to delegate the subpoena authority to members of his staff. Oftentimes, the administrator assigns a member of his legal

staff to be the hearing officer of a specified matter and to issue the subpoenas necessary to hear the matter. The information that can be obtained in connection with the issuance of the subpoena is limited to what could be obtained in a court issued subpoena.

Once an administrative adjudication action has been filed, both parties to the action would be limited to discovery rules in contested cases. Generally, the administrative provisions under state law control the procedural aspects of an administrative hearing conducted by the administrator or his designee.

It appears that the administrator has the authority under Section 407(c) of the Uniform Act n21 to issue subpoenas in connection with investigations both in-state and out-of-state. n22 The authority under the Uniform Act does not allow the administrator to enforce his own subpoena. Instead, under Section 407(c), n23 the administrator may, in the event of a party refusing to respond to the administrator's subpoena, apply to a court for an order compelling the testimony. The court has the authority then to determine if it is appropriate to enforce the subpoena. If the court issues an order to compel the testimony and the witness refuses to comply with that order, then, and only then, will the witness be subject to a contempt action by the court. The administrator does not have the authority to act against a person solely for refusal to respond to a subpoena. The court, in finding a witness in contempt of the court's order, does not have to find that the refusal was willful.

Whether or not the administrator has the authority to issue out of state subpoenas raises several issues including whether the administrator has jurisdiction to exercise authority over a nonresident while issuing subpoenas and whether the court in the administrator's state has the authority to enforce the subpoena against a party not located in the state if the target fails to respond to the subpoena. The leading case on this matter is *Silverman v. Berkson*. n24 Here the court determined that the administrator did have the authority to issue the subpoena to an out of state party and could turn to a court in the administrator's home state to enforce the subpoena. The court's decision was chiefly based on the fact that Section 407(a) of the Uniform Act n25 allows the administrator to conduct investigations "within or outside of this state" and Section 407(b) n26 provides that the administrator is authorized to issue subpoenas in connection with "any investigation."

In addition to the Uniform Act providing the administrator with broad authority to obtain out-of-state evidence directly, the State Administrators will oftentimes, to the extent they believe that their state privacy or other laws do not stand in the way, issue their own subpoenas to assist other state administrators needing information there. n27

Besides the authority to issue a subpoena, the administrator may request registered persons to provide records for the administrator to review. Refusal to provide such information upon request by the administrator is grounds for a summary suspension of the target's registration. Obviously, this is a substantial and important weapon for the administrator in determining if the registrant has or is about to violate provisions of the Uniform Act. In almost all cases, the registrant, fearful of losing registration status, will comply with the administrator's request.

Generally, counsel for the registrant, upon receiving the administrator's request for records or other information should: (i) determine that the records or information requested is within the administrator's authority to obtain; and (ii) negotiate with the administration to narrow the request if it appears overly broad or would be difficult to comply with (i.e., considerable time spent to accumulate the requested information and expense of reproducing documents to be delivered to the administrator). During this time, counsel should be able to obtain a clearer picture of what the administrator is looking for and possibly his enforcement intentions.

A person who is an issuer of securities registered with the administrator and refuses to honor the administrator's subpoena can be subject to the administrator's stop order against the securities registration effectiveness under Section 306 of the Uniform Act. n28 That stop order may be issued upon the securities registration if an officer, director or control person of the issuer refuses to honor a subpoena. Further, a person who refuses to respond to the administrator's subpoena and is relying on a securities exemption, may find himself at the end of an order summarily revoking the use

of the exemption. Persons not registered or with their securities not registered and who refuse to respond to the subpoena, may find themselves the subject of a cease-and-desist order issued by the administrator.

In an adjudicative hearing, the hearing officer has the authority, in the event a party refuses the hearing officer's subpoena, to take whatever action a court would be able to take. Accordingly, the hearing officer could restrict the use of documents by a party or deny that party the right to present evidence on the particular issues to which the documents that were not provided are relevant.

In the event the administrator asks a court to issue an order to compel testimony when the target refuses pursuant to an administrator's subpoena, generally the court will require the administrator to show that: (1) the investigation will be conducted pursuant to a legitimate purpose; (2) the information sought may be relevant to the investigation; (3) the information sought is not presently in the possession of the administrator; and (4) the appropriate statutory administrative steps have been taken in the issuance of the subpoena. The administrator must generally show the court his "good faith" by showing that: (1) the investigation was conducted for a lawful purpose; (2) the information sought may be relevant to the investigation; (3) the subpoena is sufficiently specific to obtain documents which are adequate but not excessive for the inquiry; (4) the information sought is not presently in the possession of the administrator; and (5) the appropriate statutory administrative steps have been taken in the issuance of the subpoena. n29

[4] Possible Defenses to Subpoena Request

Once the administrator has made a *prima facie* case of good faith for the court, the burden is on the target or party opposing the enforcement of the subpoena to show that compliance should not be required. The party might invoke defenses such as bad faith, abuse of process, relevancy and reasonableness. Other defenses may be the *First, Fourth and Fifth Amendment* defenses and even financial privacy. Such rights are extended to state proceedings by the *Fourteenth Amendment of the United States Constitution*. Other defenses include common law privileges (e.g., attorney client, work product, and accountant-client) recognized by the relevant state.

One of the major defenses to a subpoena enforcement action is the right against self-incrimination defense. The federal right against self-incrimination is discussed in Chapter 13, and applies to state subpoena enforcement action. Counsel should also consider whether the constitution of the relevant state provides a broader right against self incrimination.

Section 407(d) of the Uniform Act n30 recognizes the fact that there may be times where the administrator needs information for the public interest that could be provided by the witness even though that witness invokes the privilege against self-incrimination. This section provides that the witness may be forced to testify, but it grants the witness immunity from prosecution of the crimes disclosed. The immunity afforded under Section 407(d) of the Uniform Act n31 is a broad form of transactional immunity. This immunity means that the witness cannot be prosecuted for any criminal activity about which he testifies. This immunity does not include any criminal activity that is uncovered separately by the administrator from the witnesses' testimony. The grant of immunity under Section 407(d) of the Uniform Act n32 may complicate prosecution under the federal securities acts or that of other states. n33

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 407(a).

(n2)Footnote 2. *Mullet v. Miller*, 816 P.2d 251 (Ariz. Ct. App. 1991) .

(n3)Footnote 3. Unif. Sec. Act § 407 was patterned after § 21 of the 1934 Act.

(n4)Footnote 4. *See Genuine Parts Co. v. F.T.C.*, 445 F. 2d 1382, 1387-88 (5th Cir. 1971) .

(n5)Footnote 5. Unif. Sec. Act § 408.

(n6)Footnote 6. Unif. Sec. Act § 409.

(n7)Footnote 7. Unif. Sec. Act § 204(c).

(n8)Footnote 8. Unif. Sec. Act § 306(b).

(n9)Footnote 9. Unif. Sec. Act § 407(a).

(n10)Footnote 10. Unif. Sec. Act § 407(a).

(n11)Footnote 11. Unif. Sec. Act § 412(f).

(n12)Footnote 12. Unif. Sec. Act § 407(a)(2).

(n13)Footnote 13. Unif. Sec. Act § 407(a)(2).

(n14)Footnote 14. *See* Unif. Sec. Act §§ 408 and 409(a), respectively.

(n15)Footnote 15. Unif. Sec. Act § 407.

(n16)Footnote 16. Routine examinations are conducted to the extent that the administrator has staff and resources to conduct such activities. Otherwise, some of the State Administrators have the authority to collect from the registrant the administrator's reasonable costs incurred while conducting the examination.

(n17)Footnote 17. For an example of where state securities examiners from several states conducted a "joint" examination of a registered broker-dealers, see "NASAA ARS Arbitration Information Center" http://www.nasaa.org/issues_answers/enforcement_legal_activity/9431.cfm.

(n18)Footnote 18. Unif. Sec. Act § 407. *See also* *A. G. Edwards, Inc. v. Secretary of State*, 772 N.E.2d 362, 365 (Ill. App. Ct. 2002) , for an example where the administrator, during a "routine" examination of a registered broker-dealer, requested the "personal financial records" of the broker-dealer's agents. The court determined that the administrator did not have the authority to obtain such records, under the circumstances.

(n19)Footnote 19. Unif. Sec. Act § 407(b). This Section was modeled generally after §§ 21(a)-(d) of the 1934 Act. *See* 10 Louis Loss & Joel Seligman, *Securities Regulation* 4917-4937 (3d ed. rev. 1996).

(n20)Footnote 20. Unif. Sec. Act § 407(b).

(n21)Footnote 21. Unif. Sec. Act § 407(c).

(n22)Footnote 22. *Silverman v. Berkson*, 661 A.2d 1266 (N.J. 1995) .

(n23)Footnote 23. Unif. Sec. Act § 407(c).

(n24)Footnote 24. *Silverman*, 141 N.J. 412, 661 A.2d 1266 .

(n25)Footnote 25. Unif. Sec. Act § 407(a).

(n26)Footnote 26. Unif. Sec. Act § 407(b).

(n27)Footnote 27. For a more complete discussion of cooperation among the states in issuing local subpoenas to assist another state administrator in collecting evidence, see SEC, *Report on Reciprocal Subpoena Enforcement Laws*, (Nov. 2000), www.sec.gov/news/studies/subpoenalaw.htm.

(n28)Footnote 28. Unif. Sec. Act § 306.

(n29)Footnote 29. Feigin v. Colo. Nat'l Bank N.,A., 897 P.2d 814, 821 (Colo. 1995) .

(n30)Footnote 30. Unif. Sec. Act § 407(d).

(n31)Footnote 31. Unif. Sec. Act § 407(d).

(n32)Footnote 32. Unif. Sec. Act § 407(d).

(n33)Footnote 33. See *Murphy v. Waterfront Comm'n of N.Y. Harbor*, 378 U.S. 52 (1964) .



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CHAPTER 22 STATE SECURITIES ENFORCEMENT

2-22 Securities Enforcement: Counseling and Defense § 22.03

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§ 22.03 Civil Enforcement

[1] Administrative Liability--Generally

The Uniform Act authorizes the administrator to bring administrative action to revoke or deny the registration of securities or of registration to engage in the securities business. Oftentimes, administrative action is the weapon of choice for State Administrators as it can be conducted solely upon their own direction (versus civil and criminal action which relies on the courts).

[2] Cease-and-Desist Orders

One of the most powerful weapons in the arsenal of administrative remedies available to State Administrators is the power to issue a cease-and-desist order directing identified persons to cease-and-desist from engaging in further illegal activities. In some states, the authority to issue a cease-and-desist order is specified by statute. In other states, it is inferred from the power of the administrator to "make ... such ... orders as are necessary to carry out the provisions of" the Uniform Act under Section 412. n1 A cease-and-desist order can prohibit or restrict the activities of issuers, broker-dealers, agents, investment advisers and other persons engaged in securities transactions in the state. The basis and scope of an administrator's authority to issue cease-and-desist orders varies. The courts have not challenged the administrator's authority to issue such orders under this section. n2

Cease-and-desist orders may be issued either summarily or after a full administrative hearing. Generally, the orders are issued summarily. n3 The issuance of the cease-and-desist order has some limited affect. It probably is nothing more than an indication that the administrator believes there is a doubt of the legality of the alleged violator's activities and it serves as an invitation to resolve the dispute by informal administrative process. In addition, if the conduct continues subsequent to the issuance of the cease-and-desist order, the administrator is likely to seek more formal enforcement action in the form of a criminal or civil proceeding. Cease-and-desist orders are widely used by State Administrators because they have generally proven to be an effective enforcement tool. The order is a quick and inexpensive way for the administrator to bring attention to an alleged violation without going through a more time consuming and expensive civil or criminal procedure. The issuance of the order calls attention of the alleged wrongful activity to the public. Further, the order provides the target with the opportunity to respond to the administrator's concerns outside of the civil and criminal process.

A cease-and-desist order has a number of adverse collateral consequences. A cease-and-desist order is a disclosable item in future securities offerings and on Form BD, Form U-4 n4 and Form ADV n5 (i.e., the uniform forms for registration of broker-dealers, agents and investment advisers, respectively), and a disqualifying event preventing use of the NASAA Uniform Limited Offering Exemption ("ULOE") n6 and NASAA's Small Corporate Offerings Registration Form (SCOR Form) n7 for state registration requirements.

In some states (e.g., California), the administrator can summarily issue cease-and-desist orders without notice and without providing the affected persons an opportunity to be heard. In other states, the administrator may issue a cease-and-desist order only after notice and opportunity for a hearing.

The respondent typically has the right to challenge the cease-and-desist order at a hearing. In some states, the respondent has only a limited amount of time to request the hearing. For example, in Wisconsin, the respondent must request the hearing within 15 days of receipt of the notice of the cease-and-desist order. In other states, the respondent has an unlimited amount of time in which to challenge the order. In many states, the summary cease-and-desist order can become permanent if the respondent fails to request a hearing.

Oftentimes, because of a shortage of manpower and/or funds to further investigate a matter, the administrator may issue a cease-and-desist order as the only practical method he may have to call attention to the alleged violations of the target.

[3] Administrative Hearings

While administrative hearings are conducted somewhat like a trial, the rules of procedure and of evidence typically are more relaxed. In most states, the hearing officer is the administrator or a member of the administrator's staff. Because an employee of the administrator is not truly independent, some states have adopted procedures by which an employee of an independent state agency acts as the hearing officer. For example, in California and Texas, an administrative law judge from the Office of Administrative Hearings will act as the hearing officer. In other states, like in Wisconsin, the proposed hearing officer (typically the administrator) will be "shielded" from involvement in the staff's investigation in an attempt to maintain the administrator's independence as the hearing officer. Defense counsel may want to probe whether or not the administrator was involved in the investigative phase for a possible challenge to the administrator's ability to conduct a hearing as an impartial hearing officer. After the hearing, the hearing officer issues a decision setting forth proposed findings of fact and conclusions of law. The administrator (if not the hearing officer) then reviews the hearing officer's decision, which he can adopt, modify or reject.

The administrator's authority to deny or suspend registration is subject to judicial review under Section 411 of the Uniform Act. n8 A person aggrieved by a final order generally has 60 days from the entry of the order to seek judicial review. The administrator's factual findings will be treated as conclusive if supported by competent, material and substantial evidence. n9 Under certain circumstances, the court may order the administrator to adduce additional evidence and the administrator may modify his findings based upon the additional evidence. Unless otherwise ordered by the reviewing court, the commencement of judicial review does not operate as a stay.

[4] Action with Respect to Securities Registrations

The administrator may deny, suspend, or revoke the registration of securities if the registration statement contains a false or misleading statement or if the administrator finds that the issuer or its principals, underwriters, controlling persons, or the person filing the registration statement has violated any provision of the Uniform Act, or any rule or order issued under the Uniform Act. A hearing is required before the issuance of any such order under this provision except that the administrator may issue a summary order which may be issued upon appropriate notice with a right to a hearing within 15 days from the date of the summary order.

Under Section 306 of the Uniform Act, n10 the administrator has the authority to refuse to register the securities which are the subject of a pending securities registration application or to suspend a registration which has already been made effective under the Uniform Act. In order to exercise this authority, the administrator must: (1) determine that his action is in the public interest, and (2) find that any one or more of specified grounds for refusal, revocation, or suspension exists. n11

The specific grounds for refusal, revocation or suspension of a securities registration application are as follows:

- the registration statement is or was materially incomplete or contained misrepresentations of material facts;
- there has been a willful violation in connection with the offering, of the Uniform Act, any rule or order of the administrator, or any condition lawfully imposed on the registration under the Uniform Act;
- the securities involved are the subject of a stop order or temporary or permanent injunction from another jurisdiction;
- the issuer's enterprise or method of doing business is illegal;
- the offering would work or tend to work a fraud upon a purchaser;
- the offering contains unreasonable amounts of underwriters', promoters', or sellers' profits, discounts, commissions, or options;
- the securities sought to be registered by notification are not entitled to that registration;
- the applicant seeking a coordination registration has not provided the administrator with all amendments to its federal registration; and
- the applicant has not paid the registration fee.

Section 306(a) of the Uniform Uniform Act n12 allows the administrator to allow a securities registration application to go forward by issuing an order of registration even though the administration may believe that the application is defective in some respect. After the order of effectiveness, the administrator has 30 days to commence stop order proceedings if the defect has not been cured. The administrator must consider the public interest when issuing, modifying or vacating a stop order. n13

While the administrator's authority to deny or suspend registration is subject to judicial review under Section 411 of the Uniform Act, n14 registration applicants rarely seek judicial review because timing is crucial with registration of securities. There is virtually no time to go to court to contest the administrator's action in the matter. As a practical matter, the concerns that the administrator has with the application are either worked out between the administrator and the applicant in a give and take situation or the applicant withdraws the application so it will not be denied by order. Generally, the applicant wants to avoid any order of denial because it would be reportable to all of the states in which the applicant has applied for registration. Sometimes, an order of denial by one state will trigger similar action by other states or at least serve to delay the registration effectiveness under the securities act of other states.

[5] Action Against Exemptions

Under Section 402(c) of the Uniform Act, n15 the administrator has the authority to revoke transactional exemptions and certain securities exemptions (e.g., not-for-profit and employee benefit plan securities exemptions). This authority

is limited to a specific offering of securities and the administrator may not revoke the exemption generally for all similar offerings. n16

The Uniform Act gives the administrator the authority to summarily withdraw exemptions, but all interested parties have the right to request a hearing on the withdrawal order. However, the opportunity for hearing is an administrative proceeding and not a judicial proceeding. Generally, the administrator will, in connection with issuing a summary suspension order or revocation of an exemption, issue a cease-and-desist order as well. If a hearing is held, the administrator or hearing officer is required to issue written findings of fact and conclusions of law and the administrator's or hearing officer's decision is subject to appeal. During the appeal, the court will review the administrator's or hearing officer's decision under a "substantial evidence" test.

In order to invoke the administrator's authority in this area, the administrator must be able to show, as in all orders issued, that the order "is necessary or appropriate in the public interest or for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of [the Uniform Act]." n17 The courts have generally given substantial deference to the administrator's decision to deny or revoke an exemption if there has been compliance with due process and statutory requirements. n18

[6] Action Against Professional Registrations

The administrator may deny, revoke, or suspend the registration of a broker-dealer, agent, or investment adviser based upon evidence that the applicant or registrant has willfully violated or has willfully failed to comply with any provision of the Uniform Act or any rule or order under the Uniform Act or has engaged in dishonest or unethical practices in the securities business. The applicant or registrant has a right to a hearing before the entry of any such order denying, revoking, or suspending registration except that a registration may be summarily suspended upon appropriate notice and the right to a hearing within 15 days of the date of the summary order.

Under Section 204(a) of the Uniform Act, n19 the administrator has the authority to deny, revoke, or suspend the registration of a broker-dealer, agent, or investment adviser. n20 In order to take such action, the administrator must be able to show that: (1) it is in the public interest to deny, suspend, or revoke a registration; and (2) one or more of the following grounds applies to the applicant or registrant (the grounds also cover actions by a partner, officer, director, any person occupying a similar position, or performing similar functions, or a person directly or indirectly controlling the broker-dealer or investment adviser): n21

- has filed an application for registration which as of its effective date, or as of any date after filing in the case of an order denying effectiveness, was incomplete in any material respect, or contained any statement which was, in light of the circumstances under which it was made, false or misleading with respect to any material fact;
- has willfully violated or willfully failed to comply with any provision of the Uniform Act or predecessor act or any rule or order under the Uniform Act or a predecessor act;
- has been convicted, within the past ten years, of any misdemeanor involving a security or any aspect of the securities business, or any felony;
- is permanently or temporarily enjoined by any court of competent jurisdiction from engaging in or continuing any conduct or practice involving any aspect of the securities business;
- is the subject of any order of the administrator denying, suspending or revoking registration as a broker-dealer, agent or investment adviser;

- is the subject of an order entered within the past five years by the securities administrator of any other state or by the SEC denying or revoking registration as a broker-dealer, agent or investment adviser, or the substantial equivalent of those terms as defined in this act, or is the subject of an order of the SEC suspending or expelling such person from a national securities exchange or a national securities association registered under the 1934 Act, or is the subject of a United States Post Office fraud order; but the administrator may not institute a revocation proceeding under this section more than one year from the date of the order relied on and may not enter an order under this section on the basis of an order under another state act unless the order was based on facts which would currently constitute a ground for an order under this section;

- has engaged in dishonest or unethical practices in the securities business; n22

- is insolvent, either in the sense that his liabilities exceed his assets or in the sense that he cannot meet his obligations as they mature; but the administrator may not enter an order against the broker-dealer or investment adviser under this clause without a finding of insolvency as to the broker-dealer or advisement adviser; or

- is not qualified under the basis of such factors as training, experience and knowledge of the securities business (but subject to certain restrictions). n23

Revocation proceedings can be taken against a person, up to a year, after such person's registration has been withdrawn. n24

Further, the administrator may by order deny, suspend or revoke any registration if the administrator finds that the order is in the public interest and that the applicant or registrant has:

- failed reasonably to supervise his agents if he is a broker-dealer or his employees if he is an investment adviser; n25 or

- failed to pay the proper filing fee; but the administrator may only enter a denial order under this subsection and he shall vacate any such order when the deficiency has been corrected.

The administrator may not institute a suspension or revocation proceeding upon the basis of facts or transactions known to him when registration became effective unless the proceeding is initiated within the next thirty days.

In addition, Section 204(d) n26 permits the administrator to cancel registration if: (1) the registrant or applicant no longer exists or is no longer in business; (2) has been adjudged mentally incompetent or is subject to control of a committee, conservator or guardian; or (3) cannot be located after reasonable search.

Any action taken by the administrator under Section 204 of the Uniform Act n27 is subject to judicial review pursuant to Section 411 of the Uniform Act. n28 The authority to act afforded the administrator under this section has survived a "due process" appeal. n29

While reviewing the grounds for action by the administrator under Section 204, n30 the following should be considered:

- if the applicant or the registrant is a broker-dealer or investment adviser, the grounds for action also cover actions by a partner, officer, director or any person occupying a similar position or any person directly controlling the broker-dealer or investment adviser. This language allows the administrator to take action against the broker-dealer or investment adviser for activities by a director or officer or controlling person of violations of any of the provisions. Because such persons are not included in the

definition of "agent" under the Uniform Act, activities of such persons would not lead to direct discipline against such persons. The Uniform Act provides the administrator the authority to discipline only those persons that are registered or applying for registration under the Uniform Act. Instead, the administrator would be forced to act against the investment adviser or broker-dealer or agent of such persons.

- the grounds for taking action in the event that a broker-dealer or investment adviser has failed to supervise its agents or employees in a reasonable manner underlines the fact that the administrator is not able to use these grounds to discipline any non-registered branch manager or other supervisor who failed to supervise in a reasonable manner. This means that unless the branch manager or supervisory person is actually registered under the Uniform Act, direct disciplinary action by the administrator may not be directed against such person. In such case, the administrator may, if the supervisory person's activities are particularly egregious, take enforcement action against that person for a violation of the "anti-fraud" provisions under the Uniform Act. In such case, the administrator may issue a cease-and-desist order, seek civil injunction, or pursue criminal prosecution against such person.

[7] Civil Injunction

The last enforcement method available to the administrator under the Uniform Act is to seek civil injunction under Section 408 of the Uniform Act. n31 The administrator may seek a civil injunction

"[w]henver it appears to the [Administrator] that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of [the Uniform Act] or any rule or order hereunder Upon a proper showing a permanent or temporary injunction, restraining order, or writ of mandamus shall be granted and a receiver or conservator may be appointed for the defendant or the defendant's assets ... " n32

Interestingly, it appears that the administrator may seek an injunction based solely upon the occurrence of a "past" violation. n33 Under federal law, it is not sufficient to merely show past violations. It is necessary under federal law to show that subsequent violations are likely to occur. The idea being that the injunction would serve to prevent future violations from occurring. And, of course, the injunction may be used to "prevent" any violations from taking place in the first case.

Generally, the courts will require the administrator to show, prior to granting an injunction or taking other action, that there have been violations and that such violations were knowingly or willfully conducted. n34

There apparently is no statute of limitations under Section 408 n35 as to when an injunctive action may be initiated by the administrator subsequent to the violation. Once the court has granted the injunction, it has the power to modify or vacate the injunction. The defendant, in attempting to modify or vacate the injunction, must show that such injunction causes him great harm (i.e., cannot find employment, or some other hardship). n36

[8] Ancillary Relief

Although the Uniform Act does not expressly authorize the administrator to sue wrongdoers for restitution to investors, some State Administrators have been successful in asking the court for restitution and other forms of relief available to the court. Some State Administrators have been successful in an action for injunction and temporary restraining order, or if an emergency is shown, to have a receiver appointed prior to any hearing to show cause and without notice. n37 This type of action would especially be important when the administrator (and the court) believes that there is a high likelihood that the target may flee with investors' funds upon learning of the enforcement action.

Section 408 of the Uniform Act n38 allows the administrator to seek appointment of a receiver or conservator for any

violator's assets. n39 This authority allows the administrator to freeze and preserve assets of a violator. Such action is oftentimes required to allow time to seek civil action to claim such assets for a violation under the Uniform Act.

Another important form of ancillary relief that may be sought by the administrator is disgorgement. In such action, the administrator petitions the court to order the violator to surrender to the court any profits that the defendant has made in the course of the violation. Although Section 408 of the Uniform Act n40 does not specifically list disgorgement authority, courts have ruled that it is within the administrator's authority under the Uniform Act to seek it. n41

Normally, funds disgorged will be distributed to investors who are injured by the violator. Generally, the administrator will present a plan to the court to distribute the funds. Only profits obtained illegally are subject to disgorgement. Further, civil penalties may also be awarded by the court. n42

It does not appear that there is any statute of limitations with respect to the disgorgement actions.

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 412.

(n2)Footnote 2. *Wolcotts Fin. Servs. Inc. v. McReynolds*, 807 S.W.2d 708 (Tenn. Ct. App. 1990) .

(n3)Footnote 3. For an example of a cease-and-desist order being issued summarily by an administrator, see *In re Vang*, No. S-08154(Ex), Order (Wis. Sec. Div. Mar. 23, 2009), at http://www.wdfi.org/_resources/indexed/site/newsroom/admin_orders/2009/ma_Vang_ord.pdf.

(n4)Footnote 4. Form BD and Form U-4, available at <http://www.finra.org/industry/compliance/registration/crd/filingguidance/p005235>.

(n5)Footnote 5. Form ADV, available at www.sec.gov/divisions/investment/iard/iastuff.shtml.

(n6)Footnote 6. See Reg. D/ULOE, NASAA Reports (CCH) PP 6201-6602 at 6101-6108.

(n7)Footnote 7. The SCOR Form, also known as Form U-7, available at http://www.nasaa.org/Industry___Regulatory_Resources/Corporation_Finance/564.cfm.

(n8)Footnote 8. Unif. Sec. Act § 411.

(n9)Footnote 9. *Kops v. Office of the Comm'r of Sec.*, No. 87-1219, 1988 Wisc. App. Lexis 122 (Wis. Ct. App. Feb. 10, 1998) .

(n10)Footnote 10. Unif. Sec. Act § 306.

(n11)Footnote 11. *Mayflower Secs. Co. v. Bureau of Secs.*, 312 A.2d 497, 499-500 (N.J. 1973) .

(n12)Footnote 12. Unif. Sec. Act § 306(a).

(n13)Footnote 13. *Technomedical Labs, Inc. v. Utah Secs. Div.*, 744 P.2d 320, 324-325 (Utah Ct. App. 1987) .

(n14)Footnote 14. Unif. Sec. Act § 411.

(n15)Footnote 15. Unif. Sec. Act § 402(c).

(n16)Footnote 16. Louis Loss, Commentary on the Uniform Securities Act 136 (1976).

(n17)Footnote 17. Unif. Sec. Act § 412(b).

(n18)Footnote 18. *Johnson-Bowles Co. v. Div. of Secs.*, 829 P.2d 101 (Utah Ct. App. 1992) .

(n19)Footnote 19. Unif. Sec. Act § 204(a).

(n20)Footnote 20. Many of the states have added provisions to their state securities laws for the granting of registration to "investment adviser representatives," and the 2002 Act includes investment adviser representative registration requirements. Accordingly, such persons are subject to action against their registration in such states.

(n21)Footnote 21. *Mayflower*, 312 A.2d at 499-500.

(n22)Footnote 22. The term "dishonest or unethical practices" has been determined to be not unconstitutionally vague. *See Brewster v. Md. Secs. Comm'r*, 548 A.2d 157, 160 (Md. Ct. Spec. App. 1988) ; *Johnson-Bowles Co.*, 829 P.2d at 114.

(n23)Footnote 23. *See* Unif. Sec. Act § 204(b).

(n24)Footnote 24. *See* Unif. Sec. Act § 204(e).

(n25)Footnote 25. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) .

(n26)Footnote 26. Unif. Sec. Act § 204(d).

(n27)Footnote 27. Unif. Sec. Act § 204.

(n28)Footnote 28. Unif. Sec. Act § 411. Procedures for judicial review of the administrator's orders under Unif. Sec. Act § 411 is, in part, modeled after Section 12 of the Model Administrative Procedure Act, 54 Handbook of National Conference of Commissioners on Uniform State Laws 334 (1944) and partly on Section 25 of the 1934 Act.

(n29)Footnote 29. *State ex rel. Cord v. Bartell*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,114 at 67,469-67,470 (Wis. Cir. Ct. Dane County Feb. 4, 1974). A violation of the cease-and-desist order is also a cause for criminal and civil action under the Act.

(n30)Footnote 30. Unif. Sec. Act § 204.

(n31)Footnote 31. Unif. Sec. Act § 408.

(n32)Footnote 32. *Id.*

(n33)Footnote 33. *Page v. AEI Group, Inc.*, No. 90AP-774 1991 *Ohio App. LEXIS 3216* (Ohio Ct. App. July 2, 1991) .

(n34)Footnote 34. *State v. Creative Prod., Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,056 at 67,288-67,290 (Okla. Dist. Ct. Okla. County Nov. 17, 1972).

(n35)Footnote 35. Unif. Sec. Act § 408.

(n36)Footnote 36. *S.E.C. v. Hatch*, 128 F.R.D. 58, (D.N.J. 1989) .

(n37)Footnote 37. *Maggiore v. Palo Alto Inn, Inc.*, 57 Cal. Rptr. 787 (Cal. Dist. Ct. App. 1967) ; *Misita v. Distillers Corp.*, 128 P.2d 888 (Cal. Dist. Ct. App. 1942) .

(n38)Footnote 38. Unif. Sec. Act § 408.

(n39)Footnote 39. *Gertsch v. Perez*, [1984-1985 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,121 (Alaska Sup.

Ct. Juneau Dist. Oct. 15, 1984).

(n40)Footnote 40. Unif. Sec. Act § 408.

(n41)Footnote 41. *See State ex rel. Day v. SW Mineral Energy Inc.*, 617 P.2d 1334 (Okla. 1980) , *aff'g* Blue Sky L. Rep. (CCH) P 71,548 (Okla. Dist. Ct. Okla. County Nov. 8, 1979).[1978-1981 Transfer Binder].

(n42)Footnote 42. *S.E.C. v. Jakubowski*, No. 94-C-4539, 1997 U.S. Dist. LEXIS 14575 (N.D. Ill. Sept. 19, 1997) .



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Securities Enforcement: Counseling and Defense

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CHAPTER 22 STATE SECURITIES ENFORCEMENT

2-22 Securities Enforcement: Counseling and Defense § 22.04

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§ 22.04 Criminal Enforcement

[1] Section 409

The primary criminal liability section under the Uniform Act is Section 409. n1 Section 409(a), n2 states that:

Any person who willfully violates any provision of this act except section 404, or who willfully violates any rule or order under this act, or who willfully violates section 404 knowing the statement made to be false or misleading in any material respect, shall upon conviction be fined not more than \$5,000 or imprisoned not more than three years, or both; but no person may be imprisoned for the violation of any rule or order if he proves that he had no knowledge of the rule or order. [No indictment or information may be returned under this act more than five years after the alleged violation.]

The Uniform Act requires the administrator to refer criminal matters to local law enforcement officials. It has become a common practice of local prosecutors, who are generally unfamiliar with securities law cases, to appoint the state securities administrator or a member of the administrator's legal staff as special prosecutor to help prosecute the case under the supervision and control of the local prosecutor. Generally, investigations are conducted by the administrator's staff, sometimes in conjunction with the district attorney's or attorney general's staff.

It appears that State Administrators and local prosecutors are becoming more aggressive in pursuing criminal prosecution in securities cases. Also, it appears that State Administrators are having greater success in convincing local prosecutors and state attorney generals to prosecute securities cases because: (i) the prosecutors' increased awareness that the cases can be relatively easy to prove and prosecute; (ii) the increased media attention to such cases; and (iii) the added attention of prosecutors to "white collar crime" in general. In order to assist local prosecutors to better understand the securities laws and avenues for prosecution, NASAA developed an educational program for law enforcement officers and district attorneys. n3 Further, it appears that prosecutors are becoming more successful in such cases in obtaining stiffer penalties from the courts. n4

Criminal prosecutions generally result from violations of the failure to register as a broker-dealer, agent or investment adviser, n5 the failure to register securities, n6 or for violations of the fraud provisions. n7 Although, a violation of any section of the Uniform Act can impose criminal liability, state securities administrators, in attempting to persuade a

local prosecutor to take on a case, oftentimes find that the cases under Sections 101, 201 and 301 are more likely to interest prosecutors because they are generally more news worthy and are likely to include significant plaintiff losses in connection with the alleged violations. At least in the past, without significant plaintiff losses and/or substantial securities fraud, prosecutors were less likely to be interested in prosecuting violations of the Uniform Act. Generally, in a tactical sense, prosecutors find that it is generally prudent to prosecute, whenever possible, violations of multiple sections of the Uniform Act (e.g., securities registration or professional registration violations with securities fraud violations), so that the trier of fact can at least convict on one of the easier counts to prove (i.e., a registration violation).

Although Section 409 n8 requires the prosecutor to show that the violation was "willfully" done, the majority of the cases have held that the willfulness requirement is met by showing that the defendant acted intentionally in the sense that he was aware of what he was doing. n9 This can be shown merely by the defendant's act of offering and selling the security. Whether or not the defendant believed or understood what he was offering or sold was a security or that registration was required is not necessary for successful prosecution. n10 The majority position on this issue is aptly described in *State v. Dumke* where the court described "willfulness" as:

A "willful" act or omission may be described as an intentional act or omission to perform an act in that the person was aware of what he was doing or failing to do. Proof of evil motive, intent to violate the law, or knowledge that the law was being violated is not required. n11

In this respect, it can be substantially easier for a state prosecutor to obtain a criminal conviction than for a federal prosecutor.

Further supporting the majority view regarding the definition of "willful" is the fact that Section 404 under the Uniform Act (the false or misleading filing of a document with the administrator) n12 includes the additional requirement for criminal prosecution of a violation under Section 404 n13 that the defendant "knew" that the statement made to be false or misleading in any material respect. The fact that the "knowing" requirement in Section 409 n14 is limited to Section 404 n15 of the Uniform Act arguably suggests that the drafters of the Uniform Act intended a lesser standard (willfulness) for other criminal prosecutions. Also, courts have held that it is not an affirmative defense that the defendant received bad advice from legal counsel n16 or misinformation about the registration requirements from the state securities department. n17

The Model Penal Code suggests that a court cannot convict a person of a felony without proof of criminal intent, unless the statute that authorizes such conviction specifically negates the need for proof of criminal intent. n18 The courts in some states that have adopted the Model Penal Code while considering criminal convictions in failure to register cases have had mixed decisions in this regard. n19

In a criminal action under Section 409, n20 the prosecutor must prove each element of the crime "beyond a reasonable doubt." In general, the defendant bears the burden of showing that an exemption or exception was available to the defendant in connection with the alleged unlawful activities. Some courts have described this defendant's obligation as an "affirmative defense". n21 Further, it has been ruled not unconstitutional to treat this as an affirmative defense in such an action. n22 The courts are split on how much evidence the defendant must provide to demonstrate that an exemption or exception was available. Some courts have ruled that a defendant must show by a preponderance of the evidence that the defendant is entitled to the exemption or exception. n23 Other courts have ruled that the defendant only needs to show some evidence of an entitlement to the exemption or exception and then the prosecutor needs to carry its normal burden of proof beyond a reasonable doubt. n24

Section 409 n25 grants the defendant a partial affirmative defense in connection with an alleged violation of a rule or order if the defendant can show that he did not know of the rule or order at the time he acted. Upon successful establishment of the affirmative defense, the defendant, although found guilty of the violation, is subject to a fine, but no prison time.

To obtain conviction for a violation under Section 404 (i.e., false or misleading filings with the administrator), n26 the prosecutor must also establish that the defendant made the false filing willfully and knowingly (i.e., the person knew that he was making a filing with the administrator and knew that it contained false information or a misstatement).

[2] Failure to Register Securities Cases

In connection with a criminal prosecution involving unregistered and non-exempt securities, the prosecutor must show: (i) there was an offer or sale of a security by the defendant which took place in the state; and (ii) the security was not registered. Note that prosecution can occur for either an offer or a sale or both. Typically, however, only one felony is charged for both an offer and a sale. n27

The secondary liability provisions do not apply to criminal prosecutions under Section 409. n28 Accordingly, if the person was not a "seller" of the securities, then he is not criminally liable for the violation of the statute. However, such persons could be charged as "aiders and abettors" under Section 409. n29 Generally, persons who are not directly involved in the violation of the Uniform Act but may have secondary liability are charged under extended liability theories established by both state and federal courts in areas outside of securities. Generally, aiding and abetting (and conspiracy) secondary criminal liability can be shown by evidence that the defendant conducted some activity to aid the primary criminal violation. The federal courts have required that the person secondarily liable be shown to have known of the primary violation and knowingly aided it. Criminal liability of non-sellers turns on the application of state criminal liability statutes relating to aiding and abetting and conspiracy.

Under the Uniform Act, the majority view appears to be that the prosecutor does not have to prove that the securities were not exempt from registration. n30 Section 402(d) of the Uniform Act n31 states that "[i]n any proceeding under [the] Act, the burden of proving an exemption or an exception from a definition is upon the person claiming it." Case law appears to support the view that the defendant would have to show by a preponderance of the evidence that he is entitled to an exemption from registration in order to use it as a defense in a criminal case. n32 There are some courts, however, that have ruled that the defendant only had to show some evidence that an exemption was available. n33 The prosecutor must prove all elements of a non-registration case beyond a reasonable doubt. n34

[3] Failure to Register as a Broker-Dealer, Agent, or Investment Adviser Cases

The elements of a criminal prosecution for failure to register as a broker-dealer, agent, or investment adviser are basically the same as those for failure to register a security. For such "professional" registration violations the prosecutor, in order to prove a violation, would have to show that: (i) the person was either a broker-dealer, agent, or investment adviser; (ii) he transacted business as such in the state; and (iii) he was not registered at the time. Definitions of broker-dealer, agent and investment adviser are found under Section 401 of the Uniform Act. n35 The phrase, "engaged in the business" as part of the broker-dealer definition, is not defined under the Uniform Act and is determined by the trier of fact. Generally, courts have determined that the phrase requires a certain regularity of purchasing and selling securities. n36 However, some courts have ruled that only one transaction may constitute being engaged in the business. n37

Section 401(c) of the 1933 Act n38 excludes certain persons from the definition of "broker-dealer." Such exclusions include an agent, issuer, bank, savings institution or trust company and certain broker-dealers with no place of business in the state and conduct a *de minimis* amount of activity in the state. Defendants, in failure to register prosecutions, will often seek to assert that they are eligible for an exclusion from the definition of broker-dealer and therefore cannot be held for violations for unregistered broker-dealer activities.

"Agent" is defined under Section 401(b) of the Uniform Act n39 to mean "any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities." n40 There

are exclusions from the definition of an agent including those for a person representing an issuer in certain exempt securities or in effecting exempt transactions. n41

Section 201(c) of the Uniform Act n42 states that it is unlawful to conduct business in the state as an investment adviser without being registered (unless an exception from the definition or an exemption from registration is available). The definition of investment adviser under Section 401(f) of the Uniform Act n43 includes persons who, for compensation, engage in the business of advising others, either directly or through publications or writings, as to the value of securities or advises others as to the advisability of investing in, purchasing or selling securities or who, for compensation, issues or promulgate analyses or reports concerning securities. There are exclusions from the definition of investment adviser that include: such professionals as lawyers, accountants, engineers and teachers who provide investment advice incidental to the practice of their profession; a bank, savings institution or trust company; newspapers or other publications; and investment advisers who have no place of business in the state and conduct a *de minimis* amount of investment advisory activities in the state. n44

The prosecutor does not have to prove that the exclusions from the definition or any exemptions from registration are not available for the broker-dealer, agent, or investment adviser. Instead, it is the burden of the defendant to show as an affirmative defense that an exclusion or exemption is available. Generally, the defendant would have to prove that the exclusion or exemption being claimed by a preponderance of the evidence. Some courts, however, have ruled that the defendant only has the burden of coming forward and that it is sufficient to merely provide enough evidence to raise the issue. n45 In such cases, the prosecutor would then have the burden of persuading the trier of fact beyond a reasonable doubt that the exclusion or exemption was not available to the defendant.

A common registration violation is found when a broker-dealer, agent or investment adviser conducts business in the state prior to registration. Oftentimes, the person may have filed an application for registration but the administrator has not made that application effective and therefore registration has not been obtained. Further, for agent registration, such registration is only effective while the agent is acting for a particular broker-dealer or issuer. If the agent operates outside the scope of his agent engagement with the particular broker-dealer or issuer, the agent's registration is *not* effective for those outside activities. Any activity as a broker-dealer, agent or investment adviser without an exception from the applicable definition or an exemption from registration (assuming there are any available under the Uniform Act) would constitute a violation and provide liability, civilly, criminally and administratively. n46

The prosecutor does not have to prove intent by the defendant while violating the professional registration requirements or scienter. n47 Accordingly, it is not necessary for the prosecutor to show that the accused person knew that registration had not become effective or that even registration was required. Also, courts have held that the fact that the defendant may have received erroneous advice from counsel on the need for registration is not a defense. n48

The final element in proving a failure to register case is to show that such person transacted business in the state. Generally, the prosecutor would provide proof of transacting business in the state just as he would show that securities were offered and sold in the state under Section 414 (i.e., scope of the Uniform Act). n49

[4] Anti-Fraud Cases

Under Section 409, n50 it is possible to pursue criminal conviction against a violator of Section 101 (the "anti-fraud" provisions) n51 under the Uniform Act. This section is patterned after Section 17(a) of the 1933 Act n52 and SEC *Rule 10b-5* promulgated under Section 10(b) of the 1934 Act. n53 The prosecutor must show that the defendant acted willfully in connection with the violation of the Uniform Act and that it occurred in connection with the offer, sale, or purchase of a security. These types of cases are the most difficult to prove of the criminal cases under the Uniform Act and are the most difficult to obtain a local prosecutor to take on. Local prosecutors, who oftentimes have no familiarity with the Uniform Act, are reluctant to take on such cases that require considerable time and energy, unless there are multiple victims with significant monetary losses involved. What helps prosecution is that reliance is not required for a

criminal prosecution and that the injury does not have to be a result of the violation. n54

A violation of Section 101 n55 involves a person who, in connection with the offer, sale, or purchase of any security, directly or indirectly: (i) employed any device, scheme, or artifice to defraud; (ii) made an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statement made, in light of the circumstances under which it was made, not misleading; or (iii) engaged in any act, practice, or course of business that operated or would operate as a fraud or deceit upon any person. In connection with proving the employment of any device, scheme, or artifice to defraud, the prosecutor must prove scienter. The courts have generally indicated that scienter means that the act was knowingly done or done with reckless disregard but does not require proof of intent to defraud or an evil mind. n56

What constitutes a device, scheme or artifice to defraud is up to the trier of fact. Generally, a charge under this section most typically involves conversion of investor's funds for personal use. n57

The most widely used criminal prosecution under Section 101 n58 involves the making of material misrepresentations or omissions of material fact. As under *Rule 10b-5* under the 1934 Act, n59 Section 101 requires more than a mere omission to prove a violation. However, an omission may cause the information to be conveyed either false or misleading. n60 For example, an omission of a material fact may cause certain of the information presented to be materially incomplete or misleading. It is not, however, clear that the prosecutor must establish that the defendant acted with an intent to defraud, knowingly, recklessly or even negligently. The majority view of the courts seems to be that willfulness does not require that the defendant intended to do the act or make the omission found to be material and misleading. In other words, the defendant is liable if he voluntarily engaged in the unlawful conduct, no matter if he understood it to be unlawful at the time. The defendant acted willfully when he acted deliberately and purposefully. It does not require acting with a conscious purpose or specific intent to mislead. n61 However, some courts have held that it is necessary to show scienter, (i.e., the defendant knew that the statements were either false or omitted a material fact). n62

The final subsection of Section 101 n63 prohibits any act, practice, or course of business that operates or would operate as a fraud or deceit on any person. If the deceit also involves a misrepresentation or omission, than charges can be made under both Section 101(2) n64 and 101(3). n65 The fraud or deceit may be perpetrated on a purchaser, existing shareholders of the corporation, or even a state agency. n66

The misstatements or omissions required under Section 101 n67 that invoke criminal liability must be "material." The United States Supreme Court's ruling in *TSC Industries, Inc. v. Northway, Inc.* n68 appears to be the threshold test for materiality in these criminal actions. The ruling in *TSC Industries* indicates that the test for materiality is objective rather than subjective. It invokes a reasonable investor standard (i.e., an omitted fact is material if there is substantial likelihood that a reasonable purchaser/seller under the same or similar circumstances would deem the information material in making an investment decision). n69 The courts in state securities law enforcement actions have generally followed the conclusions reached by the Court in *TSC Industries* in applying the materiality test. n70

The final requirement for a criminal fraud prosecution is that the violation took place in connection with the offer, sale, or purchase of a security. The cases seem to indicate that the prosecution does not have to show that the violator knew that there was a security involved. n71

Oftentimes, an obstacle to successful prosecution is demonstrating that the alleged violation occurred "in connection with" the offer, sale, or purchase of a security. Courts generally look to the interpretation of this phrase under the federal securities laws. The federal courts have adopted a broad interpretation of "in connection with." The court in *Alley v. Miramon* stated that the "in connection with" requirement under *Rule 10b-5* under the 1934 Act n72 "is flexibly applied to require that there be a nexus between the defendant's fraud and the plaintiff's sale of securities." n73 The plaintiff in a *Rule 10b-5* case need not establish a direct or close relationship between the fraudulent transaction and the purchase or

sale, only that the transaction involving the sale touch the defendant's fraud. Therefore the test of "in connection with" is likely to be satisfied where the prescribed conduct and sale are part of the same fraudulent scheme. Subsequent to decisions like this, state courts have tended to take a very broad interpretation of the "in connection with" requirement. n74 The United States Supreme Court has also adopted a broad definition of the "in connection with" element. n75 This decision is likely to result in state courts continuing to interpret the element broadly.

However, that does not mean to say that there are not some limits to the latitude provided the courts on this issue. The courts have held that conduct that takes place after the purchase or sale and is not part of a continuing scheme to defraud is not covered under Section 101 of the Uniform Act. n76 Also, conduct that leads a plaintiff to retain securities rather than sell them is not actionable under Section 101 because there is no offer or sale of the securities in such a transaction. n77

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 409.

(n2)Footnote 2. Unif. Sec. Act § 409(a).

(n3)Footnote 3. *See* NASAA Newsroom, State Securities Regulators Launch Program to Help Law Enforcement Investigate Fraud (Apr. 29, 2008) *available at* www.nasaa.org/NASAA_newsroom/current_NASAA_headlines/8693.cfm.

(n4)Footnote 4. Michael Schroeder, *Securities-Fraud Penalties Stiffen: Texas Leads States in Criminal Sentences*, Wall St. J., Apr. 5, 2001, at C1; and Ed Treleven, *Judge Gives 12 Years to Man Who Tricked Investors*, Wis. State J., July 25, 2002, at B1.

(n5)Footnote 5. Unif. Sec. Act § 201.

(n6)Footnote 6. Unif. Sec. Act § 301.

(n7)Footnote 7. Unif. Sec. Act § 101.

(n8)Footnote 8. Unif. Sec. Act § 409.

(n9)Footnote 9. *State v. Montgomery*, 17 P.3d 292, 296 (Idaho 2001) ; *State v. Nagel*, 279 N.W.2d 911, 915 (S.D. 1979) ; *State v. Fries*, 337 N.W.2d 398, 405 (Neb. 1983) .

(n10)Footnote 10. *State v. Markham*, 697 P. 2d 263 (Wash. Ct. App. 1985) .

(n11)Footnote 11. *State v. Dumke*, 901 S.W.2d 100, 102 (Mo. Ct. App. 1995) ; *State v. Hodge*, 460 P.2d 596, 604 (Kan, 1969) .

(n12)Footnote 12. Unif. Sec. Act § 404.

(n13)Footnote 13. Unif. Sec. Act § 404.

(n14)Footnote 14. Unif. Sec. Act § 409.

(n15)Footnote 15. Unif. Sec. Act § 404.

(n16)Footnote 16. *Huff v. State*, 646 So. 2d 742 (Fla. Dist. Ct. App. 1994) .

(n17)Footnote 17. *United States v. Anzelmo*, 319 F. Supp. 1106 (E.D. La. 1970) .

(n18)Footnote 18. Model Penal Code § 2.05 (1985).

(n19)Footnote 19. In Oregon, which has adopted the Model Penal Code and has the "willfulness" language under its securities act comparable to that under Section 409 under the Uniform Act, the Oregon Court of Appeals in *State v. Pierre*, 566 P.2d 534 (Or. Ct. App. 1977) stated that the state securities law was not specific enough to allow for criminal prosecution without proving intent. However, an Oregon court in *State v. Jacobs*, 579 P.2d. 881 (Or. Ct. App. 1978) , narrowed the *Pierre* decision by stating that the state only had to allege that the defendant know that he was selling something which turned out to be securities.

(n20)Footnote 20. Unif. Sec. Act § 409.

(n21)Footnote 21. United States *ex rel Shott v. Tehan*, 365 F.2d 191, 195, 37 Ohio Op. 2d 341 (6th Cir. 1966) ; *Commonwealth v. David*, 309 N.E.2d 484, 488 (Mass. 1974) ; *State v. Andresen*, 773 A.2d 328 (Conn. 2001) .

(n22)Footnote 22. *State v. Frost*, 11 Ohio Op. 3d 294, 387 N.E.2d 235, 238-239 (Ohio 1979) ; *State v. Andresen*, 773 A.2d 328 (Conn. 2001) .

(n23)Footnote 23. United States *ex rel Shott v. Tehan*, 365 F.2d 191, 37 Ohio Op. 2d 341 (6th Cir. 1966) .

(n24)Footnote 24. *David*, 309 N.E.2d at 488.

(n25)Footnote 25. Unif. Sec. Act § 409.

(n26)Footnote 26. Unif. Sec. Act § 404.

(n27)Footnote 27. As those terms are defined under Unif. Sec. Act § 401(j).

(n28)Footnote 28. Unif. Sec. Act § 409.

(n29)Footnote 29. Unif. Sec. Act § 409.

(n30)Footnote 30. *State v. Newman*, 455 N.W.2d 913 (Wis. Ct. App. 1990) , *aff'd*, 469 N.W.2d 394 (Wis. 1991) .

(n31)Footnote 31. Unif. Sec. Act § 402(d).

(n32)Footnote 32. *State v. Goodman*, 521 P.2d 611 (Ariz. 1974) .

(n33)Footnote 33. *People v. Figueroa*, 715 P.2d 680, (Cal. 1986) ; *David*, 309 N.E.2d at 488.

(n34)Footnote 34. *State v. Frost*, 11 Ohio Op. 3d 294, 387 N.E.2d 235 (Ohio 1979) .

(n35)Footnote 35. Unif. Sec. Act § 401.

(n36)Footnote 36. *Musson v. Rice*, 739 P.2d 1004, 1005 (Okla. 1987) ; *United States v. Schwartz*, 464 F.2d 499, 506 (2d Cir. 1972) .

(n37)Footnote 37. *Carrousel N., Inc. v. Chelsea Moore Co.*, 460 N.E.2d 316 (Ohio. Ct. App. 1983) .

(n38)Footnote 38. Unif. Sec. Act § 401(c).

(n39)Footnote 39. Unif. Sec. Act § 401(b).

(n40)Footnote 40. Whether a person is an "agent" representing a broker-dealer or issuer is determined upon the same factors that create an agency relationship at common law. *See* *Shaughnessy & Co. v. Comm'r of Secs.*, [1971-1978

Transfer Binder] Blue Sky L. Rep. (CCH) P 71,348 at 68,135 (Wis. Cir. Ct. Dane County May 18, 1977).

(n41)Footnote 41. *See* Unif. Sec. Act § 401(b).

(n42)Footnote 42. Unif. Sec. Act § 201(c).

(n43)Footnote 43. Unif. Sec. Act § 401(f).

(n44)Footnote 44. *See* Unif. Sec. Act § 401(f). In addition, NSMIA includes provisions that prohibits a state from requiring registration for an investment adviser with no place of business in the state and with fewer than six clients in the state, and investment advisers with \$25 million or more of assets under management and certain other investment advisers are under the exclusive registration provisions of the SEC.

(n45)Footnote 45. *Newman*, 458 N.W.2d 532 . *But see also*, *Figueroa*, 715 P.2d 680 ; *David*, 309 N.E.2d at 488.

(n46)Footnote 46. The Uniform Act provides an exclusion from the definition of "broker-dealer" under § 401(c) for a "bank, savings institution, or trust company." Since the Gramm-Leach-Bliley Act was adopted in 1999 ("GLB"), the same exclusion for a bank under the federal definition of "broker" and "dealer" under Sections 3(a)(4) and (5) of the 1934 Act was revised to accommodate certain exemptions for limited type activities of such financial institutions. Some state securities laws have done the same with their exclusion for a bank and the 2002 Act also conforms to the provisions of GLB.

(n47)Footnote 47. *State v. Montgomery*, 17 P.3d 292 (Idaho 2001) .

(n48)Footnote 48. *Id.*

(n49)Footnote 49. Unif. Sec. Act § 414.

(n50)Footnote 50. Unif. Sec. Act § 409.

(n51)Footnote 51. Unif. Sec. Act § 101.

(n52)Footnote 52. 15 U.S.C. § 77q(a).

(n53)Footnote 53. 15 U.S.C. § 78j(b).

(n54)Footnote 54. *Birchfield v. State*, 401 S.W.2d 825 (Tex. Crim. App. 1966) .

(n55)Footnote 55. Unif. Sec. Act § 101.

(n56)Footnote 56. *Woods v. Barnett Bank of Ft. Lauderdale*, 765 F.2d 1004 (11th Cir. 1985) .

(n57)Footnote 57. *Queen v. Commonwealth*, 434 S.W.2d 318 (Ky. 1968) .

(n58)Footnote 58. Unif. Sec. Act § 101.

(n59)Footnote 59. 15 U.S.C. § 78j(b).

(n60)Footnote 60. *State v. Stuber*, 962 P.2d 1104 (Kan. Ct. App. 1998) .

(n61)Footnote 61. *State v. Gunnison*, 618 P.2d 609 (Ariz. Ct. App. 1979) , *aff'd in part, rev'd in part*; 618 P.2d 604 (Ariz. 1980) ; *Van Duyse v. Israel*, 486 F. Supp. 1382 (E.D. Wis. 1980) ; *State v. Temby*, 322 N.W.2d 522 (Wis. Ct. App. 1982) ; *State v. Mehling*, 115 P.3d 771 (Kan. Ct. App. 2005) .

- (n62)Footnote 62. *State v. Larsen*, 865 P.2d 1355, 1358 n.3 (Utah 1993) .
- (n63)Footnote 63. Unif. Sec. Act § 101.
- (n64)Footnote 64. Unif. Sec. Act § 101(2).
- (n65)Footnote 65. Unif. Sec. Act § 101(3).
- (n66)Footnote 66. *In re Daniel S. Brier & Co.*, [1961-1971 Transfer Binder] Blue Sky L. Rep. (CCH) P 70,917 (N.J. Secs. Bureau Dec. 14, 1970).
- (n67)Footnote 67. Unif. Sec. Act § 101.
- (n68)Footnote 68. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) .
- (n69)Footnote 69. *TSC Indus., Inc.*, 426 U.S. 438 .
- (n70)Footnote 70. *Loewen v. Galligan*, 882 P.2d 104 (Or. Ct. App. 1994) .
- (n71)Footnote 71. *Buffo v. State*, 415 So. 2d 1158 (Ala. 1982) .
- (n72)Footnote 72. 15 U.S.C. § 78j(b).
- (n73)Footnote 73. *Alley v. Miramon*, 614 F.2d 1372, 1378 n.11 (5th Cir. 1980) .
- (n74)Footnote 74. *State v. Harry*, 873 P.2d 1149 (Utah Ct. App. 1994) .
- (n75)Footnote 75. *S.E.C. v. Zandford*, 535 U.S. 813 (2002) .
- (n76)Footnote 76. Unif. Sec. Act § 101. See *Darrell v. Goodson*, No. 78-Civ.-5945 (LFM), 1980 U.S. Dist. LEXIS 10947 (S.D.N.Y. Apr. 11, 1980) .
- (n77)Footnote 77. Unif. Sec. Act § 101. See *Troyer v. Karcagi*, 476 F. Supp. 1142 (S.D.N.Y. 1979) .



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Securities Enforcement: Counseling and Defense

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CHAPTER 22 STATE SECURITIES ENFORCEMENT

2-22 Securities Enforcement: Counseling and Defense § 22.05

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§ 22.05 Civil Liability

Although not considered an enforcement weapon of the administrator, the civil liability provisions under the Uniform Act are an important and relatively easy device to be used by plaintiff's counsel to make the client/victim whole based on an alleged violation of the Uniform Act. Counsel for securities issuers and industry professionals should be familiar with Section 410 of the Uniform Act and its ramifications to defendants.

[1] Section 410

The main civil liability provision under the Uniform Act is Section 410, n1 which is patterned after the original Section 12 under the 1933 Act. n2 Section 410, n3 in part, reads as follows:

(a) any person who:

(1) offers or sells a security in violation of Section 201(a) (broker-dealer or agent registration requirement), Section 301 (securities registration requirement) or Section 405(b) (misrepresenting that the administrator recommended the securities offered), or of any rule or order under section 403 (the sales literature approval requirement), or of any condition imposed under Section 304(d), Section 305(g), or Section 305(h) (specific conditions that the administrator imposed upon a securities offering); or

(2) offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent (6%) per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for

damages if he no longer owns the security. n4

(b) Every person who directly or indirectly controls a seller liable under subsection (a), every partner, officer or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such a seller who materially aids in the sale, and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller, unless the non-seller who is so liable sustains the burden of proof that he did not know, and in exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases of contract among the several persons so liable. n5

Other material parts of Section 410 n6 are: the two year statute of limitations after the date of the contract of sale and the prohibition against bringing suit if a rescission offer was received by the investor in the form required, n7 that any condition, stipulation or provision binding any person acquiring an security to waive any provision of the Uniform Act or any rule or order thereunder is void (under Section 410(g)), n8 and that the rights and remedies provided under the Uniform Act are in *addition* (emphasis added) to any other rights or remedies that may exist at law or in equity (under Section 410(h)). n9

Section 410(a)(1) of the Uniform Act n10 imposes "strict" civil liability for a variety of violations of the Uniform Act or rules thereunder. Section 410(a)(2) n11 imposes liability for material misrepresentations and omissions made in connection with the sale of a security. Further, under Section 410(a)(2), n12 liability attaches regardless of whether the security was registered or was exempt from the securities registration requirements under the Uniform Act. Section 410(a)(1) of the Uniform Act, n13 although patterned in theory after Section 12 of the 1933 Act, n14 is more expansive than Section 12 as it not only covers securities registration violations but also violations of the provisions under the broker-dealer and agent registration provisions, advertising filing requirements, misrepresentations concerning the administrator's recommendation of the offered securities, and for violations of specific conditions imposed by the administrator upon a specific securities offering. n15

[2] Proving a Case Under Section 410(a)(1); Registration Violations

In order to prove a case under Section 410(a)(1), n16 the plaintiff would have to prove the following elements: that there was an offer or sale; that the offer or sale involved a security; that the offer or sale took place in the state; that the security was purchased by the plaintiff; that the security was not registered; that the defendant is liable, either primarily or secondarily, for the violation; and that the plaintiff is willing to return the securities, if they are still owned or that they have been sold.

Most of these elements are easily established through the plaintiff-investor's testimony. For proving that the security or professional was not registered, testimony or an affidavit by a representative of the office of the administrator will be offered as proof of non-registration. The plaintiff may invoke the state securities law of either the state in which the sale took place or the state in which the offer took place. For example, if the offer occurred in Wisconsin but the sale occurred in Minnesota, the plaintiff would have a cause of action under the state securities law of both Wisconsin *and* Minnesota. n17

After a violation has been established, the award of recovery set out in Section 410(a)(2) n18 requires that rescission be the *sole* remedy. n19 If, however, the plaintiff already sold the security purchased in violation of the Uniform Act, he is entitled to "damages" (i.e., the amount that would be recoverable upon tender less the value of the security when the plaintiff disposed of it and interest at the legal rate from the date of disposition). Damages in this case are designed to be the substantial equivalent of rescission. n20

It is important to note that the plaintiff does *not* have to prove that: (1) he relied upon the registration of the securities or

of the professional; (2) there was any injury to the plaintiff or that the injury was caused by the violation; (3) the failure to register was the result of the seller's negligence or fraudulent act; and (4) the seller knew that registration was required. n21

[3] Affirmative Defenses in Section 410(a)(1) Actions

There are statutory and common law affirmative defenses to the allegations that must be proved by a preponderance of the evidence. The Uniform Act provides two statutory affirmative defenses: (1) that the plaintiff's action was not brought within the statute of limitations; and (2) that an exemption or exclusion from registration under the Uniform Act was available to the seller. n22 If these defenses are raised, the seller has the burden of proof. The plaintiff then may rebut the defendant's evidence.

There are various common law defenses attempted by defendants, but there is a credible argument that such defenses are not relevant to registration violations under the Uniform Act. n23 Such defenses include that: the plaintiff participated in the violation (i.e., was in para delicto with the seller); the plaintiff should be estopped from recovering; the plaintiff has waived his right to recover; and the plaintiff ratified the transaction in which the violation occurred. Other defenses used by defendants, often without success, are that: the plaintiff knew that the securities or professional was required to be registered; the plaintiff had the duty to conduct due diligence; the plaintiff is guilty of either contributory or comparative negligence; and the plaintiff failed to mitigate his damages. n24 Some defendants have offered the affirmative defense of the plaintiff's knowledge of the violation prior to the sale. Courts generally find this to be an ineffective defense. n25

In addition, Section 410(g) of the Uniform Act n26 tends to support the courts' views that a seller's attempts to get the investor to waive compliance with any provisions under the Uniform Act are void where it states: "any condition, stipulation or provision binding any person acquiring any security to waive compliance with any provision of [the] Act or any rule or order hereunder is void."

[4] Civil Remedies Under Section 410(a)(2); "Anti Fraud" Violations

Section 410(a)(2) of the Uniform Act n27 provides a civil remedy for misrepresentations and omissions ("anti-fraud provisions") and is virtually identical to Section 12(2) of the 1933 Act. n28 This section applies to initial and secondary offerings and sales in the after market, regardless of whether the securities are registered or exempt. Unlike under Section 410(a)(1) n29 of the Uniform Act, liability is not "strict" or absolute under Section 410(a)(2). n30 The defendant has the affirmative defense, for which he must bear the burden of proof, to show "that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission." As under the 1933 Act, the misrepresentations or omissions alleged in a Section 410(a)(2) n31 action must be "material." Generally the courts in determining materiality under this section, follow the decision of the United States Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, which ruled on materiality (a misstatement or omitted fact is material if there is substantial likelihood that a reasonable purchaser would consider it important in deciding whether or not to purchase. Put another way, there must be a substantial likelihood that the disclosure of the misstatement or the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available). n32

A case under Section 410(a)(2) of the Uniform Act n33 is generally more difficult to prove than under Section 410(a)(1). n34 In order to establish such a case, the plaintiff would have to show that: there was an offer or sale; the offer or sale involved a security; the offer or sale took place in the state; the security was purchased by the plaintiff; there was a material misrepresentation or omission made in connection with the sale of the security; the defendant is liable, either primarily or secondarily, for the misrepresentation or omission; the plaintiff did not know of the material misrepresentation or omission; and the plaintiff is willing to return the securities if they are still owned or they have been sold.

As previously stated, the courts typically apply an objective (rather than a subjective) test in determining whether a material misrepresentation or omission was made in connection with the sale of the security. An affirmative defense for the seller is if the seller can show that the plaintiff would have made the investment regardless of the misrepresentation or omission attaching no significance to such statement in making his decision.

Not all material omissions are actionable. If the plaintiff knows what the seller is telling him is wrong or the plaintiff knows that the seller is not telling him the complete story, then he cannot recover. n35 Courts have held that the investor has no due diligence requirement or duty to verify any information. n36

The elements that the plaintiff does not have to prove to establish a *prima facie* case under Section 410(a)(2) of the Uniform Act n37 are affirmative defenses. Courts have held that a plaintiff does not have to prove a number of elements that are required by the federal securities laws, including that the plaintiff relied on the material representations or omission, that the violation caused any injury to the plaintiff, and that the material misrepresentation or omission resulted from the seller's negligent or fraudulent act. n38

[5] Affirmative Defenses in Section 410(a)(2) Actions

The Uniform Act sets forth two statutory affirmative defenses available to defendants: (1) that the plaintiff's action was not brought within the statute of limitations; and (2) that the seller did not know or with the exercise of reasonable care, could not have discovered the material omission or misrepresentation. The defendant has the burden of proving by a preponderance of the evidence each element of such defenses. Some common law affirmative defenses utilized by defendants against claims under Section 410(a)(2) of the Uniform Act n39 are that: (1) the plaintiff was *in pari delicto* with the seller; (2) the plaintiff should be estopped from recovering; (3) the plaintiff has waived his right to recover; and (4) the plaintiff ratified the transaction in which the violation occurred. Defendants have had less success attempting to avoid liability on the ground that: (1) the plaintiff had a duty to perform due diligence; (2) the plaintiff is guilty of either contributory or comparative negligence; and (3) the plaintiff has not mitigated his damages.

In a cause of action either under Section 410(a)(1) n40 or (2), n41 the plaintiff must show that the alleged action was in connection with an offer or sale of a security. Accordingly, it is a violation under the Uniform Act if the action occurred in connection with *either* an offer or a sale. However, no civil liability will attach unless the investor purchases the security in connection with the violation. The term "offer" is defined under Section 401(j)(2) n42 as "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value." A "sale" is defined under Section 401(j)(1) of the Uniform Act n43 as "every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value."

Both terms are broadly defined. Generally, an offer is any advertisement or solicitation intended to generate interest in purchasing a security. It is clear under Section 401(a)(1) n44 that a legal sale preceded by an illegal offer is subject to rescission. n45

A sale is generally determined by the courts to have occurred when the investor is required to make the investment decision. The timing of the sale, as determined by many courts, takes place when the investor becomes committed to the transaction. Accordingly, a sale occurs when the investor tenders a signed subscription agreement for a partnership offering even though the payment for such transaction may follow later. n46

Generally, the plaintiff will bear the burden of showing that the investment constituted an investment in a security. For investments that are specifically listed under the definition of "security" under Section 401(l) of the Uniform Act, n47 the court would generally recognize the presumption that the investment was in a security and the defendant would have to rebut that presumption. For less common investments, the plaintiff will have to show that the investment is included within the "investment contract" phrase found under the definition of a security under Section 401(l) of the Uniform Act. n48 State courts oftentimes look to the interpretations of the federal definition of a security. n49

Section 410(a) of the Uniform Act n50 imposes liability if the broker-dealer or agent selling the securities is not registered and such registration was required under the Uniform Act. n51 If there is a violation of the registration provisions under the Uniform Act, the purchaser will be allowed to set the transaction aside. Each transaction is a separate violation and the investor is given the option whether to have any or all of the transactions rescinded. Investors may pick and choose among the transactions in question, having rescission on some and maintaining the securities on others. Although this does not seem to be a fair result, courts have held that the Uniform Act intended such a result. n52

[6] Persons Who Are Liable

Section 410(a) of the Uniform Act n53 imposes liability upon those persons who offer or sell the securities. Section 410(b) n54 imposes secondary liability upon certain persons. The limitation of primary liability under Section 410(a) n55 to sellers is significant. It is significant because there is no extended liability under the Uniform Act for non-sellers as provided under Section 11 of the 1933 Act n56 and *Rule 10b-5* under the 1934 Act. n57 Accordingly, in a "firm underwritten" offering where the underwriters purchase the securities from the issuer and resell them to the public, the immediate seller is the underwriting broker-dealers and not the issuer. In contrast, in a "best efforts" underwriting, where the underwriters only agree to make their best efforts in selling the securities on behalf of the issuer, the immediate seller is the issuer. However, the United States Supreme Court in *Pinter v. Dahl* appeared to reject this approach under Section 12(1) of the 1933 Act n58 and some federal courts have also rejected this approach for actions under Section 12(2) under the 1933 Act. n59 Further, some state courts have applied the *Pinter* decision under Section 410(a) matters. n60 Accordingly, there may be two or more persons who are liable (jointly and severally) either as sellers or as persons secondarily liable under Section 410(b) of the Uniform Act. n61 A typical transaction in which an investor purchases securities through a broker-dealer as agent may involve the following as sellers:

- the owner of the securities (provided the sale is not part of a firm underwritten offering);
- the seller's agent (the owner's broker-dealer);
- the seller's sub-agent (the broker-dealer's registered representative);
- the purchaser's agent (if purchaser's broker-dealer, if different); and,
- the purchaser's sub-agent (the purchaser's broker-dealer's registered representative).

State courts have generally found that any person who has participated (even on a limited basis) in any aspect of the sale to be liable to the purchaser. n62 In certain cases, the courts have found corporate officers n63 and other professionals, (such as attorneys and accountants), to be liable. n64

The Uniform Act contemplates both statutory primary n65 and secondary n66 liability. The results in various state cases involving participant's liability show no uniformity. The federal courts, in determining liability of participants under Section 12 of the 1933 Act, n67 have apparently attempted to formulate some uniformity in their rulings. n68 In *Pinter v. Dahl*, the United States Supreme Court rejected the notion that the concept of "seller" under Section 12 of the 1933 Act n69 included a mere participant. Since the Court's decision in *Pinter v. Dahl*, some state courts have ignored that decision and continue to apply a broad participation test. n70 Only time will tell as to whether state courts will follow the Court's ruling or continue to apply the board participation test.

Persons who did not engage in the act of selling the securities may be held secondarily liable because of their relationship to the persons who sold the securities in violation of the Uniform Act. Section 410(b) of the Uniform Act n71 states:

[e]very person who directly or indirectly controls a seller liable under subsection (a), every partner, officer, or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such a seller who materially aids in the sale, and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller, unless the non-seller who is so liable sustains the burden of proof that he did not know, and in exercise of reasonable care could have not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases in contract among the several persons so liable.

Accordingly, the following persons are potentially liable under Section 410(b) of the Uniform Act: n72

- all persons who control (either directly or indirectly) a seller liable under Section 410(a) of the Uniform Act; n73
- all partners, if the seller is a partnership, or all officers and directors, if the seller is a corporation (and any person occupying a similar status or performing similar functions for other types of entities such as a trust limited liability company, etc.);
- the employees of a seller liable under Section 410(a) n74 *provided* (emphasis added) they materially aided in the sale; and
- all broker-dealers and agents who materially aided in the sale.

Section 410(b) of the Uniform Act n75 provides those persons who are identified as potentially secondarily liable have an affirmative defense if they did not know, and in the exercise of reasonable care, could not have known of the existence of the facts by reason of which liability is alleged to exist. Under Section 410(a) of the Uniform Act, n76 persons who are secondarily liable are jointly and severally liable with those who are primarily liable under Section 410(a). n77 The plaintiff can seek satisfaction for part or all of his claim from the assets of any one of the persons deemed liable. The Uniform Act also provides for a right of contribution among persons who are found secondarily liable.

Persons secondarily liable under Section 410(b) of the Uniform Act n78 include control persons. The concept of control person liability under the Uniform Act was modeled after Section 15 of the 1933 Act n79 and Section 20(a) of the 1934 Act. n80 The term "control" is not defined under the Uniform Act but is generally deemed to mean "the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." n81 Control person liability under the Uniform Act is not strict liability. Under Section 410(b) of the Uniform Act, n82 a control person is liable on the basis of his status as a control person but does have an affirmative defense. The affirmative defense is that "the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." Section 410(b) of the Uniform Act, n83 notably, does not require the plaintiff to show that the defendant had participated in the alleged violation. Clearly, the Uniform Act imposes the burden upon the defendant to prove that he or she did not know and in the exercise of reasonable care could not have known of the acts producing liability under the Uniform Act. n84

Under Section 410(a) of the Uniform Act, n85 persons liable are the sellers of the securities which include broker-dealers and the agents of the broker-dealers. Under Section 410(b) of the Uniform Act, n86 the control person liability provisions apply equally to persons controlling such sellers, such as the officers, directors and shareholders who control the broker-dealer.

A broker-dealer is the control person or its agents and is held liable for their violations of Section 410(a). n87 As a result, oftentimes the broker-dealer will be primarily liable as a seller and secondarily liable as a control person of its

agents who also were sellers in the transaction. For a transaction in which the broker-dealer is not the seller (i.e., when an agent effects a transaction off the books and records of the broker-dealer) then the broker-dealer may be liable for secondary liability but not as a seller. In this case, the broker-dealer has the affirmative defense of showing that he did not know and in exercise of reasonable care could not have known of the existence of the facts in which liability is alleged to exist.

The shareholders, officers and directors (or every person who occupies a similar status or performs similar functions) of the broker-dealer are also potentially liable as control persons. Such persons may offer the affirmative defense.

Under Section 410(e) of the Uniform Act, n88 persons may not sue under Section 410 more than two years after the contract of sale or if before suit, the purchaser received a written rescission offer.

In order for a rescission offer to effectively extinguish civil liability, it must meet the specific requirements under Section 410(e). n89

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 410.

(n2)Footnote 2. *15 U.S.C. § 77(e)*.

(n3)Footnote 3. Unif. Sec. Act § 410.

(n4)Footnote 4. This clause is nearly identical with Section 12(2) of the 1933 Act which was apparently borrowed from the then Michigan and Virginia state securities laws.

(n5)Footnote 5. This sentence was added to avoid the common law rule which prohibits contribution among joint tortfeasors.

(n6)Footnote 6. Unif. Sec. Act § 410.

(n7)Footnote 7. Unif. Sec. Act § 410(e).

(n8)Footnote 8. Unif. Sec. Act § 410(g).

(n9)Footnote 9. Unif. Sec. Act § 410(h).

(n10)Footnote 10. Unif. Sec. Act § 410(a)(1).

(n11)Footnote 11. Unif. Sec. Act § 410(a)(2).

(n12)Footnote 12. Unif. Sec. Act § 410(a)(2).

(n13)Footnote 13. Unif. Sec. Act § 410(a)(1).

(n14)Footnote 14. *15 U.S.C. § 77(e)*.

(n15)Footnote 15. The Uniform Act does not impose civil liability for violations of investment adviser and investment adviser representative registration requirements. However, several states have added such violations to their civil liability provisions. In addition, the 2002 Act includes such provisions.

(n16)Footnote 16. Unif. Sec. Act. § 410(a)(1).

(n17)Footnote 17. Courts have ruled that the "in the state" element is present if there was a physical nexus between

the sale or offer to sell and a specific state. *See Ah Moo v. A.G. Becker Paribas, Inc.*, 857 F.2d 615, 620 (9th Cir. 1988) ; *Shappley v. State*, 520 S.W.2d 766, 768 (Tex. Crim. App. 1974) .

(n18)Footnote 18. Unif. Sec. Act § 410(a)(2).

(n19)Footnote 19. *Specialized Tours, Inc. v. Hagen*, 392 N.W.2d 520, 539 (Minn. 1986) .

(n20)Footnote 20. Loss, Commentary on the Uniform Securities Act at 145.

(n21)Footnote 21. Neither causation nor reliance is a required element of a private cause of action under this section. *See Gohler v. Wood*, 919 P.2d 561 (Utah 1996) ; *Kaufman v. i- Stat Corp.*, 754 A.2d 1188 (N.J. 2000) . Good faith reliance on an opinion of counsel or of the securities agency is not a defense. *People v. Clem*, 114 Cal. Rptr. 359 (Cal. Ct. App. 1974) . *Klein v. Boyd*, 1996 U.S. Dist. LEXIS 17153 .

(n22)Footnote 22. The defendant has the burden of producing evidence that an exemption from registration was available at the time of the transaction(s). *See Tehan*, 365 F. 2d at 195; *David*, 309 N.E.2d at 488; *Frost*, 387 N.E.2d at 238-239 .

(n23)Footnote 23. *Duperier v. Tex. State Bank*, 28 S.W.3d 740 (Tex. App. 2000) .

(n24)Footnote 24. *Odmark v. Westside Bancorporation, Inc.*, 636 F. Supp. 552 (W.D. Wash. 1986) .

(n25)Footnote 25. *Klein v. Boyd*, 1996 U.S. Dist. LEXIS 17153 .

(n26)Footnote 26. Unif. Sec. Act § 410(g).

(n27)Footnote 27. Unif. Sec. Act § 410(a)(2).

(n28)Footnote 28. 15 U.S.C. § 771(2).

(n29)Footnote 29. Unif. Sec. Act § 410(a)(1).

(n30)Footnote 30. Unif. Sec. Act § 410(a)(2).

(n31)Footnote 31. Unif. Sec. Act § 410(a)(2).

(n32)Footnote 32. *TSC Indus., Inc.*, 426 U.S. at 449 .

(n33)Footnote 33. Unif. Sec. Act § 410(a)(2).

(n34)Footnote 34. Unif. Sec. Act § 410(a)(1).

(n35)Footnote 35. *Wright v. Nat'l. Warranty Co.*, 953 F.2d 256 (6th Cir. 1992) .

(n36)Footnote 36. *Quincy Coop. Bank v. A.G. Edwards & Sons, Inc.*, 655 F. Supp. 78 (D. Mass. 1986) ; *Kelsey v. Nagy*, 410 N.E. 2d 1333, 1336 (Ind. Ct. App. 1980) .

(n37)Footnote 37. Unif. Sec. Act § 410(a)(2).

(n38)Footnote 38. *Cuene v. Hilliard*, 754 N.W.2d 509, 2008 WI App. 85 .

(n39)Footnote 39. Unif. Sec. Act § 410(a)(2).

(n40)Footnote 40. Unif. Sec. Act § 410(a)(1).

(n41)Footnote 41. Unif. Sec. Act § 410(a)(2).

(n42)Footnote 42. Unif. Sec. Act § 401(j)(2).

(n43)Footnote 43. Unif. Sec. Act § 401(j)(1).

(n44)Footnote 44. Unif. Sec. Act § 410(a)(1).

(n45)Footnote 45. Loss, Commentary on the Uniform Securities Act at 146.

(n46)Footnote 46. *Hill v. Equitable Trust Co.*, 562 F. Supp. 1324 (D. Del. 1983) .

(n47)Footnote 47. Unif. Sec. Act § 410(1).

(n48)Footnote 48. Unif. Sec. Act § 410(1).

(n49)Footnote 49. The definition of a "security" under the Unif. Sec. Act § 401(l) is nearly identical with the definition of "security" under Section 2(1) of the 1933 Act. The definition under Section 401(l) includes the catch-all "investment contract" which has been broadly applied by both state and federal courts. *See* L. Loss, Commentary on the Uniform Securities Act at 148; Theresa A. Gabaldon, *A Sense of a Security: An Empirical Study*, 25 *J. Corp. L.* 307 (2000); 2 Louis Loss & Joel Seligman, Securities Regulation 923-1138.19 (3d ed. rev. 1999).

(n50)Footnote 50. Unif. Sec. Act § 410(a).

(n51)Footnote 51. Under the definitions of "broker-dealer" and "agent" under Unif. Sec. Act § 401, certain exceptions to the definitions apply to persons who have limited activity in the state.

(n52)Footnote 52. *Dixon v. Oppenheimer & Co.*, 739 F.2d 165 (4th Cir. 1984) .

(n53)Footnote 53. Unif. Sec. Act § 410(a).

(n54)Footnote 54. Unif. Sec. Act § 410(b).

(n55)Footnote 55. Unif. Sec. Act § 410(a).

(n56)Footnote 56. 15 U.S.C. § 77k.

(n57)Footnote 57. 17 C.F.R. § 240.10(b)-5; *see Kramer v. Scientific Control Corp.*, 452 F. Supp. 812 (E.D. Pa. 1978) .

(n58)Footnote 58. 15 U.S.C. 771(1); *see Pinter v. Dahl*, 486 U.S. 622 (1988) .

(n59)Footnote 59. 15 U.S.C. 771(2); *see Crawford v. Glenns, Inc.*, 876 F.2d 507 (5th Cir. 1989) .

(n60)Footnote 60. Unif. Sec. Act § 410(a); *see Mercer v. Jaffe, Snider, Raitt & Heuer, P.C.*, 713 F. Supp. 1019 (W.D. Mich. 1989) , *aff'd*, 933 F.2d 1008 (6th Cir. 1991) .

(n61)Footnote 61. Unif. Sec. Act § 410(b).

(n62)Footnote 62. *State v. Fairchild*, 298 S.E.2d 110 (W. Va. 1982) .

(n63)Footnote 63. *Cola v. Terzano*, 322 A.2d 195 (N.J. Super. Ct. Law Div. 1974) , *aff'd*, *Cola v. Packer*, 383 A.2d 460 (N.J. Super. Ct. App. Div. 1977) . *See also* L.S. Rogers, Annotation, *Who, Other than Officers and Directors of a Corporation, is Civilly Liable Under the State Securities Acts (Blue Sky Laws) for Purchase Price of Unauthorized*

Securities, 59 A.L.R. 2d 1030 (1958) .

(n64)Footnote 64. *Felts v. Nat'l Account Sys. Ass'n*, 469 F. Supp. 54 (N.D. Miss. 1978) .

(n65)Footnote 65. Unif. Sec. Act § 410(a).

(n66)Footnote 66. Unif. Sec. Act § 410(b).

(n67)Footnote 67. 15 U.S.C. § 77(e).

(n68)Footnote 68. *Pinter*, 486 U.S. 622 .

(n69)Footnote 69. 15 U.S.C. § 77(e).

(n70)Footnote 70. *Hoffer v. State*, 776 P.2d 963 (Wash. 1989); *Hines v. Data Line Sys., Inc.*, 766 P.2d. 1109 (Wash. Ct. App. 1989) , *aff'd*, in part, *rev'd* in part, 787 P.2d 8 (Wash. 1990) .

(n71)Footnote 71. Unif. Sec. Act § 410(b).

(n72)Footnote 72. Unif. Sec. Act § 410(b).

(n73)Footnote 73. Unif. Sec. Act § 410(a).

(n74)Footnote 74. Unif. Sec. Act § 410(a).

(n75)Footnote 75. Unif. Sec. Act § 410(b).

(n76)Footnote 76. Unif. Sec. Act § 410(a).

(n77)Footnote 77. Unif. Sec. Act § 410(a).

(n78)Footnote 78. Unif. Sec. Act § 410(b).

(n79)Footnote 79. 15 U.S.C. § 77o.

(n80)Footnote 80. 15 U.S.C. § 78i(a); *see* Loss, Commentary on the Uniform Securities Act at 148.

(n81)Footnote 81. As defined under SEC Rule 405, 17 C.F.R. § 230.405. *See also*, 4 Louis Loss & Joel Seligman, Securities Regulation 1703-1727 (3d ed. rev. 2000).

(n82)Footnote 82. Unif. Sec. Act § 410(b).

(n83)Footnote 83. Unif. Sec. Act § 410(b).

(n84)Footnote 84. *Hines, Inc.*, 787 P.2d 8 .

(n85)Footnote 85. Unif. Sec. Act § 410(a).

(n86)Footnote 86. Unif. Sec. Act § 410(b).

(n87)Footnote 87. Unif. Sec. Act § 410(a); *see also* *Goldberg v. Josephthal Lyon & Ross, Inc., No. CV-92-0514864-S*, 1994 Conn. Super. LEXIS 542 (Conn. Super. Ct. Feb. 23, 1994); On the meaning of "control," *see* 4 Securities Regulation 1703-1729.

(n88)Footnote 88. Unif. Sec. Act § 410(e).

(n89)Footnote 89. Unif. Sec. Act § 410(e); *see Binder v. Gordian Secs., Inc.*, 742 F. Supp. 663, 666 (N.D. Ga. 1990) . *See also*, Michelle Rowe, *Rescission Offers Under Federal and State Securities Law*, 12 J. Corp. L. 383 (1987).



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CHAPTER 22 STATE SECURITIES ENFORCEMENT

2-22 Securities Enforcement: Counseling and Defense § 22.06

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§ 22.06 Conclusion

Historically, with respect to securities regulation in the United States, the State Administrators policed the non-federally registered securities markets and professionals while the SEC and the SROs primarily police the nationally registered securities and professionals. Due to a continuing view by State Administrators that federal regulators and SROs have not kept pace with problems and concerns in connection with the national securities markets, it is likely that there will continue to be an increase in enforcement actions by State Administrators as well as continued efforts by NASAA to obtain more effective policing of the federal securities laws deemed necessary to better protect the investment public.

What this increased enforcement activity by the State Administrators means to the securities industry is increased scrutiny and attention in responding to inquiries and the possibility of enforcement actions from both state and federal regulators. This increased attention by securities regulators is likely to occur until investors' confidence is restored in the securities markets and the State Administrators are convinced of the ability of federal regulators to effectively regulate such markets.



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense 23.syn

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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.01

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§ 23.01 Introduction

Recent years have seen unprecedented enforcement against corporate malfeasance, deception, and fraud. Since 2002, the United States Department of Justice ("DOJ") has obtained almost 1,300 corporate fraud convictions of which over 370 were corporate presidents, vice presidents, CEOs, or CFOs, including important convictions in high profile cases such as Enron, Enterasys, Martha Stewart, Adelphi, Madoff and numerous others. In Fiscal Year 2008 alone, the DOJ obtained convictions for 120 defendants and filed additional charges of corporate fraud against 74. An astounding sixty percent of the convicted defendants were given prison sentences.

The message is clear: criminal enforcement of federal securities laws is currently, and will continue to be, a top priority for the DOJ and the price to be paid has never been higher. The enforcement culture has changed also. Now prosecutors in multiple jurisdictions compete for the opportunity to work with the SEC and file their criminal cases.

Criminal investigations always disrupt a corporation's business and may threaten its very existence. The manner in which a corporation responds to a criminal investigation will have a significant impact on whether the corporation itself or its directors, officers or employees are charged with criminal wrongdoing. This chapter explores the nature of criminal enforcement of federal securities laws, the most common investigative tools utilized by the government in such criminal investigations, and common issues facing corporations and individuals in responding to these criminal investigations.



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.02

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§ 23.02 Agencies Charged with Enforcing Federal Securities Law

The newly sworn-in Attorney General Eric Holder has re-asserted the priority status of white collar criminal investigations. While in the wake of 9/11, former U.S. Attorney General John Ashcroft focused much DOJ attention on terrorism prosecution, Holder has asserted DOJ renewed vigor in conducting corporate fraud investigations and enforcing securities laws. This reassertion of corporate crime as quintessential to DOJ priorities accompanied a shift in administration political outlook (including an outcry against many of the previous administration's anti-terrorism activities) and came amidst a major recession which exposed many white collar criminals that may otherwise have gone unnoticed (including the high profile prosecution of Bernie Madoff). Likewise, the SEC has undergone significant change in the wake of perceived lax enforcement during the economic crisis. New leadership at the SEC has instituted the most significant changes at the SEC in decades. The changes include streamlining its enforcement and investigations division, more along the lines of the organizational structure of the DOJ, and providing their investigators more power and discretion in conducting their investigations.

The DOJ frequently, but not always, conducts its criminal enforcement investigations at the same time that the Securities and Exchange Commission ("SEC") is conducting its investigation. As a general rule, the criminal enforcement team assigned to enforce federal securities laws consists of both government lawyers and law enforcement agents. The government lawyers who prosecute criminal violations of the securities laws are typically either (1) Assistant United States Attorneys working in the local United States Attorney's Offices, or (2) Trial Attorneys working for the Fraud Section of the Criminal Division of the United States Department of Justice (the "DOJ Fraud Section") in Washington, D.C. Although the vast majority of prosecutions involving the federal securities laws are handled locally by Assistant United States Attorneys, the DOJ Fraud Section provides assistance to the United States Attorney's Offices which lack expertise or resources to handle securities prosecutions. The DOJ Fraud Section also often assumes responsibility for prosecutions of cases that require centralized treatment because of the complexity of the case, the multi-district nature of the conduct, the political sensitivity of the case, or the advancement of an issue or legal interpretation of first impression.

There are a number of federal investigative agencies that assist the DOJ in investigating and prosecuting securities violations. These law enforcement agencies include: (1) the Federal Bureau of Investigation ("FBI"), which has broad authority to investigate federal crimes including securities fraud; n1 (2) the United States Postal Inspection Service, that

has authority to investigate federal securities fraud violations which implicate the United States mail; n2 and (3) the Internal Revenue Service, Criminal Investigation Division, which has the authority to investigate not only tax offenses, but also securities fraud violations involving money laundering and other prohibited financial transactions. n3

The SEC Enforcement Staff often provides extensive assistance to the DOJ Trial Lawyers and Assistant United States Attorneys prosecuting securities fraud cases. Historically, most criminal securities investigations were initiated by referrals from the SEC. However, DOJ or a local United States Attorney's Office often will initiate these investigations on their own. Even with a referral from the SEC, the decision of whether to initiate a criminal investigation and prosecute rests solely with the DOJ and the local United States Attorney's Offices exercising independent judgment.

FOOTNOTES:

(n1)Footnote 1. *See 18 U.S.C.S. § 3052.*

(n2)Footnote 2. *See 18 U.S.C.S. § 3061.* Note that Subsection "C" was added in 2006 allowing employment of officers in connection with property owned by the Postal Service.

(n3)Footnote 3. *See 18 U.S.C.S. § 3045.*



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.03

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§ 23.03 Basis for Criminal Enforcement

[1] Commonly Charged Offenses

[a] Historical Federal Securities Law Enforcement

The principal goals of criminal enforcement of federal securities laws include protecting innocent investors, protecting the integrity of the SEC enforcement process, and ensuring compliance with securities laws. Toward this end, Section 24 of the Securities Act of 1933 (the "1933 Act")ⁿ¹ and Section 32(a) of the Securities Exchange Act of 1934 (the "1934 Act")ⁿ² give rise to criminal liability for "willful" violations of most of the substantive provisions of these laws. What constitutes "willful" intent, however, has not been treated consistently by the courts. Indeed, some federal courts examining the scienter requirement for offenses under Section 24 of the 1933 Act and Section 32(a) of the 1934 Act have completely ignored the willfulness requirement.ⁿ³ Courts differ on whether the "willfulness" requirement requires proof that the defendant knew he was participating in a crime.ⁿ⁴

In addition to the general criminal provisions of Section 24 of the 1933 Act and Section 32(a) of the 1934 Act, both statutes contain specific anti-fraud provisions under which most federal securities prosecutions have been brought historically. Section 10(b) of the 1934 Act makes it unlawful for any person to use "in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance" in violation of any rule of the SEC.ⁿ⁵ In this regard, the SEC promulgated *Rule 10b-5* which makes it unlawful for any person, by use of any instrumentality of interstate commerce or the mails and "in connection with the purchase or sale of any security," to: (a) employ any device, scheme, or artifice to defraud; (b) make an untrue statement of material fact or fail to disclose a material fact misleading; or (c) engage in any act, or course of business which operates or would operate as a fraud or deceit upon any person.ⁿ⁶

The anti-fraud provision contained in the 1933 Act is found in Section 77(a). Section 77(a) makes it "unlawful for any person in the offer or sale of securities" to commit any of the following acts by use of any instrumentality of interstate commerce or the mails: (a) to employ any device, scheme, or artifice to defraud; (b) to obtain money or property by means of any untrue statement of material fact or material omission; or (c) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.ⁿ⁷ Because this provision only applies "in the offer or sale of securities," it is narrower than the prohibitions in Rule 10(b) of the 1934 Act and,

therefore, less often used.

Materiality under these anti-fraud provisions is defined as information for which there is a substantial likelihood that a reasonable shareholder would consider it important. n8 Examples of material misrepresentations and omissions include overstatements of corporate assets or profitability, and failure to notify prospective investors of changes in the nature of the investment that result in a greater risk of loss.

There is a great variety of misconduct that can be charged under these securities statutes. Although not legislatively defined, insider trading typically is prosecuted under Section 10(b) of the 1934 Act and *Rule 10b-5*. n9 Other types of conduct leading to prosecution under the anti-fraud provisions of the securities laws include fraudulent broker-dealer practices, n10 ponzi schemes, n11 market manipulation, n12 sales of unregistered securities, n13 false filings with the SEC, n14 accounting fraud and books and records violations, n15 "free-riding" schemes, n16 and investment advisor fraud. n17

In addition, in criminal prosecutions of securities violations, defendants historically have also faced charges of mail fraud, n18 wire fraud, n19 racketeering, n20 money laundering, n21 and interstate transportation of stolen property, n22 and conspiracy. n23 Further, apart from the underlying substantive conduct giving rise to a criminal investigation, defendants who lie to the SEC Staff or other investigating officials, influence or attempt to influence others to lie, or knowingly destroy evidence responsive to a subpoena face additional charges for perjury, n24 subornation of perjury, n25 obstruction of justice, n26 obstruction of an SEC investigation, n27 making false statements, n28 and a *Klein* conspiracy to impede an agency of the United States. n29

[b] Criminal Sanctions Under the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act") n30 made substantial changes to the securities laws, imposed strict oversight provisions for accounting firms that audit public companies, and set forth new compliance requirements for securities issuers. Although not the primary purpose of the law, the Act created a number of new crimes and significant amendments to existing criminal statutes. These new criminal provisions provide greater flexibility in charging securities violations and enhanced penalties upon conviction.

[i] Crimes

Paralleling the existing mail, wire and bank fraud statutes, the Act creates a general securities fraud statute codified as Title 18, *United States Code, Section 1348*. This statute provides that anyone who "knowingly executes, or attempts to execute, a scheme or artifice to defraud any person in connection with any security ..., or to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security ... shall be fined under this title, or imprisoned not more than 25 years, or both." n31 In addition, newly created Title 18, *United States Code, Section 1349* prohibits attempts and conspiracies to violate Section 1348 (securities fraud) and the other provisions of Chapter 63 of Title 18, United States Code. n32

No doubt in response to the wholesale destruction of documents by Enron's auditors, Arthur Andersen, Sarbanes-Oxley also created new crimes concerning document retention and obstruction of justice, namely *Sections 1519 and 1520 of Title 18 of the United States Code*, and expanded the scope of pre-existing *18 U.S.C.S. Section 1512*.

The newly-created Section 1519 provides that "whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States" or any case filed under the bankruptcy laws, or in relation to or contemplation of any such matter or case shall be subject to fine and/or imprisonment of up to 20 years. n33

The statute appears to establish a lower standard for criminal intent than has traditionally been the case. Section 1519 only requires that the government prove that a defendant acted knowingly, unlike prior obstruction of justice statutes that required proof that the defendant acted "corruptly." Moreover, the "intent to ... influence" language arguably has much broader potential application. Ultimately though, it is the courts that will interpret the statute's language and determine its scope.

Section 1519 significantly broadens the scope of the crime of document destruction. The legislative history of Section 1519 makes it apparent that it was enacted to target document destruction and alteration in connection with any federal agency action. It allows the government to bring an obstruction charge without any tie of the obstructive conduct to a pending judicial proceeding, and extends to acts done in contemplation of a federal matter. Section 1519 removes any distinction among court proceedings, investigations, regulatory or administrative proceedings and less formal government inquiries, and applies to obstruction of matters in any federal agency. n34

Newly created *Section 1520 of Title 18, United States Code*, requires any accountant who conducts an audit of an issuer to maintain all audit or review work papers for a period of five years from the end of the fiscal year of the audit period. Section 1520 makes it a crime punishable by fine and imprisonment up to ten years to commit a knowing and willful violation of the record retention rules of Section 1520 or those promulgated by the SEC.

The purpose of Section 1520 is to preserve financial and audit records and install safeguards to ensure that corporate records are retained. n35 The audit materials covered by this section specifically include e-mails and electronic records. n36

Subsection (a)(2) of Section 1520 mandates that the SEC create rules and regulations related to the retention of relevant records such as "work papers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review." n37 The final rule adopted by the SEC, Section 210.2-06, requires that audit records be retained for seven years after the auditor concludes the audit or review of the financial statements. The rule applies to audits of issuers as well as audits of registered investment companies. n38

In Sarbanes-Oxley, Congress also expanded one of the most important obstruction of justice statutes, by amending Title 18, *United States Code, Section 1512* to create criminal liability for anyone who alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding, or otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so" shall be fined and/or imprisoned for up to 20 years. n39 An "official proceeding" includes proceedings before judges and courts of the United States, United States magistrates, judges or special trial judges of the Tax Court, judges of the United States Court of Federal Claims, federal grand juries, Congress, and federal government agencies such as the SEC. n40

The significance of obstruction of justice investigations and prosecutions, and the development of new law and legal theory in this area, is reflected in the case of the three executives of Computer Associates International, Inc., who pleaded guilty to obstruction of justice based on false statements they had made to company lawyers conducting the internal investigation. The prosecutors learned of the misstatements and based their false statement charges on the answers given to the private attorneys who conducted the internal investigation for the company when the corporation waived its attorney-client privilege.

Ultimately, prosecutors will always focus on any evidence of possible obstruction of justice, which may completely eclipse the underlying alleged violation. It is a Washington truism that the real problem often becomes the cover-up, not the underlying alleged crime. A prime example is the conviction of Martha Stewart.

Sarbanes-Oxley also amended Title 18, *United States Code, Section 1513* to create a criminal whistleblower provision.

That section now provides that anyone who "knowingly, with intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense" shall be fined and/or imprisoned for up to ten years. n41

Finally, Section 906 of Sarbanes-Oxley, the newly enacted Title 18, *United States Code, Section 1350*, which became effective on July 30, 2002, is the criminal provision most closely tied to the purpose of the Act. Section 906 creates a new felony in the federal criminal code of false certification. Subsections (a) and (b) set forth obligations for certification by the chief executive officer and chief financial officer of each periodic report filed by issuers with the SEC, and the required content of those reports. Because Section 906 is a criminal statute, the DOJ, and not the SEC, has enforcement responsibility and authority.

Section 906 sets forth a two-tiered penalty scheme. Subsection (c)(1) provides that "[w]hoever certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$1,000,000 or imprisoned not more than 10 years, or both." Subsection (c)(2) increases the penalties for "willful" violations to a maximum fine of \$5,000,000 and a maximum term of imprisonment of 20 years. n42 Its legislative history suggests that certifying executives cannot evade liability by avoiding acquiring knowledge (i.e., "conscious avoidance") and a deliberate attempt to avoid knowledge will not be a defense to the crime. n43

[ii] Statutory Penalty Enhancements

Sarbanes-Oxley also increased the statutory criminal penalties for a variety of existing crimes. The maximum term of imprisonment for mail and wire fraud have been increased from five years to twenty years. n44 The penalties have also been increased for criminal violations of the Employee Retirement Income Security Act of 1974. n45 Finally, the Act directed the United States Sentencing Commission to set forth new sentencing guidelines for each of the newly enacted criminal offenses and to review and amend existing guidelines to reflect the increased penalty provisions and overall policy behind Sarbanes-Oxley. n46

[2] Criminal Liability of Corporations

Corporations are legal persons, capable of suing and being sued, and capable of committing crimes. Under the doctrine of *respondeat superior*, a corporation may face criminal liability for the illegal acts of its directors, officers, employees and agents. For the government to establish criminal liability of corporations for employee misconduct it must establish that the employee's actions were: (1) illegal; (2) within the scope of his or her duties; and (3) intended, at least in part, to benefit the corporation.

Because corporations only act through the individuals they employ, in seeking to hold a corporation criminally liable, the government often establishes that a corporate employee committed an illegal act and possessed the required unlawful intent. Even the lowest level employees can create criminal liability for a corporation if they act with the requisite intent to commit the criminal act. n47 In some instances, the criminal act may be committed by a series of corporate employees under circumstances where no single employee can be said to have formed the requisite criminal intent to commit the crime. Under such circumstances, the government can attempt to show criminal intent on the basis of the "collective knowledge" of the employees as a group. n48 The cumulative knowledge of the numerous corporate agents is imputed to the corporation as a whole, even if no single corporate agent knew all of the facts. The government may then rely on the collective knowledge of the corporation to show criminal intent.

Corporations will be held criminally liable only if the agent (or agents) committing the criminal act did so within the scope of his or her employment. n49 Courts have interpreted this element broadly, extending its reach to any act that occurred while the employee was carrying out a job-related activity, even where the corporation expressly prohibited

the wrongful activity. Thus, liability may attach even without proof that the employee's act was authorized or approved by the corporation. n50 The focus here is on the employee's job function and whether the unlawful act occurred within the realm of the job function delegated to that employee. As such, the conduct of an entry level accounting clerk who knowingly enters false information into the corporation's books to overstate earnings can form the basis for criminal liability of the corporation. Moreover, criminal liability may be imposed on a corporation even if the individual employee involved in the criminal act is not indicted or found liable for his or her own conduct.

Lastly, before a corporation is found criminally liable, the government must show that the agent acted, at least in part, to benefit the corporation. Agents may act for mixed reasons, that is, for both self-advancement and the benefit of the corporation. A corporation may be held liable as long as one of its agent's motivations is to benefit the corporation. In *United States v. Automated Medical Laboratories* ("AML"), for example, the court affirmed a corporation's conviction for the actions of its employee, even though the employee appeared to act for his own benefit, namely "to ascend the corporate ladder." n51 In reaching this conclusion, the court stated that the employee was "clearly acting in part to benefit AML since his advancement within the corporation depended on AML's well-being." n52 Moreover, the corporation may be held liable for its agent's actions even if it did not actually profit from them. n53 As the court stated in *Automated Medical Laboratories*: "Benefit is not a touchstone of criminal corporate liability; benefit at its best is an evidential, not an operative, fact. Thus, whether the agent's actions ultimately redounded to the benefit of the corporation is less significant than whether the agent acted with the intent to benefit the corporation." n54

Although a corporation's crimes are derived from the acts of its employees, the corporation is a separate entity and is severally liable for those crimes. n55 A corporation cannot be an accessory to a criminal act that an employee conducted in the course of business, as the act of the employee is the act of the corporation. n56 Furthermore, as its liability is separate from that of its officers or employees, both the corporation and the individual who committed the act may be found guilty, n57 and the conviction of the responsible employees does not bar the prosecution of the corporation itself. n58

[3] Factors in the Exercise of Prosecutorial Discretion

[a] United States Attorney's Manual

Generally, prosecutors have broad discretion in determining whether to initiate criminal charges against individuals and corporations. The *United States Attorney's Manual* n59 sets forth guidelines for federal prosecutors to apply in reaching this decision. In determining whether to charge an individual, prosecutors should consider the following factors: the sufficiency of the evidence; the likelihood of success at trial; the probable deterrent, rehabilitative, and other consequences of conviction; and the adequacy of non-criminal approaches. n60

[b] Principles of Federal Prosecution of Business Organizations

On January 20, 2003, then Deputy Attorney General Larry D. Thompson issued to federal prosecutors a memorandum on the Principles of Federal Prosecution of Business Organizations (the "Thompson Memorandum"). n61

According to the Thompson Memorandum, prosecutors should apply the same factors in determining whether to charge a corporation as they do with respect to individuals. Given the nature of the corporate "person," however, the Thompson Memorandum notes that some additional factors are present. As such, in conducting an investigation, determining whether to bring charges, and negotiating plea agreements, prosecutors should consider the following nine additional factors in reaching a decision as to the proper treatment of a corporate target:

1. The nature and seriousness of the offense, including the risk of harm to the public, and applicable policies and priorities, if any, governing the prosecution of corporations for particular categories of crime;

2. The pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management;
3. The corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it;
4. The corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection;
5. The existence and adequacy of the corporation's compliance program;
6. The corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies;
7. Collateral consequences, including disproportionate harm to shareholders, pension holders and employees not proven personally culpable and impact on the public arising from the prosecution;
8. The adequacy of the prosecution of individuals responsible for the corporation's malfeasance; and
9. The adequacy of remedies such as civil or regulatory enforcement actions.

Section VI of the Thompson Memorandum describes the government's current view on what does and does not constitute cooperation and voluntary disclosure by a corporation. In particular, the new guidelines call for corporations:

- To conduct internal investigations and to disclose their findings to the appropriate authorities;
- To waive, under appropriate circumstances, the attorney-client and work product protections, both with respect to its internal investigation and with respect to communications between specific officers, directors, and employees and counsel;
- To refrain from appearing to protect its culpable employees and agents, by, among other things, advancing attorneys' fees to individual targets, retaining the culpable employees without sanction for their misconduct, or providing information to the employees pursuant to a joint defense agreement; and
- To avoid any conduct that impedes the government's investigation, including overly broad assertions of corporate representation of employees or former employees; inappropriate directions to employees or their counsel, such as directions not to cooperate openly and fully with the investigation ... ; the direction to decline to be interviewed; making presentations or submissions that contain misleading assertions or omissions; incomplete or delayed production of records; and the failure to promptly disclose illegal conduct known to the corporation.

After the issuance of the Thompson Memorandum, the government increasingly refined and tightened its definition of cooperation, with consequent significant implications for corporations and how they interact with their employees. To receive "cooperative" status, the government began demanding that companies waive attorney-client privileges and attorney work product protections, and frowned upon companies appearing to protect their agents or employees under investigation by paying their legal fees.

In December 2006, then Deputy Attorney General Paul McNulty issued a memorandum n65 (the "McNulty Memorandum") that addressed concerns that prosecutorial demands for "cooperation" were chilling attorney-client communications and violating due process rights, such as the *Sixth Amendment* right to counsel. These concerns were in part due to the uproar over the KPMG tax matter. n66 The McNulty Memorandum narrowly limited circumstances in which prosecutors could consider a company's payment of its agent and employee attorneys' fees, and provided that a prosecutor may not ask a company to waive its privileges without first obtaining the authorization of a more senior Department of Justice official.

[c] Filip Memorandum

On August 28, 2008, then Deputy Attorney General Mark Filip issued new guidance n67 (the "Filip Memorandum") for the federal prosecution of corporations. The Filip Memorandum did incorporate the Thompson Memorandum's "Principles of Federal Prosecution of Business Organizations" in substantially unchanged form, but superseded the McNulty Memorandum. Under the Filip Memorandum, cooperation is measured by the extent to which the corporation discloses relevant facts and evidence, rather than on the corporation's waiver of privilege. In determining cooperativeness, prosecutors are to consider whether the corporation has voluntarily disclosed relevant information and evidence in a timely manner. The Filip Memorandum emphasizes the importance of attorney-client privileges and work product protections, and expressly directs prosecutors not to ask for waivers of these protections.

The Filip Memorandum also prohibits federal prosecutors from considering whether a corporation has advanced attorneys' fees to its employees in evaluating that corporation's cooperation. Similarly, in evaluating corporate cooperation, the memorandum provides that a federal prosecutor is not to consider a corporation's participation in a joint defense agreement.

Regarding corporate compliance programs, the Filip Memorandum directs DOJ attorneys to evaluate whether the program is designed for maximum effectiveness and whether the program is enforced. Prosecutors are directed to consider the fundamental questions of: (1) is the compliance program well designed; (2) is the compliance program being applied earnestly and in good faith; and (3) does the compliance program work? Prosecutors should "attempt to determine whether a corporation's compliance program is merely a 'paper program' or whether it was designed, implemented, reviewed, and revised, as appropriate, in an effective manner." n68 The bottom line is that the mere existence of a corporate compliance program is not enough to justify not charging a corporation for the criminal misconduct of its officers, directors, employees, or agents. In the end, corporations should not expect to be treated leniently because of their artificial nature. The government has been clear that the prosecution of corporations is not a substitute for the prosecution of criminally culpable individuals.

[4] Changes to Organization Sentencing Guidelines

Under direction from Congress in the Sarbanes-Oxley Act, the United States Sentencing Commission amended the federal sentencing guidelines used to sentence business organizations. The amendments became effective November 1, 2004. The most significant feature of the amendment is that it more extensively defines and expands the standards, structures and procedures of an "effective" compliance program. In particular, it imposes a general obligation on the company to establish an "organizational culture that encourages a commitment to compliance." Senior management and directors must actively and regularly participate in and be briefed on the organization's compliance efforts and status. The amendment requires mechanisms for "anonymous reporting" of potential violations and encourages "incentives," as well as disciplinary measures, to enforce compliance. The amendment also indicates that waiver of attorney-client privilege is not a prerequisite for a culpability reduction for substantially assisting the government, but may be necessary in some circumstances.

Not only does the amendment impact the very small number of companies who will directly interact with federal law enforcement in the future, but the proposed change has important implications for the majority of companies who will

not. The Sentencing Guidelines' new standards for "effective" compliance programs will likely become the generally accepted standard in legal contexts beyond federal sentencing, including Sarbanes-Oxley and the fiduciary duty of good care applicable to officers and directors.

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C.S. § 77x* ("In general any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who wilfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, [shall be punished by fine and/or imprisonment].").

(n2)Footnote 2. *15 U.S.C.S. § 78ff(a)* ("Any person who wilfully violates any provision of this title (other than section 30A), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title ... which statement was false or misleading with respect to any material fact [shall be punished by fine and/or imprisonment] ... but no person shall be subject to imprisonment under this title for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.").

(n3)Footnote 3. *See, e.g., United States v. Rogers, 960 F.2d 1501, 1511 (10th Cir.) , cert. denied, 506 U.S. 1035 (1992) ; United States v. Rubin, 836 F.2d 1096, 1102-1103 (8th Cir. 1988) ; United States v. Boyer, 694 F.2d 58, 59-60 (3d Cir. 1982) .*

(n4)Footnote 4. *Compare United States v . Gentile, 530 F.2d 461, 470 (2d Cir.) , cert. denied, 426 U.S. 936 (1976) and United States v. English, 92 F.3d 909, 914-916 (9th Cir. 1996) .*

(n5)Footnote 5. *15 U.S.C.S. § 78j(b)*.

(n6)Footnote 6. *17 C.F.R. § 240.10b-5*.

(n7)Footnote 7. *15 U.S.C.S. § 77q(a)*.

(n8)Footnote 8. *T.S.C. Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) .*

(n9)Footnote 9. *United States v. Ruggiero, 56 F.3d 647 (5th Cir. 1995) .*

(n10)Footnote 10. *United States v. Fauls, 65 F.3d 592 (7th Cir. 1995) .*

(n11)Footnote 11. *United States v. Orton, 73 F.3d 331 (11th Cir. 1996) .*

(n12)Footnote 12. *United States v. Russo, 74 F.3d 1383 (2d Cir. 1996) .*

(n13)Footnote 13. *United States v. Lindo, 18 F.3d 353 (6th Cir. 1994) .*

(n14)Footnote 14. *United States v. Moskowitz, 215 F.3d 265 (2d Cir. 2000) .* An abrogation to this was recognized in Crawford, regarding admission of testimonial statements.

(n15)Footnote 15. *United States v. Wilson, No. 01 CR 53, 2001 U.S. Dist. LEXIS 8600 (S.D.N.Y. June 27, 2001) .*

(n16)Footnote 16. *United States v. Morse, No. 96 CR 732, 1997 U.S. Dist. LEXIS 4765 (S.D.N.Y. April 11, 1997) .*

(n17)Footnote 17. *United States v. Elliott, 62 F.3d 1304 (11th Cir. 1995) .*

(n18)Footnote 18. *18 U.S.C.S. § 1341*. Amended in 2008--Pub. L. 110-179, § 4 (related to Disaster Relief and Emergency Assistance Act).

(n19)Footnote 19. *18 U.S.C.S. § 1343*. Amended in 2008--Pub. L. 110-179, § 4 (related to Disaster Relief and Emergency Assistance Act).

(n20)Footnote 20. *18 U.S.C.S. §§ 1961 et seq.*

(n21)Footnote 21. *18 U.S.C.S. §§ 1956 & 1957*.

(n22)Footnote 22. *18 U.S.C.S. § 2314*.

(n23)Footnote 23. *18 U.S.C.S. § 371*.

(n24)Footnote 24. *18 U.S.C.S. § 1621*.

(n25)Footnote 25. *18 U.S.C.S. § 1623*.

(n26)Footnote 26. *18 U.S.C.S. § 1503*.

(n27)Footnote 27. *18 U.S.C.S. § 1505*.

(n28)Footnote 28. *18 U.S.C.S. § 1001*.

(n29)Footnote 29. *18 U.S.C.S. § 371; United States v. Klein, 247 F.2d 908 (2d Cir. 1957) , cert. denied, 355 U.S. 924 (1958) .*

(n30)Footnote 30. Pub. L. No. 107-204.

(n31)Footnote 31. *18 U.S.C.S. § 1348*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title VIII, § 807.

(n32)Footnote 32. *18 U.S.C.S. § 1349*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title IX, § 902.

(n33)Footnote 33. *18 U.S.C.S. § 1519*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title VIII, § 802.

(n34)Footnote 34. *18 U.S.C.S. § 1519*.

(n35)Footnote 35. *18 U.S.C.S. § 1520*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title VIII, § 802.

(n36)Footnote 36. *18 U.S.C.S. § 1520*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title VIII, § 802.

(n37)Footnote 37. *18 U.S.C.S. § 1520*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title VIII, § 802.

(n38)Footnote 38. *18 U.S.C.S. § 1520*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title VIII, § 802.

(n39)Footnote 39. *18 U.S.C.S. § 1512(c)*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title XI, § 1102.

(n40)Footnote 40. *18 U.S.C.S. § 1515(a)*.

(n41)Footnote 41. *18 U.S.C.S. § 1513(e)*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title XI, § 1107.

(n42)Footnote 42. *18 U.S.C.S. § 1350*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title IX, § 906.

(n43)Footnote 43. 148 Cong. Rec. S5329-30.

(n44)Footnote 44. *18 U.S.C.S. §§ 1341 and 1343*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title IX, § 903.

(n45)Footnote 45. *29 U.S.C.S. § 1131*; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title IX, § 904.

(n46)Footnote 46. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Title VIII, § 805; Title IX, § 905; Title XI, § 1105.

(n47)Footnote 47. *United States v. Josleyn, 206 F.3d 144, 159 (1st Cir. 2000)* .

(n48)Footnote 48. *Josleyn, 206 F.3d at 159 (citing United States v. Bank of New England, N.A. , 821 F.2d 844, 845 (1st Cir. 1987))* .

(n49)Footnote 49. *See, e.g., United States v. Cincotta, 689 F.2d 238, 242 (1st Cir. 1984) ; United States v. Basic Construction Co. , 711 F.2d 570 (4th Cir. 1983)* .

(n50)Footnote 50. *See, e.g., United States v. Bi-Co Pavers, Inc., 741 F.2d 730 (5th Cir. 1984) ; United State v. Dye Construction Co. , 510 F.2d 78 (10th Cir. 1975)* .

(n51)Footnote 51. *770 F.2d 399 (4th Cir. 1985)* . Declined to follow by *U.S. v. Norris, 501 F.Supp.2d 1092* (S.D. Ohio, May 22, 2007) (seemingly declining to follow on a different point re: pre-indictment delay).

(n52)Footnote 52. *Automated Medical Laboratories, 770 F.2d 399, 407* .

(n53)Footnote 53. *Automated Medical Laboratories, 770 F.2d 399, 407* .

(n54)Footnote 54. *Automated Medical Laboratories, 770 F.2d 399, 407* (quoting *Old Monastery Co. v. United States, 147 F.2d 905, 908 (4th Cir. 1945)*) .

(n55)Footnote 55. *Commonwealth v. J.P. Mascaro & Sons, Inc., 402 A.2d 1050 (Penn. 1979) ; People v. Matthews, 333 N.W.2d 371 (Mich. 1983)* .

(n56)Footnote 56. *State v. Southern R. Co., 59 S.E.C. 570 (N.C. 1907)*.

(n57)Footnote 57. *United States v. Griffin, 401 F. Supp. 1222 (S.D. Ind. 1975)* .

(n58)Footnote 58. *Commonwealth v. J.P. Mascaro & Sons, Inc., 402 A.2d 1050 (Penn. 1979)* .

(n59)Footnote 59. www.usdoj.gov/usao/eousa/foia_reading_room/usam/.

(n60)Footnote 60. *See United States Attorney's Manual § 9-27.220, et seq.*

(n61)Footnote 61. www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

(n62)Footnote 65. *Available at: http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf.*

(n63)Footnote 66. *See U.S. v. Stein, 495 F.Supp.2d 390 (S.D.N.Y. 2007)* (defendant's due process rights violated by Justice Department memorandum that said payment of employee's attorney fees would be considered lack of cooperation for the purposes of whether to indict employer KPMG), *aff'd, 541 F.3d 130 (2d Cir. 2008)* .

(n64)Footnote 67. *Available at: <http://www.usdoj.gov/dag/readingroom/dag-memo-08282008.pdf>.*

(n65)Footnote 68. *Available at: <http://www.usdoj.gov/dag/readingroom/dag-memo-08282008.pdf>.*



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Securities Enforcement: Counseling and Defense

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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.04

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§ 23.04 Initial Steps to Control the Situation

[1] Document Preservation, Collection, and Analysis

There are many different ways a target of an investigation can learn that a criminal probe is underway, almost all of which leave the target and its counsel in control of relevant documentary evidence. The notable exception is when the target learns of the criminal investigation at the time of the execution of a search warrant. Once defense counsel has any reason to believe that the criminal investigation is underway or will be undertaken in the future, assuming a search warrant has not been executed, the identification and preservation of potentially relevant documents is one of the first steps that should be taken in order to gain control of the situation and minimize the impact of the investigation. Which documents are potentially relevant depends on the nature of the alleged wrongdoing.

Corporate targets are well advised to notify employees in writing not to destroy any pertinent documents, computer data or other tangible evidence relating to the subject matter of the investigation. Until such time as the scope of the investigation becomes clear, the company should consider suspending all document retention policies to ensure that no relevant documents are destroyed. Special attention must be paid to electronically stored documents such as e-mails so that any automatic deletion of files is suspended.

Preservation of documents in the face of a criminal probe serves a number of important functions. First, by ensuring that all potentially relevant documents are maintained, defense counsel can more fully assess the strength of the government's case and develop key facts necessary to present a persuasive defense. Documentary evidence is often the best source from which to identify all potential witnesses, both helpful and harmful to the defense. Preservation of harmful documents is equally important to give defense counsel an opportunity to assess and craft the defense in light of the entirety of the facts.

The failure to preserve documents material to the government's investigation can carry significant risks in and of itself. Document destruction or alteration can create an appearance of culpability and is often put to compelling use by the government to prove criminal intent. Moreover, document destruction can trigger a separate criminal investigation for obstruction of justice. Significantly, even before Sarbanes-Oxley's newly enacted prohibitions relating to destruction of documents, courts have uniformly held that a person or entity can be convicted of obstruction of justice under Title 18,

United States Code, Section 1512, even if the destroyed documents were not yet compelled to be produced by subpoena. Instead, knowledge of a potential or threatened investigation or proceeding is sufficient to trigger obstruction of justice charges. n1

Identifying and preserving potentially relevant documents is only the beginning. These same documents must be gathered and organized in a manner to facilitate analysis by defense counsel and, if necessary, subsequent production to the government. Care should be taken to maintain the original files intact so that the source of the files can be later ascertained. If practical, the original files should be copied and bates-labeled to separately identify each document by number and source. The bates-labeled copies should then be used for analysis and organized chronologically, by subject matter, or in any other manner helpful to counsel.

The analysis of the gathered documents typically is done in connection with the preparation of a working chronology of key events. In addition to analyzing the substance of the documents, counsel should also identify all potentially privileged documents to be withheld in the face of a subsequent subpoena. All such privileged documents should be segregated into separate files and should be recorded on a privilege log. These efforts will help avoid inadvertent waiver of applicable privileges.

In the end, early mastery of the documentary evidence can provide a strategic advantage in responding to a government investigation. By understanding the content of the key documents and controlling the manner in which they are presented to the government, defense counsel can make a significant impact on the government's perception of its case, the strength of the defense, and the character of the witnesses and participants to the events in question.

[2] Identifying and Interviewing Witnesses

Quickly gaining an understanding of the essential facts underlying a government investigation is critical to the defense. While much of the story may be discernable from the key documents, there is no substitute for interviewing the witnesses. Reviewing the key documents first, if possible, is always preferable as the documents will help identify the key witnesses and will help define the scope of the interviews.

In the corporate context, it is preferable to begin with interviews of the most knowledgeable current employees and those who have been or are likely to be interviewed by the government. The purpose is two-fold: to learn as much about the allegations as possible and to lock the key witnesses into a story that cannot be changed without risk of impeachment at trial. Whether to interview former employees and other third-parties often presents difficult and competing interests. In the absence of a joint defense agreement, the attorney-client privilege may not apply to these interviews. By contacting former employees and third parties, counsel risks alerting the public to the criminal investigation and alerting the government to the identity of, and information possessed by, these witnesses. In addition, there is a substantial risk that such contacts will be viewed as witness tampering. On the other hand, these risks can pale to the consequences of not knowing what information these witnesses possess, both helpful and harmful to the defense. If these interviews are necessary to ensure a thorough investigation, timing is crucial and these interviews should be arranged to occur at a time when disclosure of the investigation is least likely to prejudice the company.

Interviews of current employees by counsel representing their corporate employers ordinarily will be protected by the attorney-client privilege if: (1) the communications are made by employees to corporate counsel in order for the corporation to secure legal advice; (2) the employees are cooperating with corporate counsel at the direction of corporate supervisors; (3) the communications concern matters within the employees' scope of employment; and (4) the information was not available from upper-echelon management. n2 To preserve the attorney-client privilege and to meet applicable ethical obligations, at the outset of the interview, corporate counsel should inform the employee that: (1) corporate counsel does not represent the individual employee, if that is the case; (2) while the interview is covered by the attorney-client privilege, the corporation holds the privilege and not the individual employee; and (3) the corporation can waive the attorney-client privilege and disclose details of the interview to third-parties, including the

government, without the employee's consent or knowledge. To avoid a potential conflict of interest, corporate counsel should be extremely careful not to provide legal advice or opinions to the individual employees. While not required, some private counsel believe it is appropriate to advise employees that they need not make incriminating statements and that they have a right to separate counsel. These stern and overly paternalistic warnings, however, may result in panic on the part of the employee and a refusal to be interviewed.

Individual employees may opt to engage separate counsel prior to consenting to an interview with corporate counsel. This is not always a bad turn of events. Assuming the employee selects experienced and cooperative counsel, corporate counsel may be able to more effectively coordinate defense efforts through the employee's counsel than had the employee not opted for separate counsel. The key factor driving this dynamic will often be whether the corporation indemnifies the employee for reasonable attorneys' fees and costs. Depending on the corporation's bylaws and applicable state law, corporations may have no choice but to indemnify certain employees. There are sound practical reasons to take such action as well. Indemnification often serves to help employees feel more at ease and protected, thereby increasing morale and teamwork in overcoming the government investigation. Indemnification also provides greater control over the employee and will protect against covert attempts by the government to contact the employee. For these very reasons, the government often frowns on corporate indemnification of employees, particularly those who are viewed as culpable.

During the course of any interview, defense counsel must take care to avoid any conduct that can be viewed as obstructing or impeding the government investigation. Toward this end, counsel should: (1) never tell witnesses that they may not talk to the government lawyers or agents; (2) never tell witnesses to destroy, hide or alter documents or other physical evidence; and (3) never tell witnesses to lie. Non-client witnesses should be told that, if the government requests an interview of them, the decision to speak to the government is entirely theirs and no reprisals will come from any decision made in response to the request. Non-client witnesses should also be told that, if they elect to speak with government agents, they may do so accompanied by corporate counsel, their own counsel, all by themselves, or with any other representative with whom they feel comfortable. In addition, it is always a credibility boost to the defense for a witness to state under oath at trial in response to a question from the prosecutor that, during the course of an interview with the Company's defense counsel, defense counsel told the witness simply to tell the truth.

Comment

Companies face a difficult issue when an employee refuses to cooperate with an internal investigation. Some counsel believe that employers can, and should, terminate employees who refuse to respond to questions in an interview. Other counsel assert that such employment action is tantamount to infringing an employee's constitutional right against self-incrimination.

The issue of whether to memorialize an interview in the form of a written memorandum of interview depends in large measure on the purpose of the interview. Defense counsel often choose not to document initial interviews of individual clients and key members of the management of a corporate client for the purpose of gaining a preliminary overview of the key issues. This is particularly true in the corporate context where the government has taken aggressive positions requiring waivers of the attorney-client privilege and attorney work product doctrine to avoid prosecution. Once a decision has been made to document an interview, however, the memorandum of interview should be a complete summary of the information provided regardless of the temporal assessments of the helpfulness of the facts conveyed. Interviews of third party witnesses for the purpose of locking them into a story will often be memorialized in a formal memorandum of interview. Indeed, to avoid subsequent disputes over the content of a statement, defense counsel at times will have key third-party witnesses review and sign written statements prepared based on the information gathered

during the interview.

[3] Establishing a Media Strategy

Securities fraud investigations are highly publicized and the mere fact that an investigation is underway, without any proof of wrongdoing, can be catastrophic for both individual and corporate targets. As such, establishing a media strategy to minimize negative press coverage should not be overlooked. Credibly confronting allegations of wrongdoing in a timely manner can make not only a significant difference in the court of public opinion, but also may make dealings with the government lawyers and agents easier. It is often sound strategy to avoid making defense counsel the public face of the client. As the Martha Stewart case illustrates, a company's disclosure can be an additional source of liability. Accordingly, a company's public disclosures must be carefully tested to ensure that they are accurate and to reduce the risk that the media strategy will otherwise increase the legal risk faced by the company.

[4] Initial Contact with the Prosecution

Once defense counsel learns of the existence of the criminal investigation, one of the first responses should be a telephone call to the prosecutor to make the appropriate introductions and to attempt to learn as much as possible about the progress of and factual basis underlying the investigation. Another significant purpose to this initial contact is to notify the prosecutor that your client is now a represented party, a fact that will ordinarily preclude government agents from directly contacting your client either covertly or overtly.

Counsel should consider attempting to learn the status of its client in relation to the investigation. The DOJ classifies persons involved in a criminal investigation into three categories: targets, subjects, and witnesses. A "target" is a person as to whom the prosecutor or the grand jury has substantial evidence linking him or her to the commission of a crime and who, in the judgment of the prosecutor, is a putative defendant.ⁿ³ An officer or employee of a corporation which is a target is not automatically considered a target even if such officer's or employee's conduct contributed to the commission of the crime by the target organization.ⁿ⁴ The same lack of automatic target status holds true for organizations which employ, or employed, an officer or employee who is a target.ⁿ⁵ A "subject" of an investigation is a person whose conduct is within the scope of the grand jury's investigation.ⁿ⁶ "Witnesses" include everyone other than subjects and targets.

Comment

For disclosure or other reasons, a client might prefer not to be officially informed it is a target of a criminal investigation, especially if counsel already has a keen sense that the client is target or subject.

Comment

In contrast to the DOJ, the SEC does not designate targets, subjects, and witnesses. Rather, the SEC takes the position that it is simply conducting a fact-finding process.

Building a strong relationship with the prosecutor can be extremely advantageous and can significantly impact the methods employed during the investigation. To the extent that a prosecutor has gained trust and confidence in defense counsel and the client, the prosecutor will be far more likely to share detailed information about the investigation. Moreover, to the extent that documents or information from the client are required, the trust and confidence established with the prosecutor could mean the difference between being allowed to produce materials voluntarily pursuant to a subpoena as opposed to having materials involuntarily taken and business disrupted by the execution of a search warrant.

Trust, however, usually comes through cooperation by defense counsel and the client. Whether to cooperate with a criminal investigation is an extremely difficult decision and there is no right answer. Individuals, of course, have a right

under the *Fifth Amendment of the United States Constitution* not to be compelled to produce incriminating evidence. While corporations have no rights under the *Fifth Amendment*, n7 corporations still have a broad spectrum of discretion in terms of cooperation, ranging from merely responding to subpoenas and other orders as required by law to proactively disclosing all information to the government in its possession relating to the underlying allegations including all privileged information. Cooperating with the goal of convincing the government not to prosecute is extremely difficult, but can be accomplished under the right circumstances. By completely cooperating, however, the defense often provides the government with a roadmap of the defense thereby enabling the government to test the defense and fill any holes in the government's case before trial.

FOOTNOTES:

(n1)Footnote 1. *United States v. Frankhauser*, 80F.3d 641, 652 (1st Cir. 1996); *United States v. Morrison*, 98 F.3d 619, 630 (D.C. Cir. 1996) .

(n2)Footnote 2. *Upjohn v. United States*, 449 U.S. 383 (1981) .

(n3)Footnote 3. *United States Attorney's Manual* § 9-11.151.

(n4)Footnote 4. *United States Attorney's Manual* § 9-11.151.

(n5)Footnote 5. *United States Attorney's Manual* § 9-11.151.

(n6)Footnote 6. *United States Attorney's Manual* § 9-11.151.

(n7)Footnote 7. *Doe v. United States*, 487 U.S. 201, 206 (1988) .



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Securities Enforcement: Counseling and Defense

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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.05

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§ 23.05 The Grand Jury Process

[1] Nature of Proceedings

The *Fifth Amendment of the United States Constitution* provides that "[n]o person shall be held to answer for a capital, or otherwise infamous crime, unless on presentment or indictment of a Grand Jury." This constitutional requirement has been implemented and refined by the *Federal Rules of Criminal Procedure*. Rule 7 provides that capital offenses must be prosecuted by indictment in all cases, and offenses punishable by imprisonment for more than one year (i.e., all felonies) must be prosecuted by indictment unless waived by the defendant. n1

At least one grand jury is empanelled in every federal district. In larger districts, there are often multiple grand juries empanelled at the same time, some of which may be designated to hear specialized matters such as those involving organized crime. Grand juries must consist of a minimum of 16 and a maximum of 23 members. n2 Alternate grand jurors may be designated at the time of empanelment, but are not required. n3 From this number, the court will select one of the grand jurors to act as foreperson and one to act as deputy foreperson. The responsibilities of the foreperson include administering oaths and affirmations, signing all indictments returned by the grand jury, and recording the number of grand jurors concurring in each indictment. n4

The requirements for grand juror selection are contained in the Jury Selection and Service Act, n5 which provides that grand jurors must be "selected at random from a fair cross-section of the community in the District or Division wherein the court convenes." n6 This requirement does not require the grand jury to statistically mirror the community, but rather to be selected from a source that is reasonably representative. n7 In addition, each grand juror must meet certain specified criteria, including United States citizenship, a minimum age of 18 years, English language proficiency, absence of physical or mental infirmity, and lack of felony convictions. n8 Both the government and the defendant may challenge the grand jury as a whole or individual grand jurors on the grounds that the jurors were improperly selected or are not legally qualified. n9 The court may remove a grand juror temporarily or permanently at any time for good cause, including conflicts of interest concerning matters under investigation. n10

Federal grand juries generally serve for 18 months. n11 However, the district court may discharge the grand jury earlier or extend its service for up to six additional months if it is in the public interest to do so. n12 "Special Grand Juries"

empanelled under Title 18, *United States Code, Section 3331*, may be required to serve up to 36 months, n13 or longer if the grand jury issues a report that fails to comply with the statute. n14

A principal function of the grand jury is to "return" indictments charging federal felony violations. In making this decision, the grand jury must find probable cause to believe that a crime has been committed and that the person or entity to be charged in the indictment committed that crime. n15 The return of an indictment requires only 12 grand jurors to vote in favor. n16 Moreover, those grand jurors who vote in favor of indictment need not be present at every grand jury session at which evidence was presented relating to the indictment. n17 For an indictment to be valid, however, the prosecutor must concur and the indictment must be signed by an attorney for the government. n18 If a grand jury refuses to indict, the prosecutor may resubmit the evidence to another grand jury, n19 though DOJ policy requires approval of the responsible United States Attorney prior to re-submission. n20

Grand jury proceedings are conducted in secret. While the grand jury is deliberating and voting, only grand jurors and any interpreter required to assist a hearing or speech impaired juror may be present. n21 At all other times while the grand jury is in session, only the following persons may be present: the grand jurors, attorneys for the government, the witness being questioned, interpreters when needed, and a court reporter or operator of a recording device. n22 Significantly, a witness's lawyer may not accompany the witness while testifying before the grand jury. The witness, however, has the right to take a break from testifying and consult with his or her attorney outside of the grand jury.

In order to maintain grand jury secrecy, with the exception of the witness being questioned, all other persons present during a grand jury proceeding are prohibited from disclosing any "matter occurring before the grand jury" subject to certain specified exceptions designed to allow prosecutors to perform their official duties. n23 These secrecy obligations are designed to: (1) encourage witnesses to come forward and testify freely and honestly; (2) minimize the risks that prospective defendants will flee or obstruct an investigation; (3) safeguard the grand jurors and the proceedings from extraneous pressures and influences; and (4) protect accused persons who are ultimately exonerated from unfavorable publicity. n24

[2] Grand Jury Powers

It has been observed that the grand jury "has a right to every man's evidence." n25 To enforce this right, grand juries have been vested with broad powers to subpoena witnesses to testify and provide physical evidence. Physical evidence includes not only documents, computer records and tangible items already in existence, but witnesses may also be compelled to provide photographs of themselves, fingerprints, handwriting exemplars, voice exemplars, and hair samples. n26 While grand juries alone cannot compel compliance with its subpoenas, the courts are vested with this power. n27 A witness who refuses to comply with an order enforcing a grand jury subpoena on grounds other than the assertion of a valid privilege may be held in civil or criminal contempt and fined or imprisoned. n28 No class of individuals or entities is legally exempted from compliance with a grand jury subpoena. Indeed, the grand jury's subpoena power extends to the President of the United States, n29 members of Congress, n30 doctors, n31 lawyers, n32 journalists, n33 and accountants. n34

Comment

In many securities cases, the investigation function of the grand jury is limited, much of the evidence having been gathered by the SEC. Additionally, prosecutors often gather evidence through witness interviews and other non-compulsory processes.

[3] Responding to a Subpoena *Duces Tecum*

The recipient of a lawfully served grand jury subpoena *duces tecum* is compelled to produce all non-privileged documents and physical items requested by the subpoena. This obligation extends to all specified items that are not only

in the possession of the recipient, but also within the recipient's constructive possession or control. n35 Yet, it is possible to challenge a grand jury subpoena if it is unreasonable when put in the context of the investigation. n36 In assessing reasonableness, courts consider: (1) whether the subpoena commands production of items relevant to the grand jury's investigation; (2) the particularity with which the items sought are described; and (3) the burden involved in compliance. n37 Because courts presume that grand jury subpoenas issued through normal channels are reasonable, n38 these challenges rarely succeed.

The *Fifth Amendment* privilege against self-incrimination does not apply to corporations or other artificial entities. n39 This is true even if the corporation is closely held and an individual is the sole owner. n40 As such, corporations and other organizations cannot refuse to comply with a grand jury subpoena *duces tecum* on the grounds of the *Fifth Amendment*. n41 While individual employees retain their *Fifth Amendment* rights, the act of producing corporate records is deemed a corporate act (as opposed to a personal act) not subject to the *Fifth Amendment*. n42

Business documents held by sole proprietors or individuals present a different issue. While the underlying documents subject to the subpoena are not subject to the *Fifth Amendment* if they were voluntarily created before the subpoena, n43 the production of the records in compliance with the subpoena is testimonial because it concedes the existence and possession of the records and the witness's belief that they are responsive to the subpoena. Where the act of production itself becomes incriminating, individuals have a *Fifth Amendment* right to refuse production. n44 This circumstance can arise, for instance, when a former employee receives a subpoena for documents that were unlawfully taken from the former employer. Production of these documents by the former employee can be viewed as incriminating because it would work as an admission that the former employee possessed stolen documents. To resolve this stalemate, prosecutors can be coaxed into granting act-of-production immunity thus placing the witness in the same position as had he or she been allowed to assert the privilege.

There are a number of steps that should be taken in responding to a subpoena *duces tecum*, including the following:

- Once the subpoena is received, the individual corporate officer upon whom it is served should note the date and time of service. The name, title and agency of the law enforcement agent serving the subpoena should also be noted, along with any information provided by this agent concerning the nature of the investigation underlying the subpoena.
- A copy of the subpoena should be forwarded immediately to legal counsel before any response is made. This will afford counsel with the opportunity to assess the reasonableness of the subpoena and whether any legal challenges can be mounted. A careful review of the subpoena is also important because it will likely reveal the name and telephone number of the prosecutor, the approximate date that the grand jury investigation was initiated, and the documents of interest to the government and thus the potential scope and nature of the investigation.
- Counsel should meet with senior management and knowledgeable employees to determine all potential sources of responsive documents and the locations of these documents. Special attention should be paid to electronic information and documents that may be stored offsite.
- All employees with access to potentially responsive documents should be notified in writing of the existence of the subpoena and their obligation to preserve all such documents indefinitely. The communication should specifically advise all employees not to destroy, alter or conceal any potentially responsive documents and that any prior document retention policies are suspended. Any automatic deletion of electronic information, including e-mails, should be suspended.
- Armed with an estimate of the scope and burden of responding to the subpoena, counsel should contact the prosecutor to make the appropriate introductions, learn as much as possible about the focus of

the investigation, and if appropriate, negotiate the scope and manner of production. The government will often serve corporations with very broad subpoenas to freeze a company's records. In these cases, the government is often open to negotiating a narrowed production, so long as the corporation agrees to preserve all documents responsive to the initial subpoena. Although some prosecutors will insist on the production of original records, counsel should also attempt to gain an agreement that production of copies is sufficient where the company agrees to preserve the originals for inspection.

- Collection of the responsive documents should be either conducted by counsel or under direction of counsel. In interpreting the subpoena requests, narrow and overly technical interpretations should be avoided. Unlike civil suits where counsel often attempt to produce as little as possible to the adversary, in the context of a criminal investigation an unreasonable interpretation brings a risk of obstruction of justice charges. Any ambiguities in interpretation should be negotiated with the prosecutor in advance of production to avoid the uncertainty of whether a court will accept counsel's interpretation as reasonable in a contested proceeding. When gathering documents, it is important to maintain the original files intact and to keep track of the sources of the documents.

- All documents should be reviewed by counsel prior to production to the government. In addition to gaining an appreciation of the substance of the documents to be produced, this review is necessary to remove all privileged documents and any documents containing trade secrets for which a protective order can be sought. All privileged documents should be recorded in a privilege log that will be produced to the government.

- Documents produced to the government should be bates labeled for tracking purposes and copies ordinarily should be retained by counsel. Electronically-stored documents can be printed out and bates labeled or shared with the government through an internet site which provides electronic bates labeling services.

[4] Responding to a Subpoena *Ad Testificandum*

A grand jury subpoena *ad testificandum* requires a witness to appear at a specified time before the grand jury and provide oral testimony under oath. Absent truly extraordinary circumstances, courts will not quash these subpoenas. Whether an individual should agree to testify before the grand jury--as opposed to asserting a *Fifth Amendment* right not to provide self-incriminating evidence--is a decision that starts with an assessment of whether the subpoenaed individual is a target, subject or witness in the investigation.

A grand jury may properly subpoena a subject or a target of the investigation and question these individuals about their involvement in the crime under investigation. n45 DOJ guidelines provide, however, a subpoena issued to a target or subject to provide testimony before a grand jury must include an "Advice of Rights" form, n46 which advises the witness: (1) of the general subject matter of the criminal investigation; (2) that the witness may refuse to answer questions if a truthful answer would tend to incriminate the witness; (3) that anything the witness says or does before the grand jury can be used against the witness in a subsequent proceeding; and (4) that if the witness has obtained counsel, the grand jury will permit reasonable recesses for the witness to consult with counsel. Obviously, the receipt of an "Advice of Rights" form, along with a subpoena *ad testificandum*, ought to prompt a witness to give serious consideration to the possibility of asserting the *Fifth Amendment* privilege against self-incrimination.

Most experienced defense counsel advise clients that, to the extent that the client can assert the *Fifth Amendment* privilege, he or she ought to do so unless granted one of two types of immunity. Formal or statutory immunity is court-ordered upon application by the United States Attorney. n47 Prior to submitting the immunity petition, the United States Attorney must obtain approval from the designated Assistant Attorney General of the Criminal Division of the DOJ, a cumbersome process. n48 In making the determination of whether to compel a witness to testify under

court-ordered immunity, the government typically considers the following non-exclusive factors:

- The importance of the investigation or prosecution to effective enforcement of the criminal laws;
- The value of the person's testimony or information to the investigation or prosecution;
- The likelihood of prompt and full compliance with a compulsion order, and the effectiveness of available sanctions if there is no such compliance;
- The person's relative culpability in connection with the offense or offenses being investigated or prosecuted, and his or her criminal history;
- The possibility of successfully prosecuting the person prior to compelling his or her testimony; and
- The likelihood of adverse collateral consequences to the person if he or she testifies under a compulsion order. n49

Once granted court-ordered immunity, the witness is compelled to testify without resort to the *Fifth Amendment*, "but no testimony or other information compelled under the order (or any information directly or indirectly derived from such testimony or other information) may be used against the witness in any criminal case, except a prosecution for perjury, giving a false statement, or otherwise failing to comply with the order." n50 Ordinarily, court-ordered immunity only protects testimony or information provided in connection with the proceeding for which it is granted. As such, a witness who receives formal immunity to testify before a grand jury should request a second court order prior to testifying at trial.

The second type of immunity is known as informal, pocket or letter immunity. Informal immunity is an agreement between the witness and the prosecution that testimony and information provided by the witness will not be used against the witness in a subsequent criminal case, except for perjury or providing false statements. The scope of informal immunity will be explicitly set forth in a letter to the witness and is governed by ordinary contract principles. n51 As such, unless explicitly provided for, informal immunity does not bind the entire federal government, but only the local United States Attorney's Office that is a party to the agreement. Likewise, informal immunity agreements are not binding on state or local prosecutors unless they are made party to the agreement. Prosecutors generally favor informal immunity because it is less cumbersome and does not require approval from main Justice. There may be advantages to informal immunity for witnesses as well in that, with some successful negotiations, the protection afforded by informal immunity may be broader than that provided by statute.

A "proffer" session often may precede or be a prerequisite of an offer of immunity. The government typically will insist on a proffer prior to agreeing to a plea agreement or offer of immunity. A proffer may also be used independently of such a decision. Also known in some jurisdictions as "Queen For a Day" agreements, they may be used by both the prosecutors and defense counsel to allow the government to evaluate the individual's testimony and to make a determination whether the individual should continue to be the target or subject of a criminal investigation, or should avoid criminal prosecution or further criminal investigation.

The proffer typically consists of an oral debriefing of the witness by government agents and lawyers. The purpose is to allow the government to evaluate the extent and accuracy of the witness's knowledge before committing to a grant of immunity, a plea agreement or otherwise. In exchange for the proffer, the government typically will provide a proffer letter containing an agreement not to use any information provided by the witness against the witness in any subsequent proceeding, in the government's direct case, except in a prosecution for perjury or making false statements and to impeach the witness if he or she later testifies in a materially different manner. The proffer letter also typically allows the government to use the information provided by the witness as "leads" to discover other evidence. The government

has become increasingly restrictive in the terms of the proffer letter, specifying additional uses of the information by the government, to include rebuttal of both the witness and his or her lawyer's arguments made during a trial or sentencing or other proceeding. The terms of a proffer letter may vary district by district and increasingly are not subject to negotiation.

Comment

In securities matters, SEC Staff often is heavily involved in the proffer process.

Prosecutors typically have nothing to lose by participating in the proffer process. The fairly modest restrictions on use are well worth the opportunity to learn the witness's version of events. The decision to enter into the proffer process is far more difficult for the witness. While many try, very few targets have successfully used a proffer to convince the prosecutor of innocence. Likewise, the most culpable targets are rarely granted immunity, making a proffer unattractive. Proffers are ideal for those witnesses with a legitimate opportunity to obtain immunity based on the criteria listed above or for those who seek to plead guilty and enter into a cooperation agreement with the government in exchange for a reduced sentence. They also may be an important tool in the hands of an experienced criminal defense counsel attempting to persuade the prosecutors that a subject of a criminal investigation should not become a target, or should be viewed as a witness instead.

While grand jury subpoenas cannot be used to compel witness interviews outside of the grand jury,ⁿ⁵² it is often possible for a witness to avoid testifying before the grand jury by offering to submit to a government interview instead. Interviews are typically preferable for both the witness and the prosecutor. Unlike while testifying before a grand jury, a witness will have the benefit of having counsel present during a witness interview. From the prosecution perspective, an interview allows the government to learn information possessed by the witness without expending the limited time available for use of the grand jury. Participation in a government interview, however, does not preclude later demands by the government that the witness testify before the grand jury.

Witnesses who cooperate with the government prior to testifying before the grand jury are sometimes afforded the opportunity to read a prepared written statement to the grand jury. These prepared statements are reviewed by the witness and counsel in advance, thereby reducing the risk of miscommunications and confusion in both the questions and answers. Witnesses who testify before a grand jury without a prepared statement must be carefully prepared by counsel to minimize the risk of providing inaccurate information. It should go without saying that all witnesses who choose to testify before a grand jury should be instructed to tell the truth. During breaks and immediately following the grand jury testimony, counsel should immediately debrief the witness concerning not only the questions asked and answers given, but also any statements made by the prosecutor or grand jurors that would reveal the nature of the investigation and the witness's status.

FOOTNOTES:

(n1)Footnote 1. *Fed. R. Crim. P. 7(a) & (b)*.

(n2)Footnote 2. *Fed. R. Crim. P. 6(a)(1)*.

(n3)Footnote 3. *Fed. R. Crim. P. 6(a)(2)*.

(n4)Footnote 4. *Fed. R. Crim. P. 6(c)*.

(n5)Footnote 5. *28 U.S.C.S. §§ 1861-1878*.

(n6)Footnote 6. *28 U.S.C.S. § 1861*.

(n7)Footnote 7. *United States v. Test, 550 F.2d 577 (10th Cir. 1976)*.

- (n8)Footnote 8. *28 U.S.C.S. § 1865.*
- (n9)Footnote 9. *Fed. R. Crim. P. 6(b).*
- (n10)Footnote 10. *Fed. R. Crim. P. 6(h).*
- (n11)Footnote 11. *Fed. R. Crim. P. 6(g).*
- (n12)Footnote 12. *Fed. R. Crim. P. 6(g).*
- (n13)Footnote 13. *18 U.S.C.S. § 3331.*
- (n14)Footnote 14. *18 U.S.C.S. § 3333(e).*
- (n15)Footnote 15. *Branzburg v. Hayes, 408 U.S. 665, 686-687 (1972) .*
- (n16)Footnote 16. *Fed. R. Crim. P. 6(f).*
- (n17)Footnote 17. *United States v. Provenzano, 688 F.2d 194, 202-203 (3d Cir. 1982) .*
- (n18)Footnote 18. *Fed. R. Crim. P. 7(c)(1).*
- (n19)Footnote 19. *United States v. Thompson, 251 U.S. 407, 413-414 (1920) .*
- (n20)Footnote 20. *United States Attorney's Manual § 9-11.120.*
- (n21)Footnote 21. *Fed. R. Crim. P. 6(d)(2).*
- (n22)Footnote 22. *Fed. R. Crim. P. 6(d)(1).*
- (n23)Footnote 23. *Fed. R. Crim. P. 6(e)(2)(B).*
- (n24)Footnote 24. *United States v. Procter & Gamble, 356 U.S. 677, 681-682 (1958) .*
- (n25)Footnote 25. *Branzburg v. Hayes, 408 U.S. 665, 688 (1972) .*
- (n26)Footnote 26. *United States v. Dionisio, 410 U.S. 1, 5-15 (1973) (voice exemplar); United States v. Mara, 410 U.S. 19, 22 (1973) (handwriting exemplar); United States v. Boykins, 966 F.2d 1240, 1243 (8th Cir. 1992) (photographs and fingerprints); In re Grand Jury Proceedings (Mills), 686 F.2d 135, 139-140 (3d Cir. 1982) (hair samples).*
- (n27)Footnote 27. *United States v. Williams, 504 U.S. 36, 48 (1992) .* However grand juries are not vested with the power to judge the sufficiency of the evidence itself before the Grand Jury. *See U.S. v. Shyne, 2008 U. Dist. Lexis 26994 (S.D.N.Y., April 5, 2007) .*
- (n28)Footnote 28. *28 U.S.C.S. § 1826(a); 18 U.S.C.S. § 401.*
- (n29)Footnote 29. *United States v. Nixon, 418 U.S. 683 (1974) .*
- (n30)Footnote 30. *United States v. Gravel , 408 U.S. 606 (1972) .*
- (n31)Footnote 31. *United States v. Mullings, 364 F.2d 173, 176 n.2 (2d Cir. 1966) .*
- (n32)Footnote 32. *In re Grand Jury Matters, 751 F.2d 13 (1st Cir. 1984) .*
- (n33)Footnote 33. *Branzburg v. Hayes, 408 U.S. 665 (1972) .*

(n34)Footnote 34. *United States v. Arthur Young & Co .*, 465 U.S. 805 (1984) .

(n35)Footnote 35. *Couch v. United States*, 409 U.S. 322, 333 (1973) .

(n36)Footnote 36. *New Jersey v. T.L.O .*, 469 U.S. 325, 337 (1985) .

(n37)Footnote 37. *United States v. R. Enterprises*, 498 U.S. 292, 301 (1991) .

(n38)Footnote 38. *R. Enterprises*, 498 U.S. at 300 .

(n39)Footnote 39. *Bellis v. United States*, 417 U.S. 85 (1974) .

(n40)Footnote 40. *Braswell v. United States*, 487 U.S. 99, 100 (1988) .

(n41)Footnote 41. See Chapter 13 for a more detailed discussion of the *Fifth Amendment*.

(n42)Footnote 42. *Braswell*, 487 U.S. at 110 .

(n43)Footnote 43. *Fisher v. United States*, 425 U.S. 391, 409-410 (1976) .

(n44)Footnote 44. *United States v. Doe*, 465 U.S. 605, 610 (1984) .

(n45)Footnote 45. See *United States v. Wong*, 431 U.S. 174, 179 n.8 (1977) .

(n46)Footnote 46. United States Attorney's Manual § 9-11.151.

(N47)Footnote 47. 18 U.S.C.S. §§ 6002-6003.

(n48)Footnote 48. 18 U.S.C.S. § 6003; United States Attorney's Manual § 9-23.130.

(n49)Footnote 49. United States Attorney's Manual § 9-23.210.

(n50)Footnote 50. 18 U.S.C.S. § 6002.

(n51)Footnote 51. *United States v. Camp*, 72 F.3d 759 (9th Cir. 1996) .

(n52)Footnote 52. *United States v. Santucci*, 674 F.2d 624, 627 (7th Cir. 1982) .



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.06

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§ 23.06 Search Warrants

[1] Issuance of a Search Warrant

One of the government's most powerful investigative tools is the search warrant. Search warrants typically are used in instances where law enforcement agents do not trust an individual or organization to respond to a subpoena without destroying, altering or losing responsive materials. At the request of the government, search warrants are issued by an impartial magistrate judge or other authorized judge in the district in which the property to be seized is located. n1 To obtain the search warrant, the government must persuade a neutral and detached judicial officer that there is probable cause to believe that evidence, instrumentalities, or fruits of a crime presently exist at a specified location. n2 In addition, a judicial officer may issue an anticipatory search warrant upon a finding that it is now probable that the items to be seized will be on the described premises when the warrant is executed. n3

Law enforcement agents typically submit evidence to the judicial officer to support the issuance of the warrant in the form of sworn testimony or a written affidavit filed under oath. n4 This is an *ex parte* proceeding, meaning that the parties affected by the warrant are not present upon issuance. Moreover, the affidavit and other paperwork filed with the magistrate judge in support of the warrant are typically maintained under seal to prevent advance notice of the execution of the warrant and to prevent disclosure of the underlying information supporting the probable cause determination.

A search warrant allows the agents to search a specifically identified location and seize documents and tangible items described in the warrant that may constitute evidence, instrumentalities or fruits of the commission of specific crimes alleged in the warrant. A search is limited to the premises and items specified on the warrant. A generic description in the warrant such as "files," "business records" or "medical records" in conjunction with a well-defined and accurate search location, e.g., accounting department or Chief Financial Officer's office, is usually sufficient. n5 Moreover, once lawfully within the premises to be searched, any item of incriminating character that is in plain view of the agent may be seized even if that particular item is not specified on the warrant. n6 A valid search warrant confers the right to open closets, chests, drawers and containers in which the objects of the search might reasonably be found. n7

[2] Execution of a Search Warrant

Federal investigative agencies are structured in a paramilitary fashion. The investigating agency designates an

"Agent-in-Charge" of the search. The Agent-in-Charge is the commanding officer and the other agents will take instruction only from the Agent-in-Charge. The Agent-in-Charge is responsible for securing the premises, conducting the search, and delivering to the court an inventory of all items taken. While the Agent-in-Charge directs all aspects of the search, if legal issues arise which he or she is unable to resolve, the Agent-in-Charge will obtain guidance from the prosecutor involved in the investigation.

In general, there is little ability to prevent or control the search of property on the premises described in the warrant unless the warrant is defective on its face. A claim that a warrant is defective on its face may exist if, for example, the warrant specifies the wrong address or business name or is limited to one floor in a multi-floor premise. In such circumstances, it may be possible to successfully persuade the Agent-in-Charge not to conduct the search, or at least to limit it. If the Agent-in-Charge decides to proceed with the search, however, any interference with or obstruction of the execution of the warrant by refusing access to the agents, removing or destroying any documents or items, or taking any other obstructive actions, can be grounds for separate criminal charges.

Agents often execute the warrant in the early morning hours shortly after 6:00 a.m. n8 in order to maintain the element of surprise and, in the case of business premises, to gain access at a time when innocent third-parties are least likely to be present. Absent exigent circumstances, agents executing a search warrant at a private dwelling must first knock and announce their authority and purpose before entering the premises and may resort to forcible entry only when denied admittance. n9 Once the premises are secure, the agents must provide the affected person with a copy of the warrant authorizing the search. n10 In addition, prior to removing the items from the premises, the agents must provide the affected person with a receipt for the property taken. n11

In premises with multiple rooms, such as business premises, agents usually number the door of each room to be searched as a way to track the origin of each particular item taken. Employees and other persons are typically escorted by the agents from the areas to be searched to ensure complete control of these areas. It is common federal practice for agents to take photographs and videotapes of the premises before and after the search in order to defend against claims of stolen or damaged property or allegations that the agents exceeded the legal parameters of the search.

Government agents frequently attempt to interview witnesses during the course of a search. The search warrant itself provides no authority to question or to detain a witness for the purpose of questioning. Absent a grand jury subpoena or other legal obligation, the witness has a choice as to whether to submit to an interview by a government agent.

[3] Responding to the Execution of a Search Warrant

Federal agents typically are quite effective in asserting total control over the scene of a search. Nonetheless, those affected by the execution of a search warrant can take a number of steps to minimize the impact of the search, preserve rights and objections to the search, and limit unauthorized fact gathering by the agents. The following list is geared toward responding to the search of a business facility. Most of these actions, however, should also be observed in responding to searches of other locations including residential dwellings.

1. As part of a routine compliance program, many companies now recognize the need to form a response team to deal with search warrants long before the need ever arises. The company should designate a trusted senior official at each business location to serve as a Response Leader to coordinate the company's response.
2. When the agents arrive at the premises, the Response Leader or some other designee should immediately contact in-house or pre-designated outside counsel. This must be done quickly because the agents have no obligation to wait for counsel to arrive prior to commencing the search. Receptionists or other persons most likely to have first contact with the agents should be trained to refer the agents to the Response Leader.

3. The Response Leader should seek to identify the Agent-in-Charge. Once the Agent-in-Charge has been identified, the following items and information should be requested: (a) an explanation of the nature, scope, and reason for the search; (b) photo identification and business cards from each of the agents or at least the full name of the agency represented and the name, work address, and telephone number of each agent; and (c) a copy of the search warrant and, if available, the affidavit filed in support of the warrant. The search warrant will show the issuing judge, the specific location and areas authorized to be searched, and documents or objects for which the agents are authorized to search. Finally, the Response Leader should also attempt to obtain the name and phone number of the prosecuting attorney.

4. The Response Leader should request that the Agent-in-Charge communicate with the company and its employees exclusively through the Response Leader or legal counsel.

5. The Response Leader should ask the Agent-in-Charge to delay the execution of the search warrant until company counsel arrives on the premises. If the Agent-in-Charge insists on pursuing the search without delay, then the designated Response Leader should proceed to coordinate the search without delay. The Response Leader should advise the Agent-in-Charge that the company objects to, and is not consenting to, the search, but that it will voluntarily cooperate with the government during the search. The Response Leader should ensure that no employee interferes with the search in any manner in order to avoid obstruction of justice charges.

6. The Response Leader should fax a copy of the warrant to legal counsel. Both legal counsel and the Response Leader must review the search warrant to see if it is defective on its face. The warrant must specify the premises to be searched by correct address, contain a correct description of the property to be searched, be signed by a magistrate or judge, be dated within ten days of the date of the search, and describe the items to be seized with particularity. The search warrant is defective if any of these items is not present. If the warrant appears defective, the Agent-in-Charge should be informed of this fact and the search should be objected to based on the defects. If the warrant is defective, but the Agent-in-Charge insists on executing the search, then the company must allow him to proceed with the search. The Agent-in-Charge should be advised that the company objects to the search, but that it will voluntarily cooperate with the government during the search.

7. If possible, the Response Leader should convene a meeting of all present employees. The employees should be instructed to be respectful to the agents and not to interfere with the search in any way, including destroying or removing documents or items. Employees should also be informed of their rights regarding requests for interviews and that the only questions they are required to answer are those in regard to the location of items or documents.

8. The Response Leader should send all non-essential employees home. This will limit the opportunity for agents to try to question employees and limit any unnecessary, idle conversations. The Agent-in-Charge should be notified of this event. The Agent-in-Charge has no authority to detain employees, but he may request their identities and addresses.

9. The Response Leader should assign trusted employees to monitor the search. An employee should be assigned to each location of the search to watch and record the scope, duration, and items examined in the search. An inventory should also be kept of each item and document seized, the manner and location of the seizure, and the identity of the seizing agents. Also, the monitoring employees should be instructed to record the numbers or other designations assigned to offices by the agents to track the source of the items seized. The monitoring employees should also be instructed to object if an agent attempts to enter an area not specified in the warrant, but not to interfere with the search.

10. Companies should consider videotaping the search. Agents will probably act reasonably if they know that they are being videotaped. If possible, videotape agents if they attempt to prohibit the videotaping because they have no right to prevent videotaping unless it interferes with the search.

11. The Response Leader should ask to make copies of all documents and computer data seized. Companies should attempt to photocopy the documents wanted by the agents and keep the originals. However, if the agents insist on the originals, then companies should try to make copies of all the documents for themselves. If the copy request is denied, then a company should ask for permission to copy any documents that are essential to operation (e.g., personnel records, payable and receivable records, and customer lists).

12. The Response Leader should ask to inventory any seized documents. If the request is granted, a designated employee should inventory all seized documents by title, number of pages, and the area from which they were seized.

13. Privileged documents must be protected. If the agents attempt to seize privileged documents, the Response Leader should lodge an objection with the Agent-in-Charge and state that documents are privileged, that they should not be seized, and that the company does not waive any privileges. If the Agent-in-Charge insists on seizing the privileged documents, the company should ask for time for a conference between counsel and the prosecutor to discuss the issue. Additionally, if seizure continues, the Response Leader should request that the privileged documents be placed in a sealed envelope and that they be delivered directly to the prosecutor's office.

14. The Response Leader should request a copy of the "return of search warrant" or "inventory of search" list. Agents are required to prepare a list of items seized and to provide the company a copy upon its request. Employees should be instructed not to sign the list if requested by an agent.

15. Legal counsel should contact employees involved in the search after it is completed. All employees involved in the search should be asked to share any relevant observations or information regarding the search, including the property seized, the areas searched, and any comments made by agents or other employees.

16. Finally, immediately following the search, the company and counsel must consider a number of issues including, but not limited to, how to respond to media inquiries, whether to initiate an internal investigation, and whether to file a motion for return of property.

Comment

Criminal prosecutors often share with SEC Staff materials obtained pursuant to a search warrant.

FOOTNOTES:

(n1)Footnote 1. *Fed. R. Crim. P. 41(b)*.

(n2)Footnote 2. *Fed. R. Crim. P. 41(d)(1); Warden v. Hayden, 387 U.S. 294, 301-302 (1967)* .

(n3)Footnote 3. *United States v. Grubbs, 126 S.Ct. 1494, 1499-1500 (2006)* .

(n4)Footnote 4. *Fed. R. Crim. P. 41(d)(2)*.

(n5)Footnote 5. *Andresen v. Maryland, 427 U.S. 463, 480, n.10 (1976)* .

(n6)Footnote 6. *Horton v. California*, 496 U.S. 128 (1990). There is disagreement on whether under the "plain view" doctrine, the test involves 2 or 3 factors: (1) lawful vantage point; (2) immediately apparent incriminating nature; (3) lawful right to access in plain view. Compare *Commonwealth v. Ellis*, 541 PA 285 (1995); with *Horton*.

(n7)Footnote 7. See *California v. Acevedo*, 500 U.S. 565 (1991).

(n8)Footnote 8. Unless otherwise provided in the warrant, search warrants must be executed during the "daytime," which is defined as between 6:00 a.m. and 10:00 p.m. local time. *Fed. R. Crim. P. 41(a)(2)(B)*.

(n9)Footnote 9. 18 U.S.C.S. § 3109; *Hudson v. Michigan*, 126 S.Ct. 2159 (2006).

(n10)Footnote 10. *Fed. R. Crim. P. 41(f)(3)*.

(n11)Footnote 11. *Fed. R. Crim. P. 41(f)(3)*.



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.07

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§ 23.07 Covert Investigative Techniques

The use of grand jury subpoenas and search warrants are common overt investigative techniques employed by the government. While historically reserved for cases involving organized crime and narcotics trafficking, prosecutors now more than ever are using a variety of covert investigative techniques in connection with securities fraud and other white collar offenses. Some of the more common techniques are described below.

[1] Title III Wiretaps

Title III of the Omnibus Crime Control and Safe Street Acts of 1968 allows for court-ordered interception of oral and wire communications without the consent of any of the parties to the communication. n1 The government may seek a court order authorizing such a "wiretap" only after obtaining approval from the properly designated Assistant Attorney General. Although a wiretap is an extraordinary tactic in terms of both resources and the approval process, wiretaps have been used in securities law cases. n2 Because wiretaps are extremely invasive, they will be approved only when no other reasonable investigative techniques are viable. n3 They are typically reserved for closed organizations which can not be penetrated through an informant or otherwise. The government's goal in conducting a wiretap is to record statements that an individual has made during the commission of a crime or shortly thereafter, that discuss the crime and are therefore extremely powerful as evidence of guilt.

Courts consider applications for wiretaps *ex parte* and will rely on the factual summaries provided in the application itself and supporting affidavits. An application for a wiretap order must include: (1) a full and complete statement of the alleged offense; (2) the facilities from which the communications are to be intercepted or a request for permission to conduct a "roving wiretap;" (3) a particular description of the communications sought to be intercepted; (4) the identity of the persons committing the offense and the identity of the persons whose communications will be intercepted, if known; (5) a full and complete statement of whether other investigative techniques have been tried and have failed or why they appear unlikely to succeed or are too dangerous; and (6) a full and complete statement of the period of time for which the interception is to be maintained. n4

The court will enter an order authorizing the wiretap if it finds probable cause to believe: (1) a person is committing, has committed or is about to commit one of the specified offenses; (2) particular communications concerning the specified

offense will be obtained through the interception; and (3) the facilities from which the communications are to be intercepted are being or will be used in connection with the specified offense. n5 Courts may not approve interceptions for periods of time greater than thirty days, although the government may, and frequently does, apply for additional thirty day extensions. n6 The court may also require the government to submit reports on the progress of the surveillance and the need for further interception. n7

The government has a duty to minimize the interception of communications unauthorized by the order. n8 As such, government agents must discontinue monitoring and recording conversations that do not involve criminal behavior. All recordings made pursuant to the court order must be returned to the court and sealed. n9 Further, within a reasonable period of time after the interception is completed, persons listed in the order must be given notice that the order was entered, the date of entry and the interception period, and whether communications were intercepted during that period. n10 The court may also require notice be provided to individuals not named in the order but whose conversations were intercepted. n11

[2] Cooperating Informants and Consensual Recordings

Under federal law, government agents can monitor and record conversations or electronic communications with the consent of a single party to the communication. n12 Because consent of a single party provides an exception to the Title III requirements, the government need not obtain judicial authorization to record such conversations nor obey any of the minimization or notice provisions of Title III. For this reason, law enforcement agents consistently strive to find cooperating informants who are willing and able to secretly record conversations with targets of the investigation.

[3] Mail Drops

The United States Postal Inspectors can also be requested to turn in all mail coming to a designated address. The Postal Inspectors can initiate a mail drop without a court order or notice to affected persons.

[4] Pen Registers and "Trap and Trace" Devices

A pen register, also known as a dialed number recorder, allows law enforcement to record the numbers dialed from a particular telephone. Pen registers work for both hard lines and mobile telephones. With modern technology, pen registers can be connected to a person's telephone line from a remote location. Gone are the days of federal agents climbing telephone poles or setting up next door to the location of a target phone in order to hook into the line. Once connected, the pen register activates every time the target telephone is taken off the hook and will record every number and symbol that is dialed.

A "trap and trace" device is used to record the telephone numbers of the phones used to call a particular telephone. Prior to the advent of "Caller ID," the local telephone company was required to perform the trace and provide the law enforcement agency with information as to which telephone numbers were used to call the target telephone. Now, law enforcement agencies can obtain this information in real time from the same dialed number recorder used for pen registers.

The Supreme Court has held that persons do not have a reasonable expectation of privacy in the numbers dialed on their telephones and, thus, the use of pen registers does not implicate the *Fourth Amendment*. n13 Nonetheless, the Electronic Communications Privacy Act of 1986 prohibits use of pen registers and trap and trace devices without a court order. n14

FOOTNOTES:

(n1)Footnote 1. *18 U.S.C.S. §§ 2510-2520.*

(n2)Footnote 2. A court will not authorize a wiretap unless there has been a showing of probable cause to believe

that one of the offenses specified in *18 U.S.C.S. § 2516* has been committed. These specified offenses include mail fraud, wire fraud, money laundering, and racketeering. Note, there is proposed legislation adding § 641 - embezzlement or theft of public money, property, or records; § 666 - theft or bribery concerning the use of Federal funds; and § 224 - bribery in sports.

(n3)Footnote 3. *18 U.S.C.S. § 2518; United States v. London, 66 F.3d 1227, 1237 (1st Cir. 1995), cert. denied, 116 S.Ct. 1542 (1996)* .

(n4)Footnote 4. *18 U.S.C.S. § 2518*.

(n5)Footnote 5. *18 U.S.C.S. § 2518(3)*.

(n6)Footnote 6. *18 U.S.C.S. § 2518(5)*.

(n7)Footnote 7. *18 U.S.C.S. § 2518(6)*.

(n8)Footnote 8. *18 U.S.C.S. § 2518(5)*.

(n9)Footnote 9. *18 U.S.C.S. § 2518(8)(a)*.

(n10)Footnote 10. *18 U.S.C.S. § 2518(8)(d)*.

(n11)Footnote 11. *18 U.S.C.S. § 2518(8)(d)*.

(n12)Footnote 12. *Katz v. United States, 389 U.S. 347 (1967); 18 U.S.C.S. § 2510(2)*.

(n13)Footnote 13. *Smith v. Maryland, 442 U.S. 735, 741-746 (1979)* . There is disagreement among authorities regarding this issue, *see, e.g., In re: U.S. for Orders Authorizing use of pen registers and trap and trace devices, 515 F.Supp.2d 325 (E.D.N.Y. 2007)* .

(n14)Footnote 14. *18 U.S.C.S. § 3121*.



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.08

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§ 23.08 Joint Defense Agreements

The joint defense privilege can provide an efficient means for multiple parties that are or could become the subject of a government investigation to organize their defense efforts through a joint examination of the relevant facts. n1 In the context of allegations of possible violations of federal securities laws, joint defense agreements allow such parties to combine forces, facilitate the review and sharing of often complex factual information, and develop a unified and coherent defense to the allegations prompting the inquiry.

Joint defense agreements can be particularly useful in the context of representation of corporate entities. By facilitating the flow of sensitive information, joint defense relationships allow corporate entities with common interests to investigate, detect, and if necessary report possible wrongdoing, thereby furthering the corporate entities' obligations to comply with all applicable laws.

In the event that allegations of wrongdoing are pursued by government prosecutors, courts often recognize joint defense agreements as necessary to providing a fair opportunity to defend against the alleged wrongdoing. n2 Additionally, courts typically view joint defense agreements as beneficial to an efficient adversarial process as the results of allowing co-defendants to share information without waiving the attorney-client privilege often serves to expedite the trial and trial preparation. n3

[1] Benefits and Scope of Joint Defense Agreements

The central value of a joint defense agreement is that it allows parties to exchange confidential information without destroying the attorney-client privilege shared by an individual client and its attorney. The attorney-client privilege extends to all parties in a joint defense agreement and protects communications between all entities and their attorneys when "the communications are part of an on-going and joint effort to set up a common defense strategy." n4 The privilege applies to communications between prospective, as well as actual, co-defendants and their attorneys, where those communications are made solely in the interests of a joint defense effort. n5 As is the case with an individual attorney-client privilege, the burden of establishing the applicability of a joint defense privilege rests on the party asserting it. n6

Communications between multiple clients and their attorneys are protected only where they concern a matter of common interest. Specifically, the party asserting the privilege must establish that: (1) the communications were made in the course of a joint defense effort; (2) the statements were designed to further the effort; and (3) the privilege has not been waived. n7 Different jurisdictions interpret the meaning of "common interest" differently. While some courts interpret the requirement broadly, others strictly construe the common interest requirement, holding that only those communications made in the course of an ongoing common interest are protected. n8 Under either interpretation, the importance of satisfying the common interest requirement cannot be overstated: without a common interest, no privilege applies, and disclosure of the information to another entity may be taken as a waiver of the attorney-client privilege as to that information. n9

The existence of a common interest does not render all communications between parties privileged, and counsel should not assume general common interests alone will be sufficient to qualify their communications for joint defense privilege protection. One commentator explained, "even where parties have agreed to pursue a common goal, the privilege will not apply if the statement is extraneous to the common interest and thus does not further the agreed-upon goal." n10 As a result, counsel should clearly identify any information communicated for joint defense purposes, even where a written agreement has been signed between entities with a common interest. n11

Similarly, the existence of a valid joint defense agreement does not mean that all communications between parties to the agreement are protected as privileged. As with individual attorney-client communications, the presence of anyone not party to the joint defense agreement during joint defense communications will destroy the privilege. n12 In short, non-privileged information does not become privileged simply because it was shared pursuant to a joint defense agreement. Instead, the joint defense agreement acts to preserve *existing* privileges when information is shared under the circumstances described above.

Additionally, it is widely recognized that attorneys or their agents must be present when the communications are made for the joint defense privilege to attach. Indeed, many courts have held that, in the absence of any attorney, the joint defense privilege does not extend to conversations among the clients. n13 These courts reason that, "when a person provides information to another without first consulting his own attorney, it is difficult to see how the information was given as part of a joint defense, even when the recipient may be viewed as a party with similar interests." n14 As long as any attorney to the agreement is present, however, the communicating party's attorney need not be. n15

[2] Potential Risks Associated with Joint Defense Agreements

There are many practical and legal risks associated with joint defense agreements which must be carefully evaluated by counsel and their clients before entering into such an agreement and sharing information. An inherent risk with joint defense agreements is the potential disclosure of confidential information to the government or other adversary, whether intentionally or inadvertently. As a joint defense agreement allows co-defendants to obtain information they might not otherwise have had access to, parties may be tempted to use that information to their advantage as the case develops. It may be difficult to determine if the joint defense agreement has been breached or to obtain a remedy for such a breach.

It is uniformly accepted that a joint defense privilege remains intact even after the litigation is over, and parties to a joint defense agreement may not betray confidences in later third party actions. However, information divulged by and to co-defendants in the course of mounting a common defense typically will not be protected, and in a subsequent controversy between or among the clients, courts will often hold that the privilege no longer applies. n16 The court in *In re Grand Jury Subpoena* reasoned: "[w]hen parties once joined assume the stance of opposing parties in subsequent litigation ... neither can reasonably be allowed to deny to the other the use of information which he already has by virtue of the former's own disclosure." n17 However, the privilege of one joint client cannot be destroyed by another simply where the two have a "falling out." n18

Because of their fiduciary obligations to shareholders, a corporation's board of directors and officers are required to

resolve an investigation into allegations of corporate wrongdoing in a manner consistent with the best interests of the corporation. n19 Thus, the corporation may seek redress against a corporate employee or another entity that appears to have caused harm to the corporation. Conflicts could arise where the defendant corporation has a joint defense agreement with individuals or entities that have caused harm to the corporation, particularly where the corporation discovers the damaging action through information obtained pursuant to the joint defense agreement itself. n20

Nonetheless, a corporation taking legal action against another party to the joint defense agreement will not necessarily be legally prohibited from using information obtained through the joint defense agreement. As noted above, where parties to a joint defense agreement face each other in litigation, courts have found that the parties are not entitled to enforce the privilege against each other. n21 Thus, where a corporation learns that a co-defendant's wrongdoing caused harm to the corporation, there generally is no legal prohibition against using such information in a later suit against that individual or entity. n22

Government investigations also pose particular problems with respect to joint defense relationships. Government investigations can seriously impair a corporation's business, resulting in, for example, significant fines and penalties, distraction of management, loss of focus on core business activities and, potentially, shareholder suits. n23 Thus, when faced with a long and protracted government investigation, many publicly-traded corporations attempt to negotiate a resolution. n24 As a result, corporations are vulnerable to government attempts to extract confidential information disclosed pursuant to joint defense relationships, to disrupt such relationships, or even to prevent the relationship from forming in the first instance. n25 Prosecutors now more than ever often seek both voluntary and court-ordered waivers of the corporate attorney-client privilege where such waivers would result in evidence relating to a criminal investigation. n26 In light of today's prosecutorial climate, a corporation may find itself forced to divulge information ordinarily protected by an attorney-client privilege or the work product doctrine. n27

Finally, upon learning of the existence of a joint defense agreement, the government may seek to disqualify counsel based on the receipt of confidential information relating to parties to the joint defense agreement who later become government witnesses. The rationale behind such action by the government is the perceived advantage of counsel in later cross-examining these government witnesses at trial.

[3] Elements of a Joint Defense Agreement

Ideally, the joint defense group will execute a written joint defense agreement. Although agreements need not be in writing to be enforceable, n28 courts and commentators regularly recommend the use of a written agreement. n29 A written agreement establishes the nature of the common interest, the desire of all parties to enter into the agreement, the timing and scope of the agreement and the obligations of the signatories. n30 A written agreement clarifies whether the parties intended to be bound and, thus, whether the joint defense privilege is applicable at all. n31 Any written agreement should include a provision concerning how the privileged information will be protected, especially where one member becomes a government witness or drops out of the agreement for any reason.

At a minimum, a joint defense agreement should declare the following:

- the common interest of the parties;
- that the parties are making disclosures with the understanding that they are covered by the joint defense doctrine;
- that materials previously confidential will remain confidential when communicated to members of the agreement or their counsel;
- that members may not disclose information obtained under the joint defense agreement;

- that members may withdraw from the agreement, but that information obtained under the agreement will remain privileged;
- that counsel intends to pursue the separate but common interests of their respective clients; and
- conflict waivers by all members to avoid disqualification of defense counsel based on the sharing of joint defense materials.

Comment

In connection with joint defense agreements, a public company should also address the possibility that information obtained pursuant to a joint defense agreement is material and must be disclosed to investors.

FOOTNOTES:

- (n1)Footnote 1. For a more detailed discussion of joint defense agreements, *see* Chapter 12 on privileges.
- (n2)Footnote 2. *See United States v. McPartlin*, 595 F.2d 1321 (7th Cir. 1979) .
- (n3)Footnote 3. *McPartlin*, 595 F.2d at 1337 .
- (n4)Footnote 4. *In re Bevill*, Bresler & Schulman Asset Management Corp., 805 F.2d 120, 126 (3d Cir. 1986) (citing *Eisenberg v. Gagnon*, 766 F.2d 770, 787 (3d Cir. 1985)) .
- (n5)Footnote 5. *In re Grand Jury Subpoena Duces Tecum Dated November 26, 1974*, 406 F. Supp. 381, 389 (S.D.N.Y. 1975) .
- (n6)Footnote 6. *United States v. Bay State Ambulance and Hospital Rental Service, Inc.*, 874 F.2d 20, 28 (1st Cir. 1989) .
- (n7)Footnote 7. *In re Bevill*, 805 F.2d at 126 .
- (n8)Footnote 8. *See United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989) .
- (n9)Footnote 9. *See United States v. Lopez*, 777 F.2d 543, 553 (10th Cir. 1985) .
- (n10)Footnote 10. Robert E. Sims & Philip E. Ferrari, *Look Before You Leap: Problems and Pitfalls in Joint Defense Agreements*, White Collar Crime 2001, ABA-CLE.
- (n11)Footnote 11. *See Bay State Ambulance*, 874 F.2d at 24 .
- (n12)Footnote 12. *Bay State Ambulance*, 874 F.2d at 29 .
- (n13)Footnote 13. *United States v. Gotti*, 771 F. Supp. 535, 545 (E.D.N.Y. 1991) .
- (n14)Footnote 14. *Bay State Ambulance*, 874 F.2d at 29 .
- (n15)Footnote 15. *Schwimmer*, 892 F.2d at 244 .
- (n16)Footnote 16. *In re Grand Jury Subpoena*, 406 F. Supp. at 386 .
- (n17)Footnote 17. *In re Grand Jury Subpoena*, 406 F. Supp. at 394 .

(n18)Footnote 18. *In re Grand Jury Subpoena*, 406 F. Supp. at 394 .

(n19)Footnote 19. *See In re Caremark, Int'l*, 698 A.2d 959 (Del. 1996) .

(n20)Footnote 20. Curtis P. Lu, *Collateral Consequences of Entering Joint Defense Relationships with Corporations in the Context of Government Investigations*, White Collar Crime 2001, R-2.

(n21)Footnote 21. *In re Grand Jury Subpoena*, 406 F. Supp. at 386 .

(n22)Footnote 22. Lu, White Collar Crime 2001, R-2 *above*.

(n23)Footnote 23. Lu, White Collar Crime 2001, R-3 *above*.

(n24)Footnote 24. Lu, White Collar Crime 2001, R-3 *above*.

(n25)Footnote 25. Lu, White Collar Crime 2001, R-3 *above*.

(n26)Footnote 26. Memorandum from Larry D. Thompson, Deputy Attorney General, Regarding Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003).

(n27)Footnote 27. Lu, White Collar Crime 2001, R-2 *above*.

(n28)Footnote 28. *Continental Oil v. United States*, 330 F.2d 347, 350 (9th Cir. 1964) (no writing is required when an attorney provides documents to co-defendant's attorney to assert common claims). One district court, however, recently held that courts have inherent authority to require co-defendants in criminal prosecutions to memorialize in writing all joint defense agreements so that the court can safeguard each defendant's *Sixth Amendment* right to conflict-free counsel. *See United States v. Stepney*, 246 F. Supp. 2d 1069 (N.D. Cal. 2003) .

(n29)Footnote 29. *See, e.g., United States v. Sawyer*, 878 F. Supp. 295, 297 (D. Mass. 1995) (court found it "significant" that defendant could not specify the time frame of his joint defense agreement or acts that constituted and/or terminated the agreement).

(n30)Footnote 30. Robert E. Sims & Philip E. Ferrari, *Look Before You Leap: Problems and Pitfalls in Joint Defense Agreements*, White Collar Crime 2001, ABA-CLE R-26.

(n31)Footnote 31. Amy Foote, *Joint Defense Agreements in Criminal Prosecutions: Tactical and Ethical Implications*, 12 *Geo. J. Legal Ethics* 377, 391 (1999).



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.09

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§ 23.09 Indictments

[1] Prior Notice and the Opportunity to Testify Before the Grand Jury

In connection with investigations of securities violations and other white collar offenses, targets may request the opportunity to tell the grand jury their side of the story. While the prosecutor has no legal obligation to permit a target to testify, n1 a refusal to do so can create the appearance of unfairness. Accordingly, under normal circumstances, where no burden upon the grand jury or delay of its proceedings is involved, DOJ guidelines direct prosecutors to honor such reasonable requests of a target to testify personally before the grand jury, provided that the target explicitly waives his or her privilege against self-incrimination on the record before the grand jury, and is represented by counsel or voluntarily and knowingly appears without counsel and consents to full examination under oath. n2

When a target is not subpoenaed to testify before the grand jury, and does not request to testify on his or her own motion, DOJ guidelines encourage the prosecutor, in appropriate cases, to notify the target a reasonable time before seeking an indictment in order to afford him or her an opportunity to testify before the grand jury, subject to the conditions stated above. n3 Obviously, targets will not receive advance notice of indictment when cases when such action might jeopardize the investigation or prosecution because of the likelihood of flight, destruction or fabrication of evidence, endangerment of other witnesses, undue delay or otherwise would be inconsistent with the ends of justice. n4

[2] Pre-Indictment Conferences with the United States Attorney

An Assistant United States Attorney typically must obtain approval from a number of persons prior to seeking an indictment, including his or her immediate supervisors, the United States Attorney, and in some cases a designated official within the DOJ. If it becomes abundantly clear that the Assistant United States Attorney handling the investigation will recommend prosecution, defense counsel should consider a written request to the United States Attorney for a pre-indictment meeting. Such a request is a sensitive strategic decision in that once it is made, the Assistant United States Attorney will likely become entrenched in the decision to indict and may feel that his judgment has been improperly called into question.

The pre-indictment meeting typically is used to make a full presentation of the facts and applicable law for the purpose of convincing the government not to prosecute. The risks to this approach are abundant, including the loss of surprise

regarding the defense strategy. Nonetheless, in appropriate cases, it is possible to dissuade the government from prosecuting. While an indictment will issue only upon a finding of probable cause, prosecutors typically will not indict a case if they believe they cannot meet the burden at trial of proving the case beyond a reasonable doubt. In addition, there may be persuasive policy arguments in favor of pretrial diversion or some other resolution short of prosecution. A key factor in white collar cases is the harm to the victims. If there are victims, prior to attempting to persuade a prosecutor not to indict, the target should make an effort to ensure that all victims are fairly compensated for their losses.

FOOTNOTES:

(n1)Footnote 1. *United States v. Leverage Funding System, Inc.*, 637 F.2d 645 (9th Cir. 1980) , cert. denied, 452 U.S. 961 (1981) ; *United States v. Gardner*, 516 F.2d 334 (7th Cir. 1975) , cert. denied, 423 U.S. 861 (1976) .

(n2)Footnote 2. United States Attorney's Manual § 9-11.152.

(n3)Footnote 3. United States Attorney's Manual § 9-11.153.

(n4)Footnote 4. United States Attorney's Manual § 9-11.153.



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Securities Enforcement: Counseling and Defense

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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.10

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§ 23.10 Trial Preparation--Pretrial Discovery

[1] Government's Constitutional Disclosure Obligations

While there is no general constitutional right to discovery in criminal cases, n1 the Supreme Court has held that due process requires the government to produce evidence favorable to an accused person when such evidence is material to guilt or punishment. n2 The government's obligation to produce favorable evidence includes not only exculpatory evidence but also information that could be used to impeach government witnesses. n3 Such information includes agreements whereby the government provides compensation or favorable treatment in exchange for testimony. n4

The government's constitutional obligation to produce favorable evidence under *Brady v. Maryland* and its progeny is governed by a materiality standard and is not limited to situations in which the defendant has requested the favorable evidence. n5 Evidence is material, and thus should be disclosed, if there is a reasonable probability that it would change the outcome of the proceeding. n6 To demonstrate a reasonable probability of a different outcome, the defendant must show that "the favorable evidence could reasonably be taken to put the whole case in such a different light as to undermine confidence in the verdict." n7

[2] Government's Statutory Disclosure Obligations

[a] Federal Rule of Criminal Procedure 16

Federal Rule of Criminal Procedure 16 allows the defendant to discover upon request five types of information before trial. First, the government must produce the defendant's own oral, written or recorded statements. n8 This includes not only memoranda summarizing government interviews with the defendant, but also all secretly recorded tape recordings of defendant's conversations. With respect to corporate defendants, the government must disclose statements of all directors, officers, employees, or agents legally able to bind the corporation. n9 Second, the government must disclose the defendant's prior criminal record. n10 Third, the government must disclose documents of independent evidentiary value (not police reports) and tangible items (including places) if (a) they are in the government's possession or control and are material to defense; (b) they are intended for use by the government in its case-in-chief; or (c) they were obtained from or belong to the defendant. n11 Fourth, the government must produce reports of examinations and tests (i.e., fingerprint, handwriting analysis, etc.). n12 Finally, the government must disclose the contents and bases of expert

testimony to be offered by the government in its case-in-chief. n13

Once the defendant makes a timely and specific request for discovery under Rule 16, the government has a continuing obligation to produce any newly discovered evidence satisfying the request. n14 The district court has broad discretion to sanction the government for failure to comply with its disclosure obligations under Rule 16, including ordering inspection of the withheld items, granting a continuance, prohibiting the introduction of the withheld items into evidence, and entering any other just order. n15

[b] Witness Statements (Jencks Material)

The government's obligation to disclose to the defense pretrial statements of its witnesses is governed by *Federal Rule of Criminal Procedure 26.2* and the Jencks Act. n16 Prior statements of government witnesses must be produced by the government if: (1) they are in the government's possession; (2) they relate to subject matter on which witness has testified; and (3) the defendant has moved for their production. n17 By statute, statements of government witnesses are not discoverable until after the witness testifies on direct examination. Nonetheless, in practice and upon request, the government will often voluntarily give or the court may order the government to produce these statements to the defense several days or weeks before trial.

Much litigation has resulted over the definition of a statement for purposes of the government's disclosure obligation. The Jencks Act defines a statement to be: (1) a written statement made by the witness and signed or otherwise adopted or approved by witness; (2) a stenographic, mechanical, electrical, or other recording, or a transcription thereof, which is a substantially verbatim recital of an oral statement made by the witness and recorded contemporaneously with the making of such oral statement; or (3) a statement, however taken or recorded, or a transcription thereof, if any, made by a witness to a grand jury. n18 Courts have held that the following generally are not Jencks Act statements: (a) notes of the prosecutor not read back to or adopted by the witness; n19 (b) rough surveillance notes; n20 (c) an agent's "scattered jottings;" n21 (d) interview notes which are merely fragmentary; n22 (e) handwritten versions of typed memoranda which do not differ materially from the typed version; n23 (f) radio transmissions of an officer tracking a suspect; n24 (g) a private diary which has not been shared with anyone; n25 and (h) an FBI identi-kit composite drawing. n26

Significantly, the attorney work product privilege does not bar production of a prosecutor's notes which are otherwise required to be produced under the Jencks Act. n27

[3] Other Methods to Obtain Information from the Government

There are many limitations on the government's statutory obligations to provide pretrial discovery to the defense. There is no requirement that the government account to the defendant for all facets of its investigation, such as providing lists of all persons interviewed and all agents conducting the interviews. n28 Interrogatories are not permitted in federal criminal discovery. n29 Although *Federal Rule of Criminal Procedure 15* provides a mechanism to preserve testimony of a party's own witnesses by evidence depositions under "exceptional circumstances," the Federal Rules of Criminal Procedure do not authorize discovery depositions. Further, disclosure of tax returns and tax information is governed by *26 U.S.C.S. § 6103*. The Federal Rules of Criminal Procedure cannot be employed to compel production of tax returns not already in the possession of the United States Attorney. n30

Given these limitations, defense counsel may seek alternatives to pretrial discovery to obtain relevant information in the possession of the government. For instance, defense counsel may seek information through the Freedom of Information Act ("FOIA"). n31 Despite the Supreme Court's admonitions that FOIA was not intended to displace or supplement normal discovery procedures and the nine exemptions to disclosure under the Act, there is some older precedent permitting defendants to raise FOIA claims in criminal proceedings. n32

Likewise, defense counsel at times have issued subpoenas *duces tecum* seeking documents from the government. In

United States v. Nixon, n33 the Supreme Court established a four part test for enforcement of such subpoenas. The party seeking enforcement must show: (1) that the documents are evidentiary and relevant; (2) that the documents are not otherwise procurable in advance of trial; (3) that the documents are necessary to the party's trial preparation; and (4) that the subpoena is issued in good faith and not as part of a general "fishing expedition." Defense subpoenas to the government must also comply with the *Touhy* regulations of the agency subpoenaed. n34

Occasionally, defendants will attempt to obtain information about the government's case through the institution of a separate civil proceeding. This is usually a futile effort as criminal defendants who initiate civil proceedings to obtain discovery relating to a criminal case often face a stay of the civil proceeding. Indeed, the Anti-Injunction Act, n35 which limits the power of federal courts to stay state proceedings, has been held inapplicable when the United States is the plaintiff in the competing federal proceeding. n36

[4] Defense Disclosure Obligations to the Prosecution

The Federal Rules of Criminal Procedure place reciprocal disclosure obligations upon the defense. Rule 16(b)(1) requires disclosure of the following items upon request by the government: (1) documents and objects which the defense intends to use in its case-in-chief; (2) reports of any examination or tests which the defense intends to use at trial or prepared by a witness the defense intends to call at trial; and (3) a written summary of any expert testimony to be offered by the defense along with the qualifications of the witness. Similarly, once witnesses have testified for the defense, upon request of the government, the defense must produce all oral and written statements of that witness. n37 Defendants are also required upon request to provide the government with notice of an alibi defense. n38 Even without a request by the government, the defense must provide notice of any defense premised on insanity or public authority. n39

FOOTNOTES:

(n1)Footnote 1. *Weatherford v. Bursey*, 429 U.S. 545, 559 (1977) .

(n2)Footnote 2. *Brady v. Maryland*, 373 U.S. 83 (1963) .

(n3)Footnote 3. *Giglio v. United States*, 405 U.S. 150 (1972) .

(n4)Footnote 4. *United States v. Boyd*, 55 F.3d 239, 245-246 (7th Cir. 1995) .

(n5)Footnote 5. *United States v. Agurs*, 427 U.S. 97, 107-111 (1976) .

(n6)Footnote 6. *United States v. Bagley*, 473 U.S. 667 (1985) .

(n7)Footnote 7. *Kyles v. Whitley*, 514 U.S. 419 (1995) .

(n8)Footnote 8. *Fed. R. Crim. P. 16(a)(1)(A) & (B)*.

(n9)Footnote 9. *Fed. R. Crim. P. 16(a)(1)(C)*.

(n10)Footnote 10. *Fed. R. Crim. P. 16(a)(1)(D)*.

(n11)Footnote 11. *Fed. R. Crim. P. 16(a)(1)(E)*.

(n12)Footnote 12. *Fed. R. Crim. P. 16(a)(1)(F)*.

(n13)Footnote 13. *Fed. R. Crim. P. 16(a)(1)(G)*.

(n14)Footnote 14. *Fed. R. Crim. P. 16(c)*.

- (n15)Footnote 15. *Fed. R. Crim. P. 16(d)(2)*.
- (n16)Footnote 16. *18 U.S.C.S. § 3500*.
- (n17)Footnote 17. *18 U.S.C.S. § 3500(b); Fed. R. Crim. P. 26.2(a)*.
- (n18)Footnote 18. *18 U.S.C.S. § 3500(e); Fed. R. Crim. P. 26.2(f)*.
- (n19)Footnote 19. *United States v. O'Malley, 796 F.2d 891, 900 (7th Cir. 1986)* .
- (n20)Footnote 20. *United States v. Andersson, 813 F.2d 1450, 1459 (9th Cir. 1987)* .
- (n21)Footnote 21. *United States v. Mora, 994 F.2d 1129, 1139 (5th Cir. 1993)* .
- (n22)Footnote 22. *United States v. Mena, 863 F.2d 1522, 1529 (11th Cir.) , cert. denied, 110 S. Ct. 109 (1992)* .
- (n23)Footnote 23. *United States v. Bastanipour, 697 F.2d 170, 174 (7th Cir. 1982)* .
- (n24)Footnote 24. *United States v. Bobadilla-Lopez, 954 F.2d 519, 522 (9th Cir. 1992)* ; *contra United States v. Florack, 155 F.R.D. 49, 55 n.2 (W.D.N.Y. 1994)* .
- (n25)Footnote 25. *See United States v. Carrasco, 537 F.2d 372 (9th Cir. 1976) as interpreted in United States v. Bobadilla-Lopez, 954 F.2d 519, 522 (9th Cir. 1992)* .
- (n26)Footnote 26. *United States v. Zurita, 369 F.2d 474 (7th Cir. 1966)* .
- (n27)Footnote 27. *Goldberg v. United States, 425 U.S. 94, 105-108 (1976)* .
- (n28)Footnote 28. *United States v. Russo, 699 F. Supp. 1344 (N.D. Ill. 1988)* .
- (n29)Footnote 29. *United States v. Conder, 423 F.2d 904, 910 (6th Cir. 1970)* .
- (n30)Footnote 30. *United States v. Recognition Equipment, Inc., 720 F. Supp. 13, 14 (D.C. 1989)* .
- (n31)Footnote 31. *5 U.S.C.S. § 552*.
- (n32)Footnote 32. *See United States v. Brown, 562 F.2d 1144, 1152 (9th Cir. 1977)* ; *United States v. Wahlin, 384 F. Supp. 43, 47 (W.D. Wis. 1974)* .
- (n33)Footnote 33. *418 U.S. 683, 697-702 (1974)* .
- (n34)Footnote 34. The *Touhy* regulations of the DOJ are found at *28 C.F.R. § 16.21 et seq .*, while those of the Treasury Department are at *26 U.S.C.S. § 6103(b)(2)(A)*.
- (n35)Footnote 35. *28 U.S.C.S. § 2283*.
- (n36)Footnote 36. *Leiter Minerals, Inc. v. United States, 352 U.S. 220, 224-226 (1957)* .
- (n37)Footnote 37. *Fed. R. Crim. P. 26.2; United States v. Nobles, 422 U.S. 225 (1975)* .
- (n38)Footnote 38. *Fed. R. Crim. P. 12.1*.
- (n39)Footnote 39. *Fed. R. Crim. P. 12.2 & 12.3*.



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.11

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§ 23.11 Negotiated Resolutions

[1] The Negotiation Process

Historically, criminal prosecutors typically either decided not to prosecute or proceeded with a prosecution either by obtaining an indictment against one or more defendant(s) or entering into a plea agreement with one or more defendants, or both. Although there is no constitutional right to plea bargain, n1 many criminal cases are resolved by plea agreements through which a defendant agrees to plead guilty to one or more of the offenses charged. Securities fraud cases are no exception.

More recently, the Department of Justice has developed two alternative options: deferred prosecution agreements and nonprosecution agreements. These agreements allow a company to avoid most of the collateral consequences of a conviction. Typically, the company stipulates to facts sufficient to establish a criminal charge. In addition, the company sometimes agrees to a monetary sanction (e.g., a criminal fine, civil penalty, and/or restitution) and to the implementation of specified remedial measures (e.g., the appointment of an independent monitor). Sometimes, a criminal complaint is filed against the company with the understanding that the charges will be stayed for a set period (typically for less than four years) at the conclusion of which, if the company has not violated the terms of the agreement (e.g., payment of criminal fines and civil penalties, cooperation with the Department of Justice, establishment of a compliance program, appointment of an independent monitor), the prosecutors will seek dismissal of the charges. Sometimes, the company simply agrees to the statement of facts and no charges are filed in court unless the company violates the terms of the agreement. n2

Federal Rule of Criminal Procedure 11(c) governs the parameters of the plea bargain process. While the court is prohibited from participating in the plea bargain negotiations, n2.1 in the end the court retains complete discretion in deciding whether to accept, reject or defer the plea agreement and proposed guilty plea. n3

On September 23, 2003, Attorney General John Ashcroft issued a memorandum to all prosecutors concerning the charging of criminal offenses, the disposition of cases, and sentencing (the "Ashcroft Memorandum"). The Ashcroft Memorandum directs prosecutors to charge and pursue the most serious, readily provable offense in all federal prosecutions, unless authorized to do so otherwise by an Assistant Attorney General, United States Attorney or

designated supervisory attorney in certain limited situations, such as substantial assistance or in cases of post-indictment reassessment (i.e., where there is a change of evidence or unavailability of a witness that makes it impossible to prove the most serious offense). This policy severely limits "charge" or "sentencing" bargaining in plea negotiations.

Nonetheless, plea bargaining is in many respects a negotiation process, the results of which are influenced by many factors, including the nature of the criminal act, the evidence, the government's evaluation of the case, other defendants and other circumstances. Now, more than ever, the ability to engage in plea negotiation largely depends on whether a charging decision has already been made. And even in those circumstances the prosecutor's discretion is increasingly limited by the Ashcroft Memorandum, absent significant extenuating circumstances. As a result, it is imperative that an early and accurate evaluation of the many factors, including the role and culpability of the client, the evidence, the charges, other potential defendants and the prosecution, be made as soon as possible, so that a defense strategy can be set. Although it is an old axiom, it can still be true that the first person to strike a deal with the government--particularly one in which he or she promises to cooperate with and testify on behalf of the government--often will receive the most favorable plea agreement. However, now the ability to negotiate a plea to a lesser crime and penalty is significantly limited. Instead, the government will demand a plea to the most serious provable offense. As a result, increasingly the emphasis in plea negotiation is the ability of the defendant to cooperate and gain the support of the government at their sentencing in seeking a reduction from the guidelines mandated sentence.

The negotiation process, however, does not always proceed with both sides having equal access to crucial information about the underlying offense. Indeed, the Supreme Court recently held that defendants are not entitled to receive exculpatory information under *Brady v. Maryland*ⁿ⁴ or impeachment information under *Giglio v. United States*ⁿ⁵ prior to entering a plea of guilty.ⁿ⁶ As such, decisions regarding whether to enter into plea bargaining and the acceptable terms of a plea agreement often must be made in the face of uncertainty as to the ability of the government to prove its case beyond a reasonable doubt.

Our court system has a vested interest in ensuring that plea bargaining occurs. Without plea bargains, the courts would face a substantial crisis of resources in ensuring that all charged criminal defendants received a speedy trial. To encourage plea bargaining and to foster open discussions during the negotiation process, the *Federal Rules of Criminal Procedure* and the *Federal Rules of Evidence* provide that statements made during the course of plea negotiations that do not result in a guilty plea or that result in a guilty plea that is later withdrawn, evidence of withdrawn guilty pleas, and statements made in the course of Rule 11 proceedings are not admissible against the participating defendant in any criminal or civil proceeding.ⁿ⁷ This prohibition includes a bar against using such evidence for impeachment purposes as well.ⁿ⁸

[2] Consequences of a Guilty Plea

Entering into a plea agreement with the government affords a defendant a number of potential benefits. Ordinarily, to the extent that their later conduct does not belie acceptance of responsibility for their actions, defendants who plead guilty are afforded a reduction in their offense level under the *United States Sentencing Guidelines* which usually results in a lower sentence.ⁿ⁹ Additionally, defendants who agree to provide substantial cooperation with the government in the form of testimony or otherwise may receive a downward departure from the sentence otherwise mandated by the *United States Sentencing Guidelines*.ⁿ¹⁰ Defendants sometimes are successful in extracting agreements by the government not to prosecute them for further crimes. Moreover, some plea agreements allow for agreed upon sentences which are binding upon the court once the court accepts the plea agreement, thereby eliminating the uncertainty as to the actual sentence to be imposed.ⁿ¹¹ On a more personal level, pleading guilty can reduce the stress and expense associated with a trial. Finally, pleading guilty can help avoid a sentencing enhancement for obstruction of justice, a common occurrence for defendants who testify at trial and are later convicted.ⁿ¹²

To gain these potential benefits, defendants who plead guilty give up a number of constitutional rights. A guilty plea operates as a waiver of most non-jurisdictional constitutional rights and privileges, including the right to a jury trial, the

right to confront the accuser, and the privilege against self-incrimination. n13 A guilty plea also generally works as a waiver of non-jurisdictional defects committed by the government prior to entry of the plea of guilty, such as Speedy Trial Act violations, n14 illegal search and seizures, n15 coerced confessions, n16 improper grand jury selection, n17 entrapment, n18 and prosecutorial vindictiveness. n19

A guilty plea does not waive jurisdictional challenges to a conviction, such as lack of subject matter jurisdiction, n20 failure of the indictment to charge an offense, n21 claims the sentencing judge was biased, n22 claims that the indictment on its face violates double jeopardy, n23 and in some cases challenges to the constitutionality of the underlying statute. n24

To the extent that a defendant wishes to have an appellate court review the denial of a specified pretrial motion, the *Federal Rules of Criminal Procedure* allow for entry of conditional pleas. n25 Upon entry of a conditional plea, if the defendant enters a conditional plea and prevails on appeal, he or she may then withdraw the guilty plea. The entry of a conditional plea requires the consent of the court and the government.

The rights and obligations of the parties to a plea agreement are governed by ordinary contract law. n26 As such, in the absence of a global plea agreement expressly providing to the contrary, plea agreements in federal court typically bind only the United States Attorney's Office in the district in which the plea is entered. n27 In the event that a defendant breaches a plea agreement, the agreement can be revoked and the defendant can be re-charged even after sentencing. n28 On the other hand, if the government breaches a plea agreement, the court may permit a defendant to withdraw the guilty plea, n29 alter the sentence, n30 or grant specific performance to rectify the breach. n31

[3] Rule 11 Requirements for Entry of a Guilty Plea

Although there is no requirement, plea agreements are often reduced to writing and filed with the court. *Rule 11 of the Federal Rules of Criminal Procedure* only requires that plea agreements be disclosed in open court when the plea is offered, unless the court finds good cause to allow disclosure of the plea agreement in camera. n32 This disclosure can be accomplished orally.

Rule 11 sets forth requirements necessary to ensure that a defendant's guilty plea is made knowingly and voluntarily. To ensure that the plea is made "knowingly," the Court must advise the defendant in open court of the following:

- (1) the government's right, in a prosecution for perjury or false statement, to use against the defendant any statement made by the defendant under oath during the plea colloquy;
- (2) the right to plead not guilty, or having already so pleaded, to persist in that plea;
- (3) the right to a jury trial;
- (4) the right to be represented by counsel--and if necessary have the court appoint counsel--at trial and every other stage of the proceeding;
- (5) the right at trial to confront and cross-examine adverse witnesses, to be protected from compelled self-incrimination, to testify and present evidence, and to compel the attendance of witnesses;
- (6) the defendant's waiver of these trial rights if the court accepts a plea of guilty or *nolo contendere*;
- (7) the nature of each charge to which the defendant is pleading;
- (8) any maximum possible penalty, including imprisonment, fine, and terms of supervised release;

- (9) any mandatory minimum penalty;
- (10) any applicable forfeiture;
- (11) the court's authority to order restitution;
- (12) the court's obligation to impose a special assessment;
- (13) the court's obligation to apply the Sentencing Guidelines, and the court's discretion to depart from those guidelines under some circumstances; and
- (14) the terms of any plea agreement provision waiving the right to appeal or to collaterally attack the sentence. n33

To ensure that the plea is "voluntary," the court must establish through questioning of the defendant and counsel that the guilty plea is not the result of any threats, force or promises apart from those contained in the plea agreement. n34 The court will also typically inquire of the defendant and counsel whether there are any factors rendering the defendant incompetent to enter a knowing and voluntary plea, such as current drug or alcohol use or mental illness. Likewise, the court will typically specifically inquire as to whether a represented defendant believes he has received effective assistance of counsel from his lawyer and that the lawyer specifically reviewed the plea process and plea agreement with the defendant prior to the plea colloquy.

Rule 11 also requires that, before the court enters judgment on a guilty plea, it must determine that there is a factual basis for the plea. n35 Typically, written plea agreements will contain a detailed recitation by the defendant of the relevant facts satisfying each element of each offense and any relevant conduct. The court will require a recitation of these facts either by the defendant himself or by the prosecutor. If given by the prosecutor, the court will require a statement from the defendant that the factual recitation was accurate.

Finally, with respect to sentencing, for all pleas other than those governed by Rule 11(c)(1)(C), the court must advise the defendant in open court that all preliminary agreed upon guideline calculations and sentencing recommendations are not binding on the court. As such, a defendant will not have a right to withdraw from such a plea agreement if the court or probation officer does not agree with the guideline calculations or accept the parties' sentencing recommendations. n36 For pleas entered pursuant to Rule 11(c)(1)(C), the Court must inform the defendant if it intends to reject the plea agreement. Under these circumstances, the court must then inform the defendant that he or she may withdraw the plea of guilty and, if the defendant does not withdraw the guilty plea, that the court may dispose of the case less favorably toward the defendant than the plea agreement contemplated. n37

FOOTNOTES:

(n1)Footnote 1. *Weatherford v. Bursey*, 429 U.S. 545, 561 (1977) . However, once a prosecutor decides to conduct plea bargaining, the prosecutor must comply with Equal Protection requirements and cannot make plea bargaining decisions based on improper factors such as age, race or gender. *Bordenkircher v. Hayes*, 434 U.S. 357, 364 (1978) . Declined to be extended by *Erwin v. Woodford*, 2008 U.S. Dist. Lexis 31745 (E.D. Cal. April 16, 2008) .

(n2)Footnote 2. For a useful discussion of deferred prosecution and nonprosecution agreements, see F. Joseph Warin and Peter E. Jaffe, "Rolling the Dice in Corporate Fraud Prosecutions," 33 Litigation No. 3 at 12 (ABA Section of Litigation Spr. 2007).

(n3)Footnote 2.1. *Fed. R. Crim. P. 11(c)(1)*.

- (n4)Footnote 3. *Fed. R. Crim. P. 11(c)(3)-(5)*.
- (n5)Footnote 4. *373 U.S. 83 (1963)* .
- (n6)Footnote 5. *405 U.S. 150 (1972)* .
- (n7)Footnote 6. *United States v. Ruiz, 536 U.S. 622 (2002)* .
- (n8)Footnote 7. *Fed. R. Crim. P. 11(f); Fed. R. Evid. 410*.
- (n9)Footnote 8. *United States v. Lawson, 683 F.2d 688, 690-693 (2d Cir. 1982)* .
- (n10)Footnote 9. *18 U.S.C.S. Appx. § 3E1.1*.
- (n11)Footnote 10. *18 U.S.C.S. Appx.; 18 U.S.C.S. § 3553(e)*.
- (n12)Footnote 11. *Fed. R. Crim. P. 11(c)(1)(C)*.
- (n13)Footnote 12. *U.S.S.G. § 3C1.1*.
- (n14)Footnote 13. *Tollett v. Henderson, 411 U.S. 258, 267 (1973)* .
- (n15)Footnote 14. *Tiemens v. United States, 724 F.2d 928, 929 (11th Cir. 1984) (per curium)*.
- (n16)Footnote 15. *United States v. Arango, 966 F.2d 64, 66 (2d Cir. 1992)* .
- (n17)Footnote 16. *McMann v. Richardson, 397 U.S. 759, 768-771 (1970)* .
- (n18)Footnote 17. *Tollett v. Henderson, 411 U.S. 258, 266-267 (1973)* .
- (n19)Footnote 18. *United States v. Riles, 928 F.2d 339, 342 (10th Cir. 1991)* .
- (n20)Footnote 19. *United States v. Taylor, 814 F.2d 172, 174 (5th Cir. 1987)* .
- (n21)Footnote 20. *United States v. Kunzman, 125 F.3d 1363, 1365 (10th Cir. 1997)* , Superseded on other grounds by *U.S. v. Glover, 216 F.3d 1088 (10th Cir. June 9, 2000)* .
- (n22)Footnote 21. *United States v. Rivera, 879 F.2d 1247, 1251-1252 (5th Cir. 1989)* . Overruled on other grounds by *U.S. v. Pettigrew, 468 F.3d 626 (10th Cir., Oct. 12, 2006)* .
- (n23)Footnote 22. *United States v. Troxell, 887 F.2d 830, 833-834 (7th Cir. 1989)* .
- (n24)Footnote 23. *Menna v. New York, 423 U.S. 61, 62-63 n.2 (1975) (per curium)*.
- (n25)Footnote 24. *Menna, 423 U.S. at 62-63* .
- (n26)Footnote 25. *Fed. R. Crim. P. 11(a)(2)*.
- (n27)Footnote 26. *United States v. Clark, 55 F.3d 9, 12 (1st Cir. 1995)* .
- (n28)Footnote 27. *United States v. Russo, 801 F.2d 624, 626 (2d Cir. 1986)* .
- (n29)Footnote 28. *Ricketts v. Adamson, 483 U.S. 1, 9-12 (1987)* .
- (n30)Footnote 29. *United States v. Taylor, 77 F.3d 368, 372 (11th Cir. 1996)* .

(n31)Footnote 30. *United States v. Nolan-Cooper*, 155 F.3d 221, 236 (3d Cir. 1998) .

(n32)Footnote 31. *United States v. Carrero*, 77 F.3d 11 (1st Cir. 1996) .

(n33)Footnote 32. *Fed. R. Crim. P. 11(c)(2)*.

(n34)Footnote 33. *Fed. R. Crim. P. 11(b)(1)(A)-(N)*.

(n35)Footnote 34. *Fed. R. Crim. P. 11(b)(2)*.

(n36)Footnote 35. *Fed. R. Crim. P. 11(b)(3)*.

(n37)Footnote 36. *Fed. R. Crim. P. 11(c)(3)(B)*.

(n38)Footnote 37. *Fed. R. Crim. P. 11(c)(5)(C)*.



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.12

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§ 23.12 Sentencing

Following conviction, with extremely limited exceptions, the sentencing process begins with a presentence investigation conducted by the probation officer. n1 In connection with this investigation, the probation officer will attempt to interview the defendant to obtain the defendant's version of events and to assess subjective factors, such as the defendant's level of remorse. Defendants are not required to participate in an interview with the probation officer, but often do in an attempt to minimize the sentence imposed.

Upon completion of the investigation, the probation officer must submit to the court a Presentence Investigation Report (known as the "PSI" or "PSR"). n2 The PSR plays a critical role in the court's application of the United States Sentencing Guidelines and in the imposition of an appropriate sentence. The PSR must contain: (1) the history and characteristics of the defendant, including prior criminal history, financial condition, and any circumstances affecting the defendant's behavior that may be helpful in imposing sentence or in correctional treatment; (2) the impact of the crime on the victim; (3) the nature and extent of nonprison programs and resources available to the defendant; (4) information sufficient to arrive at an appropriate order of restitution; (5) the probation officer's calculation of the applicable sentencing guideline range, along with all factors relevant to determining the appropriate sentence within the guideline range and those which may warrant departure; and (6) any other information required by the court. n3

The PSR typically will be disclosed to the defense at least 35 days before sentencing, affording the defense an opportunity to object in writing to any findings or conclusions contained therein. n4 The probation officer is afforded the first opportunity to resolve any defense objections. n5 Any unresolved objections will be resolved by the court at or before sentencing. n6 In addressing these unresolved objections, the court may permit the parties to present witnesses and other evidence. n7 Facts considered by the court at sentencing must be proved only by a preponderance of the evidence, n8 and hearsay testimony is admissible at sentencing. n9

Before imposing a sentence, the court must ensure that the defendant and defense counsel have read and discussed the PSR. n10 The court must also allow defense counsel an opportunity to comment on the PSR and any other matters relating to an appropriate sentence. n11 Most critical to the sentencing process, the defendant has an absolute right to allocution. As such, the court must personally address the defendant prior to imposing sentence and inform the defendant that he or she may speak or present any information to mitigate the sentence. n12 The court may also allow

any victim to speak or submit information relative to sentencing, but is required to do so only for victims of crimes of violence or sexual abuse. n13

The statutory penalty for the offense of conviction provides the maximum term of imprisonment to be imposed at sentencing. To help courts determine the appropriate sentence in any particular case since November 1, 1987, courts were required to apply the United States Sentencing Guidelines. At the heart of the United States Sentencing Guidelines is a table used to determine each defendant's applicable guideline range of imprisonment. The table consists of 43 separate offense levels and six criminal history categories. The offense level is determined based on application of guideline sections relating to the conduct at issue. Every guideline section starts with a base offense level and points are added and subtracted based on specific offense criteria, such as the loss resulting from the offense. The offense level is further refined based on general adjustments for, among other factors, a defendant's acceptance of responsibility for his or her conduct or for acts of obstruction of justice. After determining the total offense level, the court will determine the defendant's criminal history category based on the nature and number of defendant's prior criminal offenses. Based on the total offense level and the criminal history category, the table will produce a sentencing range applicable to the defendant. Unless the court finds that the case includes an aggravating or mitigating factor not adequately considered by the United States Sentencing Guidelines or the government moves for departure based on the defendant's substantial cooperation, the court must impose a sentence within the applicable guideline range.

However, since 2005, the federal sentencing guidelines have been reduced to mere advisory status. In *United States v. Booker* and *United States v. Fanfan*, n14 the United States Supreme Court struck down the 17-year old federal sentencing guidelines, reducing them to advisory rather than mandatory status. By a 5-4 vote (Justice Stevens, joined by Justices Scalia, Thomas, Souter, and Ginsburg), the Court applied the *Sixth Amendment* analysis advanced in *Blakely v. Washington*, n15 to the federal sentencing guidelines. In *Blakely*, the Court held that Washington's sentencing guidelines violated the defendant's *Sixth Amendment* right to a jury trial because the judge increased his sentence with evidence not presented to the jury, and based on a "preponderance" rather than "beyond a reasonable doubt" evidentiary standard.

The Court's ruling in *Booker/Fanfan* held that because the federal sentencing guidelines scheme was mandatory, and included enhancement procedures indistinguishable from those declared unconstitutional in *Blakely*, the federal guidelines were equally unconstitutional. Justice Breyer, joined by the other three dissenters and Justice Ginsburg, said that the correct remedy was to declare unconstitutional the provisions that made the guidelines mandatory, leaving the rest of the system intact. As a consequence, the federal sentencing guidelines are now "advisory."

Amendments made in 2007 to the Federal Rules of Criminal Procedure codify the Supreme Court's holdings in *Booker/Fanfan*. The amended Rule 32(d) describes the federal sentencing guidelines as "advisory" and authorizes deviation from the applicable sentencing range. While judges are still required to calculate a sentence under the guidelines as a starting point, they may offer some reasoned basis for declining to apply the suggested sentence. n16

Previously, Congress, in legislation known as the PROTECT Act (Prosecutorial Remedies and Other Tools to End the Exploitation of Children Today Act of 2003), enacted a provision expressly designed to greatly inhibit federal judges from sentencing below the applicable sentencing guidelines. n17 It provided that, for child crimes and sexual offenses, a court could only base a downward departure from the guidelines on aggravating or mitigating circumstances not adequately taken into consideration in the guidelines. A court should determine whether a circumstance was adequately taken into account only by examining sentencing guidelines, policy statements, and official commentary of the Sentencing Commission, together with any statutory amendments. By prohibiting the consideration of other information, the PROTECT Act significantly restricts the authority of federal judges to depart downward on a sentence.

Also, pursuant to the direction of the PROTECT Act, former Attorney General Ashcroft issued a memorandum to all prosecutors on July 28, 2003, n18 outlining new DOJ policies with respect to downward departures, providing that prosecutors should not "acquiesce" to departures, and when a judge does downwardly depart from a guidelines

sentence, requiring the prosecutor to report the departure to DOJ within 14 days. It is a provision widely interpreted by the judiciary and the government as a means of further limiting the discretion of federal judges. So, despite the advisory status of the federal sentencing guidelines, they still have much authority over the sentencing process.

Since 2003, the guidelines have provided for the heightened punishment of white collar criminals. The guidelines define significant sentence enhancements for white collar offenses that affect a large number of victims or endanger the solvency or financial security of publicly traded corporations, other large employers, or 100 individual victims. Officers and directors of publicly traded corporations who commit securities violations are targeted for particularly substantial increases in penalties. For example, an officer of a publicly traded corporation who defrauds more than 250 employees or investors of more than \$1 million will receive a sentence of more than 10 years in prison (121-151 months). Moreover, the guidelines limit the availability of probation to offenses involving losses of \$10,000 or less.ⁿ¹⁹ The intended result of the 2003 amendments that implemented these tougher guidelines is for more white collar defendants to go to jail and for much longer terms.

Note that there is no parole from a federal prison. Federal prisoners receive only 54 days of good-time credit per year beginning in the second year of confinement for complying with institutional regulations.ⁿ²⁰ In other words, federal prisoners must serve 100% of the first year of confinement and 85% of the remaining term.

Where a defendant serves his or her term is dependent on several factors, the most important of which are the crime, the length of the sentence, and the background and history of the defendant. The Bureau of Prisons determines where a defendant is placed in the federal prison system, which is grouped into five security levels: minimum, low, medium, high, and administrative. Early involvement in the process, well before sentencing, is critical to proper placement for a white collar defendant.

FOOTNOTES:

(n1)Footnote 1. *Fed. R. Crim. P. 32(c)(1)*.

(n2)Footnote 2. *Fed. R. Crim. P. 32(c)(1)*.

(n3)Footnote 3. *Fed. R. Crim. P. 32(d)*.

(n4)Footnote 4. *Fed. R. Crim. P. 32(e) and (f)*.

(n5)Footnote 5. *Fed. R. Crim. P. 32(f)(3)*.

(n6)Footnote 6. *Fed. R. Crim. P. 32(i)(3)*.

(n7)Footnote 7. *Fed. R. Crim. P. 32(i)(2)*.

(n8)Footnote 8. *See United States v. Watts, 117 S. Ct. 633, 638 (1997)*.

(n9)Footnote 9. *18 U.S.C.S. Appx., § 6A1.3*.

(n10)Footnote 10. *Fed. R. Crim. P. 32(i)(A)*.

(n11)Footnote 11. *Fed. R. Crim. P. 32(i)(C)*.

(n12)Footnote 12. *Fed. R. Crim. P. 32(i)(4)(A)*.

(n13)Footnote 13. *Fed. R. Crim. P. 32(i)(4)(B)*.

(n14)Footnote 14. *125 S. Ct. 738 (2005), as amended*.

(n15)Footnote 15. *124 S. Ct. 2531 (2004)* .

(n16)Footnote 16. *FED. R. CRIM. P. 32(d)*.

(n17)Footnote 17. *See generally* Pub. L. 108-21, Section 401.

(n18)Footnote 18. *Available at:* news.findlaw.com/hdocs/docs/doj/ashcroft92203chrgmem.pdf.

(n19)Footnote 19. *U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)* (2008).

(n20)Footnote 20. *18 U.S.C.S. § 3624(b)*. Amended in 2008 on other points; §§ (c) and (e).



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.13

AUTHOR: Scott L. Fredericksen

§ 23.13 Collateral Consequences of Conviction

Defendants convicted of federal felony securities violations face consequences that extend beyond imprisonment and fine. There are a number of collateral consequences to a felony conviction. First, a convicted felon may be ineligible to vote. State laws providing for restoration of civil rights will govern if and when a felon may vote. Second, convicted felons may not possess firearms. n1 Resident aliens additionally face deportation upon conviction of "aggravated felonies," which include money laundering, felony theft, tax evasion, and any offense that involves fraud or deceit. n2

Moreover, a felony securities fraud violation brings a number of occupational restrictions. For instance, Section 9(a) of the Investment Advisers Act prohibits firms and its affiliates from serving as investment advisors and in other related positions if convicted for any of a wide variety of securities violations. Likewise, both the 1933 Act and the 1934 Act have been amended by Sarbanes-Oxley to authorize the SEC to enter orders prohibiting persons who have committed securities violations from serving as officers or directors of issuers. n3 Following a conviction, there are also statutory bars on holding certain positions in labor organizations n4 and from engaging in the insurance business. n5

FOOTNOTES:

(n1)Footnote 1. *18 U.S.C.S. § 922(g)(1)*.

(n2)Footnote 2. *8 U.S.C.S. § 1101(a)(43)*.

(n3)Footnote 3. *15 U.S.C.S. § 78u-3(f); 15 U.S.C.S. § 77h-1(f)*.

(n4)Footnote 4. *29 U.S.C.S. § 504*.

(n5)Footnote 5. *18 U.S.C.S. § 1033(e)(1)*.



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CHAPTER 23 CRIMINAL PROSECUTIONS

2-23 Securities Enforcement: Counseling and Defense § 23.14

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§ 23.14 Parallel Proceedings

It is increasingly common for individuals and companies to be targets of a criminal investigation at the same time that they are undergoing an SEC investigation or enforcement action. Simultaneous SEC and criminal investigations or enforcement actions can impose substantial challenges on an individual or company. Although it is almost always prudent for the target of a criminal investigation to assert the *Fifth Amendment* right against self-incrimination, the invocation of that privilege can pose substantial difficulties in the context of an SEC investigation or enforcement action. The defense of an SEC investigation or enforcement action can also adversely impact the defense of a criminal investigation or prosecution by revealing the defendant's defense strategies. Moreover, the defense of a criminal or SEC investigation or enforcement action can require substantial commitments of time and other resources, making it difficult for an individual or company to devote adequate resources to simultaneous matters. Furthermore, certain materials that are arguably discoverable in an SEC investigation or enforcement action may not be discoverable under the Federal Rules of Criminal Procedure. Yet, on the other hand, an SEC enforcement action can provide an opportunity for the defendant to take discovery in the SEC enforcement action that will assist in the defense of the criminal prosecution.

[1] Sharing of Information

The SEC and the DOJ tend to consult with each other when conducting parallel investigations or actions. In addition, the SEC tends to share with criminal prosecutors all of the testimony, documents and other information that it obtained in an investigation. In conducting grand jury investigations, the DOJ may be less forthcoming in sharing documents, testimony and information than the SEC.

[2] Stay or Dismissal of SEC Proceeding

There is no *per se* rule forbidding the SEC and the DOJ from pursuing simultaneous investigations or enforcement actions into the same transactions. n1 As the Fifth Circuit has explained:

There is no general federal constitutional, statutory, or common law rule barring the simultaneous prosecution of separate civil and criminal actions by different federal agencies against the same defendant involving the same transactions. Parallel civil and criminal proceedings instituted by different federal agencies are not uncommon occurrences because of the overlapping nature of federal civil and

penal laws. The simultaneous prosecution of civil and criminal actions is generally unobjectionable because the federal government is entitled to vindicate the different interests promoted by different regulatory provisions even though it attempts to vindicate several interests simultaneously in different forums. The Supreme Court recognized that the federal government may pursue civil and criminal actions either "simultaneously or successively" in 1912 in *Standard Sanitary Manufacturing Co. v. United States*, 226 U.S. 20, 52, 33 S. Ct. 9, 16, 57 L.Ed. 107 and reaffirmed this principle in 1970 in *United States v. Kordel*, 397 U.S. 1, 11, 90 S. Ct. 763, 769, 25 L.Ed.2d 1. In both cases, the Supreme Court observed that prompt investigation and enforcement both civilly and criminally were sometimes necessary in order to protect the public interest and that deferring or foregoing either civil or criminal prosecutions could jeopardize that interest. Accordingly, the Supreme Court declined to create a per se rule forbidding simultaneous civil and criminal actions to enforce the antitrust and food and drug laws at issue in *Standard Sanitary Manufacturing Co.* and *Kordel*. n2

In the leading case addressing parallel SEC and criminal investigations, the D.C. Circuit provided a useful summary of the law regarding the stay of parallel proceedings:

The Constitution ... does not ordinarily require a stay of civil proceedings pending the outcome of criminal proceedings. See *Baxter v. Palmigiano*, 425 U.S. 308, 96 S. Ct. 1551, 47 L.Ed.2d 810 (1976) ; Declined to extend by *Evans v. City of Chicago*, 513 F.3d 735 (7th Cir. 2008) . *DeVita v. Sills*, 422 F.2d 1172, 1181 (3d Cir. 1970) . Nevertheless, a court may decide in its discretion to stay civil proceedings, postpone civil discovery, or impose protective orders and conditions "when the interests of justice seem() to require such action, sometimes at the request of the prosecution, * * * sometimes at the request of the defense(.)" *United States v. Kordel*, above, 397 U.S. at 12 n.27, 90 S. Ct. at 770 (citations omitted); see *Horne Brothers, Inc. v. Laird*, 463 F.2d 1268, 1271-1272 (D.C. Cir. 1972) . The court must make such determinations in the light of the particular circumstances of the case.

Other than where there is specific evidence of agency bad faith or malicious governmental tactics, the strongest case for deferring civil proceedings until after completion of criminal proceedings is where a party under indictment for a serious offense is required to defend a civil or administrative action involving the same matter. The noncriminal proceeding, if not deferred, might undermine the party's *Fifth Amendment* privilege against self-incrimination, expand rights of criminal discovery beyond the limits of *Federal Rule of Criminal Procedure 16(b)*, expose the basis of the defense to the prosecution in advance of criminal trial, or otherwise prejudice the case. [FN 20] If delay of the noncriminal proceeding would not seriously injure the public interest, a court may be justified in deferring it. See, e.g., *United States v. Henry*, 491 F.2d 702 (6th Cir. 1974) ; *Texaco, Inc. v. Borda*, 383 F.2d 607, 608-609 (3d Cir. 1967) ; *Silver v. McCamey*, 221 F.2d 873, 874-875 (D.C. Cir. 1955). [footnote 21 omitted] Such cases have frequently arisen in the tax field, following the leading case of *United States v. O'Connor*, 118 F. Supp. 248 (D. Mass. 1953) . Cf. *Boren v. Tucker*, 239 F.2d 767, 772-773 (9th Cir. 1956) (distinguishing IRS summons enforcement before and after indictment). In some such cases, however, the courts may adequately protect the government and the private party by merely deferring civil discovery or entering an appropriate protective order. *Gordon v. FDIC*, 427 F.2d 578, 580-581 (D.C. Cir. 1970) .

FN20. In some cases the government seeks postponement of the noncriminal proceeding, to prevent the criminal defendant from broadening his rights of criminal discovery against the government. E.g., *Campbell v. Eastland*, 307 F.2d 478 (5th Cir. 1962) , cert. denied, 371 U.S. 955, 83 S. Ct. 502, 9 L.Ed.2d 502 (1963) . n3

Although it is common for the SEC and the DOJ to coordinate parallel investigations (and SEC attorneys and federal prosecutors often conduct joint interviews), at least one court has held that there are limits on the extent to which simultaneous investigations properly can be coordinated. In a high-profile prosecution of the former CEO of

HealthSouth, a court barred federal criminal prosecutors from introducing into evidence a transcript of the defendant's SEC testimony. The court found that the SEC did not notify the defendant that the Office of the United States Attorney was conducting a criminal investigation of which the defendant was a target even though the SEC had asked certain questions because of input from the Office of the U.S. Attorney and had moved its testimony in order to accommodate the Office of the U.S. Attorney. n4 The court reasoned that the "commingling" negated the existence of parallel investigations and that the Government's "manipulation" of the simultaneous investigations for its own purposes "departs from the proper administration of justice." n5 It is possible that the court's ruling was influenced by its conclusion that the Government had misrepresented certain key facts to the court, and the implications of the ruling are unclear. The ruling, nevertheless, indicates that there are limits on the extent to which the SEC and criminal prosecutors properly can coordinate their simultaneous investigations.

In 2003, in a related case, the United States District Court for the Northern District of Alabama held a hearing on a motion by the SEC to freeze the assets of the former CEO of HealthSouth. The court's opinion on that motion expresses concern about repeated attempts by the SEC to introduce evidence elicited by criminal prosecutors from certain witnesses. Those witnesses had entered into plea bargains with the criminal prosecutors but declined to respond to questions posed by defense counsel, asserting the *Fifth Amendment* right against self incrimination. n6 These concerns led the court to stay the SEC's action pending resolution of the criminal investigation. The court reached the conclusion to stay SEC proceedings by weighing: the extent to which the defendant's *Fifth Amendment* rights were implicated; the interest of the plaintiff in proceeding expeditiously with the litigation; the potential prejudice to the plaintiffs from delay; the burden any particular aspect of the proceedings might impose on the defendant; the efficient use of judicial resources; the interests of persons not parties to the civil litigation; the interest of the public in the pending civil and criminal litigation; the status of the case, including whether the defendant had been indicted; and the extent to which the issues in the criminal and civil cases overlapped. The court found this factor to be "the most important threshold issue" in determining whether stay was appropriate. The court found that the criminal and civil cases overlapped completely, since the subject matters of each action were directly related. The opinion explained that the situation required heightened attention to constitutional concerns:

Because this is a case where the government has undoubtedly manipulated simultaneous criminal and civil proceedings, both of which it controls, "there is a special danger that the government can effectively undermine rights that would exist in a criminal investigation by conducting a de facto criminal investigation using nominally civil means. In that special situation the risk to individuals' constitutional rights is arguably magnified." *Sterling National Bank, 175 F. Supp. 2d at 579* . n7

The court went on to find that both the SEC and the defendant would benefit from a stay of proceedings until all those who pled guilty had been sentenced, and thus could no longer plead *Fifth Amendment* protections. n8

There are a number of other unpublished opinions in which courts have stayed or dismissed SEC enforcement actions in light of parallel criminal proceedings.

FOOTNOTES:

(n1)Footnote 1. *Standard Sanitary Mfg. Co. v. United States*, 226 U.S. 20 (1912) ; *United States v. Kordel*, 397 U.S. 1 (1970) ; *SEC v. First Fin. Group of Tex.*, 659 F.2d 660, 666-668 (5th Cir. 1981) ; *SEC v. Dresser Indus.*, 628 F.2d 1368 (D.C. Cir. 1981) (en banc).

(n2)Footnote 2. *SEC v. First Financial Group*, 659 F.2d 660, 666-667 (5th Cir. 1981) (footnotes omitted) ("declin(ing) to create any per se rule forbidding the SEC and Justice Departments from pursuing simultaneous investigations or lawsuits into the same transactions allegedly in violation of the federal securities law").

(n3)Footnote 3. *SEC v. Dresser Indus., Inc.*, 628 F.2d 1368, 1375-1376 (D.C. Cir. 1980) .

(n4)Footnote 4. *United States v. Scrushy*, 366 F. Supp. 2d 1134 (N.D. Ala. 2005) .

(n5)Footnote 5. *Scrushy*, 366 F. Supp. 2d at 1135-1140 .

(n6)Footnote 6. *SEC v. HealthSouth Corp.*, 261 F. Supp. 2d 1298 (N.D. Ala. 2003) , vacated on other grounds, *Livesay v. U.S.*, 128 S. Ct. 872 (2008) .

(n7)Footnote 7. *HealthSouth Corp.* 261 F.Supp.2d at 1326.

(n8)Footnote 8. *HealthSouth Corp.*, 261 F.Supp.2d at 1327.



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CHAPTER 24 NASDAQ COMPLIANCE MATTERS

2-24 Securities Enforcement: Counseling and Defense 24.syn

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§ 24.syn Synopsis to Chapter 24: NASDAQ COMPLIANCE MATTERS

§ 24.01 Introduction

§ 24.02 NASDAQ Listing Standards

§ 24.03 Staff Deficiency and Staff Determination Notices

§ 24.04 Appeals Process

Jason S. Frankl n*

FOOTNOTES:

(n1)Footnote *. Jason S. Frankl is Senior Managing Director with FTI Consulting, Inc. ("FTI"), and is based in Washington, DC. Prior to joining FTI, from 1998 through 2004, Mr. Frankl served in escalating positions with NASDAQ's Listing Qualifications department. The views expressed in this article are solely the views of the author, who is responsible for all content, and are not necessarily those of FTI.



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CHAPTER 24 NASDAQ COMPLIANCE MATTERS

2-24 Securities Enforcement: Counseling and Defense § 24.01

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§ 24.01 Introduction

In late-2008 and early-2009, the Staff of the Listing Qualifications Department and the General Counsel's Office of the NASDAQ Stock Market, Inc. ("NASDAQ") completed a significant initiative to review all of the rules and interpretive materials relating to the initial and continued listing requirements, along with related, unpublished internal policies. The output of these efforts led to significant changes to the procedures by which NASDAQ adjudicates issuers that do not satisfy all initial inclusion requirements, and are therefore denied listing, and to the procedures by which it adjudicates existing issuers that do not satisfy its "maintenance standards" and therefore become subject to suspension and delisting from NASDAQ.

This initiative generally shifted more discretion to the NASDAQ Staff immediately after an issuer fails to satisfy one or more NASDAQ listing criteria. It also delayed the process by which an issuer faces the threat of delisting, subsequent to which the issuer has the opportunity to receive an independent review by a NASDAQ Hearings Panel (the "Panel"). NASDAQ also extended certain grace periods that are automatically afforded to issuers before being required to address the facts and circumstances underlying a new deficiency with the NASDAQ Staff.

In general, the recent changes are issuer friendly and provide the issuer's officers, directors and advisors with additional time to address the deficiency or delinquency before becoming subject to delisting. This can enable the issuer and its advisors to formulate a more detailed plan to present to NASDAQ to cure the underlying issue(s).

The benefits to investors are somewhat mixed. On one hand, management has more time to cure the underlying issue(s) before the threat of delisting occurs, improving the likelihood that the enhanced liquidity to the securities afforded by the exchange will remain intact. On the other hand, a delay in regulatory scrutiny can detract from the value of that regulation.



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CHAPTER 24 NASDAQ COMPLIANCE MATTERS

2-24 Securities Enforcement: Counseling and Defense § 24.02

AUTHOR: Jason S. Frankl

§ 24.02 NASDAQ Listing Standards

NASDAQ's listing rules enable NASDAQ to suspend or terminate the listing of securities of issuers that fail to maintain compliance with the continued listing standards. In 1975, the Securities and Exchange Commission (the "SEC") explained the rationale behind allowing NASDAQ to delist a security even though such action could injure shareholders of the delisted security:

Though exclusion from the system may hurt existing investors, primary emphasis must be placed on the interests of prospective future investors. The latter group is entitled to assume that the securities in the system meet the system's standards. Hence, the presence in NASDAQ of non-complying securities could have a serious deceptive effect. n1

Listing requirements for The NASDAQ Global Select MarketTM, The NASDAQ Global MarketTM and The NASDAQ Capital MarketTM now reside in the 5000 Series of NASDAQ's Listing Rules. n2 NASDAQ has established initial listing standards for issuers desiring to list their securities on The NASDAQ Stock Market. Once listed, the issuer is then subject to continued listing or "maintenance" requirements. The quantitative initial listing standards for each market are generally greater than the continued listing standards for each of the three markets, and the quantitative standards for the Global Select and Global Markets are generally more stringent than those applicable to the Capital Market. The corporate governance standards for all three markets are essentially identical.

Quantitative listing standards generally include the following: a minimum bid price of the shares; a minimum number of shares in the public float; a minimum value of shares in the public float; a minimum number of round lot shareholders; n3 a minimum number of registered and active market makers for the securities; and a minimum amount of stockholders' equity or an alternative listing criteria (such as market value of listed securities, a minimum amount of net income from continued operations or a minimum amount of total assets and total revenue). While the text of some Listing Rules can be cumbersome, NASDAQ has distilled its quantitative listing standards for the Global Select, Global and Capital Markets, as well as the corresponding fees for each market, into several useful charts that can be located at http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf.

NASDAQ's corporate governance rules can be generally categorized into three areas: (1) rules that pertain to the

composition of the board of directors, its underlying committees, and how the board and its committees are expected to function; (2) rules dictating when shareholder approval is required for several types of capital raising transactions; and (3) voting rights rules associated with outstanding and newly issued securities.

Collectively and individually, NASDAQ's corporate governance rules involve far greater nuance and lend themselves to interpretation more so than the quantitative criteria for each of the three NASDAQ markets. Given this level of nuance and interpretation, NASDAQ has a process by which an issuer may also formally request a corporate governance interpretation letter from NASDAQ, which is available only upon a written request by the issuer that includes a detailed description of the proposed transaction(s) or arrangement(s). n4

The vast majority of these interpretive letters involve the definition of what constitutes an "independent director" under NASDAQ's rules, the application of shareholder approval requirements involving the issuance of equity securities or securities potentially convertible into equity securities, and permissible voting rights associated with newly issued equity securities and securities that are potentially convertible into equity securities. In an effort to provide greater transparency in the application of its corporate governance rules, NASDAQ posts answers to frequently asked questions and summaries of corporate governance interpretation letters on its website, which can be located at <http://www.nasdaq.com/about/StaffInterpLetters.stm>.

Finally, NASDAQ has broad discretionary authority to deny listing or initiate delisting procedures against an issuer based upon "public interest concerns". More specifically, Listing Rule 5100 and Interpretive Material ("IM") 5100-1 discusses that authority, including a nonexclusive list of circumstances that may trigger the use of this discretion. Rule 5100 and IM-5100-1 enables NASDAQ to deny or terminate a listing if NASDAQ deems it necessary to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, or to protect investors and the public interest. In short, NASDAQ has broad discretion to deny initial inclusion or apply additional or more stringent listing criteria for continued inclusion based upon any event, condition or circumstance which exists or occurs that makes listing inadvisable or unwarranted in the opinion of NASDAQ. It should be noted that NASDAQ does not exercise this discretion with much frequency.

FOOTNOTES:

(n1)Footnote 1. *In re Tassaway, Inc., Exch. Act Rel. No. 11,291, 1975 SEC LEXIS 2057, *6* (March 13, 1975) .

(n2)Footnote 2. NASDAQ's 5000 Rule Series is available at: [http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F2=%2Fnasdaq%2Fmain%](http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F2=%2Fnasdaq%2Fmain%2F) A "round lot" is defined as 100 shares or more.

(n3)Footnote 3. A "round lot" is defined as 100 shares or more.

(n4)Footnote 4. NASDAQ charges issuers \$5,000 for written corporate governance interpretation letters with a response time of within four weeks from the date of the request and \$15,000 for an expedited letter with a response time as designated by the issuer that is not less than one week but not greater than four weeks from the date of the request. NASDAQ has posted summaries to over 250 interpretive letters dating back to 2002, which can be helpful for issuers and advisors to comply with NASDAQ's corporate governance standards.



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CHAPTER 24 NASDAQ COMPLIANCE MATTERS

2-24 Securities Enforcement: Counseling and Defense § 24.03

AUTHOR: Jason S. Frankl

§ 24.03 Staff Deficiency and Staff Determination Notices

The NASDAQ Listing Qualifications Department monitors each issuer's compliance with applicable listing standards on every trading day. NASDAQ views the enforcement of its listing standards as necessary to preserve and enhance the value of the listing. To carry-out these responsibilities, every NASDAQ listed entity is assigned a qualifications analyst who is responsible for monitoring that issuer's compliance with all continued listing requirements. When an analyst identifies one or more deficiencies or delinquencies, they will promptly notify the designated issuer representative and will explain the consequences.

If the Listing Qualifications Department determines that an issuer is not in compliance with a particular maintenance standard, it will notify the issuer of the deficiency by letter (referred to as a "Staff Deficiency letter"). The Staff Deficiency letter may invite the issuer to submit a plan of compliance to regain compliance with the standard cited. Depending on the type of deficiency, the issuer may be granted an automatic grace period that is specified by rule (such as for failure to maintain a minimum bid price of \$1.00 per share, which then affords the issuer at least one 180 calendar day grace period to regain compliance with that requirement), the issuer may be afforded a 60-day period to submit a plan of compliance which, once the NASDAQ Staff reviews, they may grant an extension of up to 180 days from the date of the delinquency (such as for a late SEC periodic public filing), or the issuer may be granted no time whatsoever (such as for a bankruptcy filing), in which case the NASDAQ Staff would forego sending a Staff Deficiency letter and will simply send a Staff Determination letter, triggering the delisting process.

In situations whereby the rules afford the issuer a period of time to submit a plan to the NASDAQ Staff (such as a filing delinquency or a stockholders' equity deficiency), the NASDAQ Staff will review the issuer's plan and may ask follow-up questions. If the NASDAQ Staff accepts the plan, they may grant an exception of up to 180 days from the date of the deficiency/delinquency. If the analyst determines that the plan is insufficient to achieve and sustain compliance with all continued listing standards, or cannot be fully implemented within a reasonable period of time, no Staff extension will be provided. In that case, the analyst will send a Staff Determination letter to the issuer, notifying the issuer that its securities will be suspended and subsequently delisted from NASDAQ in approximately one week from the date the Staff Determination letter is received, unless a hearing is requested. The same will occur should the issuer fails to comply with the rule(s) cited by the end of an exception period granted by the NASDAQ Staff.

Comment

If an issuer is cited for a quantitative deficiency, it may apply to transfer its listing to the NASDAQ Global or Capital Market, which generally have less stringent quantitative standards. To facilitate a transfer, the issuer must satisfy all quantitative *maintenance* requirements and pay the applicable fees in connection with the transfer. Initiation of delisting proceedings will be stayed, pending the analyst's review of the transfer application.



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CHAPTER 24 NASDAQ COMPLIANCE MATTERS

*2-24 Securities Enforcement: Counseling and Defense § 24.04***AUTHOR:** Jason S. Frankl**§ 24.04 Appeals Process**

An issuer may request a hearing before a Panel to appeal a Staff Determination. The cost for an oral hearing is \$5,000. The cost for a hearing based upon a written submission is \$4,000. Listing Rule 5810(b) requires the issuer to disseminate a press release as soon as possible, but not more than four business days after receipt of the Staff Determination, announcing the receipt of the letter, the deficiency(ies)/delinquency(ies) cited therein and the corresponding rule number(s). This event also requires the issuer to file a Current Report on Form 8-K with the SEC disclosing the same. In most cases, the hearing request serves to stay the delisting pending the Panel's decision and need not contain the issuer's plan of compliance or its arguments in favor of continued listing.

Hearings are typically scheduled within 30 to 45 days of the request. Although historically issuers cited for being delinquent in filing periodic public reports with the SEC or for a bankruptcy filing were scheduled for a hearing on an expedited basis (generally within three weeks of the hearing request), in practice this no longer appears to be the case. Companies are typically docketed based upon the first available hearing slot.

Upon receipt of the hearing request, NASDAQ will send an acknowledgement letter specifying the date and time of the hearing, which has historically been held in Washington, DC. Hearings are scheduled for one hour. Although the Panel members may extend the length of the hearing at their discretion, in practice this seldom occurs. The acknowledgement letter will also provide dates by which the issuer must submit its pre-hearing submission, which must include its arguments in support of continued listing, as well as a summary of all of its Current Reports on Form 8-K filed with the SEC since its last Annual Report was filed with the SEC, and the names and biographies of the individuals attending the hearing.

The pre-hearing submission is due approximately three weeks prior to the hearing date so as to afford the qualifications analyst an opportunity to evaluate the plan. One week before the hearing, NASDAQ will provide the issuer with a copy of an opening statement, a memorandum prepared by the qualifications analyst, a financial worksheet summarizing relevant financial and market information, and the identities, including a biography, of each Panel member. The memorandum will set forth, among other things, the deficiencies/delinquencies cited, a summary of the issuer's plan of compliance, a brief analysis of that plan and a recommendation to the Panel. It will also indicate whether the issuer is eligible for quotation on the OTC Bulletin Board in the event of a delisting. Additionally, the hearing memorandum will

note whether the issuer is eligible to transfer its listing to another NASDAQ market.

Hearings are held in a conference room setting and a transcript is kept. The hearing process is somewhat informal to the extent that issuers are free to determine who will attend and how to present their position in support of continued listing. It is common and appropriate for issuers to be represented by one or more members of senior management, although many issuers also choose to be represented by board or audit committee members and/or outside advisors. Hearings are not subject to formal evidentiary rules.

Panels are comprised of two individuals, each of whom is independent of NASDAQ and designated by the NASDAQ Board to make listing determinations on behalf of NASDAQ. The pool of Panel members include current and former officers and directors of publicly held entities, lawyers, academics, accountants, investment bankers and other members of the business community. Also present will be an attorney from the NASDAQ Hearings Department who will facilitate the hearing and serve as an advisor to the Panel. There is a procedure to involve a third Panel member in the event that consensus cannot be reached by the two sitting Panel members; however, this procedure is seldom if ever utilized.

While the NASDAQ Staff members who initiate the delisting process via a Staff Determination letter may appear and make a presentation to the Panel, they typically waive this right. In such cases, the NASDAQ Staff's only communication to the Panel is through the hearing memorandum. It is NASDAQ's practice not to disclose any information relating to the hearing to any party not designated by the issuer, subject to being compelled by a subpoena or a request by another regulatory entity--namely the SEC. Hearings are not open to the public.

Comment

In certain situations, an issuer may be able to remedy the deficiency prior to the hearing. For example, if a shareholders' equity deficiency is the sole deficiency cited, an issuer may complete a private placement of equity securities that enables it to achieve compliance with the shareholders' equity requirement. In that case, NASDAQ would require that the issuer demonstrate its ability to satisfy the relevant standard via a public filing with the SEC. If the qualifications analyst agrees that the transaction is sufficient to enable the issuer to achieve and sustain compliance with the shareholders' equity standard over the long term, the hearing may be deemed moot.

At the outset of a hearing, the NASDAQ attorney will ask each Panel member to introduce themselves and will then discuss various administrative matters, including appeal rights, as more fully discussed below. The issuer representatives are then invited to make their presentation. It is important to note that the presentation should include specific, near term steps that will enable the issuer to satisfy the NASDAQ requirement(s) at issue. It is advisable for the issuer to substantiate its plan with documentation wherever possible. For example, an issuer seeking to remedy a shareholders' equity deficiency may attempt to complete a private placement in an effort to satisfy that requirement in the near and long term. In order to substantiate the plan, the issuer may present an unexecuted term sheet for the private placement along with a list of possible investors. The issuer should also provide financial projections demonstrating its ability to sustain compliance with the minimum equity standard, particularly if it has experienced recent operating losses.

An issuer with a bid price deficiency should provide a plan that sets forth a timetable for obtaining shareholder approval for a reverse stock split. Plans to remedy the bid price or any other market value-based deficiency must be based on an action within the issuers' control and may not be based upon expected market reaction to future events or circumstances. It is not uncommon for a hearing to become a fairly free-flowing discussion between the Panel and the issuer representatives. While there can be a tendency on the part of an issuer representatives to explain the corporate history in detail and the benefits of its products or services, only a brief background summary is necessary. The representative's time is far better spent discussing how the deficiency or delinquency arose and by providing information that will

demonstrate its ability to achieve compliance with all continued listing requirements in the near term, and to sustain compliance with those requirements over the long term. It is critical that the issuer clearly outlines the steps necessary to fully implement the plan, including specific benchmarks and anticipated timing for completion.

In the case of a issuer that has been cited for failure to comply with NASDAQ's filing requirement (due to a failure to timely file a periodic public filing with the SEC), a Panel will expect the issuer to provide details of the events that led to the late filing, the near term steps being taken to resolve the underlying problem(s) and an expected date for filing the delinquent report. In the case of a restatement, the Panel will expect the issuer to provide the results of any investigation into the matter and describe all remedial measures instituted in response. A Panel decision is typically issued within 30 days of the hearing date. The decision is based on the information provided to the Panel by the issuer and the qualifications analyst, the issuer's public filings, press releases and the issuer's trading data. The Panel may decide to provide the issuer with an exception to one or more listing criteria requirements, which will be specifically set forth in the decision along with dates by which certain actions must occur. The Panel may also determine to delist the issuer's securities from NASDAQ or to transfer the listing to another NASDAQ market. If the Panel decides to delist the issuer's securities, suspension of the securities will typically occur on the morning of the second business day subsequent to the date of the Panel's decision. In the event of a decision to transfer a listing to another NASDAQ Market, the transfer will typically occur on the morning of the third trading day subsequent to the date of the Panel's decision. In this case, the issuer will be directed to immediately contact the qualifications analyst to file the necessary listing application and pay all applicable fees if it has not done so already.

The Listing Council is an independent body comprised of individuals who are appointed to this position by the NASDAQ Board. No Listing Council and Panel members overlap at the same time. Listing Council member backgrounds include current and former officers and directors of publicly held entities, lawyers, accountants, academics, investment bankers and other members of the business community. In contrast to a request for a Panel hearing, neither an appeal to the Listing Council nor a call for review by the Listing Council on its own motion will automatically stay a Panel decision.

Comment

Listing Rule 5820(a), which permits issuers to request an appeal of any Panel decision to the Listing Council, specifically notes that an appeal will not operate as a stay of a Panel decision. Matters before the Listing Council are usually conducted in writing. In contrast, Listing Rule 5820(b), which permits the Listing Council to call any panel decision for review on its own motion, also does not operate as an automatic stay of a Panel decision, unless a call for review specifies to the contrary. In practice, in order to prevent a suspension that is ordered by a Panel until such time as the Listing Council can consider the merits of that decision, issuers and their advisors may promptly appeal the Panel's decision to the Listing Council, and in that appeal set forth the issuer's arguments as to why the Listing Council should call the decision for review and grant a stay of the suspension.

A Listing Council decision may be called for review by the NASDAQ Board of Directors upon the request of one or more directors. Companies are not entitled to seek review by the NASDAQ Board, though in practice, many have asked anyways, particularly during the period in which a number of NASDAQ listed companies were late in filing SEC periodic reports due to accounting difficulties associated with stock option grants. One significant lesson learned from that period is that NASDAQ will not continue a listing for greater than one year after the Staff Determination letter is issued, which was recently codified in the 5800 Rule Series.

Once the administrative process with NASDAQ is exhausted, an issuer may then appeal a matter to the SEC. Although very few companies ever appeal a listing matter to the SEC, an issuer should be aware that once a matter is appealed to the SEC, the information contained in the entire NASDAQ record may become available to the public under the Freedom of Information Act. n2 Should an issuer appeal a Listing Council decision to the SEC, management and

counsel should also be aware that the SEC has stated that "[t]o the extent that discretion enters into the matter--and it very often does--the discretion in question is [NASDAQ]'s, not ours. Hence, we are not at liberty to substitute our discretion for that of [NASDAQ]." n3 The SEC's standard for review of listing determinations is quite narrow and is based on "whether 'the specific grounds on which such action is based exist in fact and are in accord with the applicable rules of ... [NASDAQ]." n4 A decision of the SEC can be appealed to the federal courts.

FOOTNOTES:

(n1)Footnote 1. Rule 5815(b) states that in the case of a late SEC periodic public filing, the delisting action will only be stayed for 15 calendar days from the hearing request deadline unless the Company specifically requests and the Panel grants a further stay. A request for a further stay must include an explanation of why such a stay would be appropriate, which should be included in the issuer's request for a hearing. Based on that submission and any recommendation provided by Staff, the Panel will determine whether to grant a further stay.

In determining whether to grant the stay, the "Panel will consider the Company's specific circumstances, including the likelihood that the filing can be made within any exception period that could subsequently be granted, the Company's past compliance history, the reasons for the late filing, corporate events that may occur within the exception period, the Company's general financial status, and the Company's disclosures to the market." The Hearings Panel must notify the issuer of its conclusion within 15 calendar days following the deadline to request the hearing.

(n2)Footnote 2. *5 U.S.C.S. § 552 (1996)*.

(n3)Footnote 3. *Tassaway, Exch. Act. Rel. No. 11,291, 1975 SEC LEXIS 2057, *7*

(n4)Footnote 4. *Tassaway, Exch. Act. Rel. No. 11,291, 1975 SEC LEXIS 2057* (citing SEC Rule 15Aj-2(c)).



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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense 25.syn

AUTHOR: Michael D. Wolk and Richard G. Wallace

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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense § 25.01

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§ 25.01 Introduction

The overall regulatory scheme addressing the conduct of broker-dealers and associated persons establishes self-regulatory organizations ("SRO"), such as the Financial Industry Regulatory Authority ("FINRA"), as the first line of defense to protect the public investor and ensure that the public markets remain transparent and operate with the highest integrity. The Securities and Exchange Commission ("SEC" or "Commission"), for the most part, fulfills its function by conducting oversight of each SRO to ensure that the SROs are carrying out the duties and responsibilities assigned to them by law to establish and enforce their own rules and regulations and the federal securities laws and regulations. As stated by former SEC Chairman William O. Douglas, "[g]overnment would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use, but with hope it would never have to be used." n1

Pursuant to the Securities Exchange Act of 1934 ("Exchange Act"), each SRO must be organized and have the capacity to enforce compliance by its members and associated persons with SRO rules and the Exchange Act and the rules promulgated thereunder. An SRO's rules must be designed, among other things, to prevent fraudulent and manipulative practices, promote just and equitable principles of trade, and appropriately discipline its members and associated persons for violating the SROs' rules or the Exchange Act and the rules promulgated thereunder. n2 FINRA is also responsible for enforcing the compliance by its members with the rules of the Municipal Securities Rulemaking Board. n3

Each SRO must ensure that its members and persons associated with its members are appropriately disciplined, by expulsion, suspension, limitation of activities, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction. In any proceeding brought by an SRO to determine whether a member or person associated with a member should be disciplined, the SRO will bring specific charges, notify such member or person of, and give him or her an opportunity to defend against such charges, and keep a record. n4 A determination by the SRO to impose a disciplinary sanction shall be supported by a statement setting forth the following: (a) any act or practice in which such member or person associated with a member has been found to have engaged, or which such member or person has been found to have omitted; (b) the specific federal law, rule, or the rules of the SRO which any such act or practice, or omission to act, is deemed to violate; and (c) the sanction imposed and the reasons therefore. n5

The past few years has seen the addition of several new SROs and the sale of others. Recently licensed and transferred SROs include BATS Options, Nasdaq OMX BX, Inc. (formerly Boston Stock Exchange), NASDAQ OMX PHLX (formerly Philadelphia Stock Exchange) and the American Stock Exchange (purchased by NYSE Euronext).

Although the authority of each SRO to examine, investigate, conduct disciplinary proceedings and impose sanctions against its members and associated persons is provided for by the Exchange Act, SROs are not recognized by law as governmental actors and, as a result, members and associated persons are not afforded all the rights they would be entitled to if they were being investigated and prosecuted by the SEC, the Justice Department, or a state regulator. n6 However, in another context the courts have recognized that the SEC is authorized to delegate certain regulatory functions to SROs. In those functions, SROs are considered "quasi-governmental" bodies and are entitled to absolute immunity for regulatory conduct. n7

FOOTNOTES:

(n1)Footnote 1. W. Douglas, *Democracy and Finance* 82 (1940).

(n2)Footnote 2. Exchange Act §§ 6(b)(1) and 15A(b)(6) and (7).

(n3)Footnote 3. Exchange Act § 15A(b)(2).

(n4)Footnote 4. Exchange Act §§ 6(d)(1) and 15A(h).

(n5)Footnote 5. Exchange Act §§ 6(d)(1) and 15A(h).

(n6)Footnote 6. Numerous courts have held that NASD, FINRA's predecessor, was not a state actor. *First Jersey Secs., Inc. v. Bergen*, 605 F.2d 690, 690, 699 n.5 (3d Cir. 1979), cert. denied sub nom., *First Jersey Secs., Inc. v. Biunno*, 444 U.S. 1074 (1980); *United States v. Shvarts*, 90 F. Supp. 2d 219, 222 (E.D.N.Y. 2000) (finding that "[i]t is beyond cavil that the NASD is not a government agency; it is a private, not-for-profit corporation"). The courts and the SEC have determined that SROs are not government actors with respect to the *Fifth Amendment*. *Jones v. SEC*, 115 F.3d 1173, 1183 (4th Cir. 1997) (*Double Jeopardy Clause of Fifth Amendment* claim is rejected because NASD is a private corporation and not a governmental agency); *Daniel Turov*, 1992 SEC LEXIS 3332, *6-9, 51 S.E.C. 235, 238 (1992) (*Fifth, Sixth, and Seventh Amendment* claims are not applicable to NYSE, which is not a government agency). However, the courts and the SEC have recognized that coercive government influence or significant encouragement of the state effectively converts the private action into state action. In re Quattrone, SEC Rel. No. 53547, Admin Proc. File No. 3-11786 (March 24, 2006) at n. 26 (quoting *Kirtley v. Rainey*, 326 F.3d 1088, 1092, 1094 (9th Cir. 2003) .

(n7)Footnote 7. *DL Capital Group*, 409 F.3d 93, (2d Cir. 2005); *Chartered, Inc. v National Association of Securities Dealers, Inc.*, 22010 U.S. Dist. LEXIS 19174 (S.D.N.Y. 2010).



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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense § 25.02

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§ 25.02 General Overview of SRO Structure and Organization

SROs carry out their regulatory functions through the conduct of examinations, surveillance and investigations. To better understand how the SROs determine how, when, and if, disciplinary action will be imposed, a brief description of the structure and specific functions of SROs will be helpful. This discussion focuses primarily on FINRA since it is the primary SRO for the overall conduct of broker-dealers and their associated persons. The National Association of Securities Dealers, Inc. and the NYSE were once the two largest SROs. On January 21, 2007, NASD member firms overwhelmingly approved the consolidation of NASD and the member regulation operations of the NYSE. Approved by the SEC on July 26, 2007, the consolidation of NASD and the member regulation, enforcement and arbitration functions of NYSE resulted in a combined entity named FINRA, the largest self-regulatory organization (SRO) responsible for the oversight of securities brokers and dealers doing business in the U.S. n1 FINRA brings together all of NASD's and NYSE's member firm examination and related enforcement functions, arbitration and risk assessment, as well as other current responsibilities, including transparency facilities and market regulation by contract for The NASDAQ, Stock Market, Nasdaq Options Market, Nasdaq OMX Boston, Nasdaq OMX Philadelphia, BATS Exchange, the International Securities Exchange, and other SROs. Additionally, on June 14, 2010, NYSE Euronext (NYSE: NYX) and FINRA entered into an agreement under which FINRA assumed responsibility for performing the market surveillance and enforcement functions formerly conducted by NYSE Regulation. As a result, FINRA assumed the regulatory functions for NYSE Euronext's U.S. equities and options markets--the New York Stock Exchange, NYSE Arca and NYSE Amex. These agreements have resulted in the elimination of duplicative examinations and a more central focus and voice regarding the regulation of broker-dealers and associated persons.

This section discusses relevant functions of FINRA concerned with regulatory matters.

[1] Office of General Counsel and Office of Disciplinary Affairs

The FINRA Office of General Counsel ("GC Office") for regulatory issues is the source of official interpretation of FINRA Rules. This group is also responsible for arguing, orally and by brief, all appeals of disciplinary actions to the SEC and preparing and submitting rule proposals filed with the SEC. FINRA District and other offices may consult with the GC Office on novel issues raised during the course of an examination and investigation. Additionally, the GC Office responds to written and sometimes oral requests for rule interpretations and exemptions from broker-dealers, the

public, and attorneys concerning most FINRA rules.

Comment

In the unusual circumstance where counsel feels that contact with this sub-division could assist his or her client in responding to an examination or investigation, it would be prudent to advise the staff of this sub-division that the request arises out of an ongoing examination or investigation and identify the office of FINRA that is conducting it. Failure to do so will likely be seen by the staffs of both offices as an underhanded attempt to thwart an ongoing inquiry.

The GC Office will not provide interpretive advice during the course of an ongoing examination or investigation unless it is an extremely novel issue and the GC office first consults with the examiners/investigators. If this situation arises, counsel should request the examining staff to make an interpretive request to the GC Office and ask to participate in the discussions. Such up-front requests will more often result in a productive and participatory dialogue.

This sub-division is also the home of the Office of Disciplinary Affairs ("ODA"). The ODA is an independent entity that authorizes the filing of any complaint and may accept certain settlements on behalf of FINRA. When the staff of the Market Regulation or Enforcement Departments of FINRA determine to commence disciplinary action, it submits to the ODA a memorandum summarizing the facts and the law in the matter and the potential respondent's response, if any. ODA is charged with reviewing each proposed settlement or complaint, including any Wells Submissions, to provide an independent review of the legal and evidentiary sufficiency of the charges proposed by the staff. ODA also reviews settlements for consistency with the Sanction Guidelines as well as applicable precedent. The potential respondent is not allowed to participate in this process. Additionally, the ODA, on behalf of FINRA, in addition to certain officers and counsel in other departments, may accept Letters of Acceptance, Waiver and Consent ("AWC"), and Minor Rule Violation Letters ("MRV") submitted by respondents to resolve disciplinary matters. The ODA's review is designed to ensure that only appropriate actions are imposed and that FINRA's regulatory response is consistent and fair.

[2] Market Regulation

The Market Regulation Department ("Market Regulation") oversees and regulates all trading, market-making, and quoting activity on The Nasdaq Stock Market and in the over-the-counter markets. In addition to the day-to-day surveillance functions of FINRA-operated trading markets, Market Regulation also regulates transactions executed and reported to Nasdaq by FINRA member firms in securities listed on the NYSE, the American Stock Exchange, and other exchanges.

Market Regulation has established real-time and historical regulatory programs focused on determining compliance with specific FINRA rules, MSRB rules, and the federal securities laws and regulations. It uses sophisticated technology to reconstruct market transactions utilizing trading data and quote information that is captured throughout the trading day and to alert staff to potential violative activity.

Market Regulation carries out its regulatory responsibilities by conducting sweeps, examinations and investigations. Regulatory sweeps are conducted (usually on a quarterly basis) to test market-wide and firm compliance with various trading and market-making rules. Broker-dealers whose performance in these areas is worse than industry and their peer-group average will likely be contacted to explain these potential violations and the firm's written supervisory procedures and supervisory systems established and maintained to detect and deter such violations.

Market Regulation also conducts onsite Trading and Market Making Surveillance examinations ("TMMS Examinations") of the largest market makers, Electronic Communications Networks ("ECNs") and Alternative Trading Systems ("ATS"). This amounts to approximately 100 different firms. These examinations consist of an intense focus

on compliance with trading and market-making rules that can not, for whatever reason, be addressed through Market Regulation's surveillance programs. In 2010 Market Regulation will be conducting a pilot TMMS Examination of "options-access" firms.

Market Regulation, based on breaks produced from its automated systems and other information, also conducts investigations of potential fraudulent and manipulative trading and quoting activities. Market Regulation attorneys prosecute most disciplinary matters that result from its sweeps, examinations, and investigations.

[3] Member Regulation and Qualifications and Testing

Member Regulation, through its 15 district office locations located throughout the United States, is responsible for, among other things, conducting FINRA's nation-wide examination program. Each year, this sub-division conducts approximately 2,500-3,000 routine cause examinations of member firm activities. The time involved and the scope of the examination varies, depending in large part upon the size of the firm, the nature of its business and the issues raised during the examination. FINRA members are examined anywhere from annually to once every four years depending on the nature of the firm's business activities, method of operation, and type of products sold. Member Regulation is comprised of two separate departments, the Department of Risk Oversight and Operational Regulation and the Department of Sales Practice Regulation. n3

Routine examinations seek to determine whether a firm is complying with federal securities laws, rules, and regulations, and with FINRA rules. FINRA examiners review the firm's books and records, such as financial computation work papers and subsidiary ledgers, order tickets and confirmations, and complaint and correspondence files. Examiners check that the firm's records support the regulatory filings that the firm has made to FINRA in trade reporting, financial filings, complaint filings, and advertising filings. Examiners prepare independent financial calculations to determine the financial condition of the firm (net capital and customer reserve) and interview the firm's compliance officers and management to learn about its supervision and operational practices.

Upon completion of the examination, examiners provide a summary of the initial findings of the examination to the firm's management and compliance personnel, and the firm is asked to respond, if it can at that time, to any potential violations identified. The sub-division will attempt to resolve the matter with the firm and if it is unsuccessful will refer the matter to the Enforcement Department for prosecution. Additionally, if during the course of an examination, serious violations are discovered, the matter may be immediately referred to the Enforcement Department for further investigation.

In addition to routine field examinations, FINRA District Offices also conduct thousands of investigations and cause examinations each year involving matters, such as customer complaints, terminations of registered persons for cause, financial problems, and questionable sales practices or fraud.

[4] FINRA Enforcement Department

The Enforcement Department is FINRA's main prosecutorial arm and, as such, serves two functions. The home office investigates and prosecutes fraudulent and other egregious activity by member firms or associated persons that involve complex and serious violations of the securities laws and FINRA rules. The second function of the Enforcement Department is to prosecute securities violations uncovered through Member Regulation's examination programs. This function is carried out by regional attorneys and personnel located in each of FINRA's District Offices. n4 The Enforcement Department also investigates and prosecutes cases that are the result of referrals from other departments such as Member Regulation, Market Regulation, Advertising Regulation and Corporate Financing, and the newly formed Office of Fraud Detection and Market Intelligence. n5

[5] Chief Hearing Officer

The Office of the Chief Hearing Officer is an independent division that employs professional hearing officers that are assigned to each disciplinary hearing to chair the hearing panel that will conduct the hearing and issue a decision.

[6] Investment Company Regulation, Corporation Finance and Advertising Regulation

These units carry out FINRA's regulatory functions concerning investment company, corporate finance and advertising regulation. These entities may conduct investigations and refer their findings to the Enforcement Division for further investigation and/or the imposition of disciplinary action.

[7] Office of Fraud Detection and Market Intelligence

In October 2009, FINRA established the Office of Fraud Detection and Market Intelligence to provide heightened review of allegations of serious fraud and provide a centralized point of contact on fraud issues. The office will pursue matters with the same investigative authority as the Enforcement Department and the Market Regulation Department.

FOOTNOTES:

(n1)Footnote 1. At the time this chapter was written, FINRA had adopted certain rules into a new FINRA rulebook consolidating NASD and NYSE Rules. NASD and NYSE rules that have not yet been approved by the SEC for inclusion in the consolidated FINRA rulebook are still cited as NASD and NYSE rules.

(n2)Footnote 2. FINRA Regulatory Notice 09-17 (March 2009).

(n3)Footnote 3. FINRA Press Release (July 30, 2007).

(n4)Footnote 4. In 2009, FINRA issued Regulatory Notice 09-17 "Investigations and Formal Disciplinary Actions," (March 2009) which provides a description of the enforcement process at FINRA.

(n5)Footnote 5. On March 5, 2009, FINRA announced the creation of The Office of the Whistleblower to expedite the review of high-risk tips by FINRA senior staff and ensure a rapid response for tips believed to have merit. FINRA Press Release (March 5, 2009).



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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense § 25.03

AUTHOR: Michael D. Wolk and Richard G. Wallace

§ 25.03 SRO Examination Process

[1] Scheduling of Routine Examinations

Most SROs attempt to conduct routine examinations annually or less frequently if the firm does not present risk and has a good disciplinary record. The examination process concentrates on sales practices, trade practices, operations and capital concerns. Generally, SROs attempt to coordinate with each other so they conduct their examinations of a firm at the same time, as that can make it easier for the firm from a resource and scheduling standpoint. A broker-dealer will normally receive advance notice that an SRO examination has been scheduled. The purpose of this notice is to allow the SRO to obtain documentation prior to its on-site examination to enable it to appropriately focus its on-site work and to ensure that SRO examiners will be immediately provided with requested documentation when they arrive on-site for the field portion of its examination. FINRA's policy is to try and coordinate the timing of the various exams for each member, but members may request that a Trading and Market Making Surveillance examination be scheduled separately.

[2] Preparing for Examination

Upon receiving notice of an examination, a broker-dealer should immediately inform the SRO of any scheduling conflicts (CEO, CFO, CCO or head trader will be out of office or other regulatory authority will also be present), contemporaneous changes in systems or location, or of any difficulty in producing the requested documentation. Since technology now plays such a significant role in the record keeping process, a broker-dealer should inquire of the SRO as to what format requested documentation (hard copy, maintained on a CD, or downloaded) should be produced in. Every effort should be made to ensure that the SRO receives all requested information by the deadlines it imposes and that other requested information is available to the SRO when they arrive for their field examination. The broker-dealer, if at all possible, should arrange a quiet and comfortable work area for the examination staff.

The firm should provide a specific contact at the firm for the examining staff to ask questions of and request further documentation. Any requests for further documentation should be complied with as soon as possible. Moreover, copies of the documentation provided to the examining staff should be maintained by the firm so it can ensure that it complied with all requests for information and that it can explain any future concerns or findings that may arise.

The firm should engage the examination staff in an ongoing dialogue throughout the examination to discover and immediately address, if possible, any concerns raised by the review and to attempt to obtain guidance from the SRO staff concerning "best practices." Firms should be particularly careful to understand the basis for the staff's concern. A minor matter can become much more serious if the firm is not taking the appropriate corrective action based on a misunderstanding of what the staff is investigating.

It is not usually advisable to get outside counsel involved during the conduct of a routine examination, at least to the extent of meeting with the examining staff, because of the likelihood that the staff will incorrectly interpret counsel's involvement as a sign that there may be significant compliance issues at the firm.

[3] Post-On Site Examination

After the field work of the examination is concluded, the examination staff will normally conduct an exit interview in which they will summarize their preliminary findings. The broker-dealer should only respond to those findings that are clearly in error and which can immediately, with documented support, be refuted. Otherwise, the broker-dealer should listen to and memorialize the staff's findings and respond to them at a subsequent time or when the staff issues a "Wells Letter" describing its preliminary findings. In any event, the broker-dealer should immediately investigate the staff's preliminary findings, determine if they are supported, and, if so, identify the cause of the misconduct and immediately implement corrective action. Updating written supervisory procedures shortly after a deficiency is noted can be a particularly effective response.

At this time, the firm should also commence its preparation of a response to the staff's preliminary findings. The firm may not be contacted by the staff again for an extended period of time and, if it is in the form of a Wells Letter or a proposed settlement, the preparation of a response at this time will protect the firm from the loss of documentation, faded memories and loss of involved personnel that may occur during this delay.

If the staff sends a Wells Letter, the broker-dealer may respond directly or may want counsel to do so. It is important to remember that at the time this letter is issued, SRO legal staff may not have reviewed the file. A Wells Letter provides the firm an opportunity to formally respond to the staff's preliminary findings and explain, factually or legally, why these findings are incorrect and not deserving of disciplinary action. If the staff's findings are correct, the firm should explain how the violations were caused, how they were discovered, particularly if the firm discovered the violations prior to staff inquiry, and the corrective action that has already or will be implemented to ensure that it will not recur.

[4] Cause Examinations

As part of every examination request, the broker-dealer should determine whether it is a routine or cause examination. This will normally be obvious; however, if the firm is unsure, it should inquire. As a rule of thumb, an unannounced examination or an examination focused on a specific issue will normally be a cause examination. A cause examination is usually triggered by an event such as a customer complaint, a termination for cause, a surveillance break or a special examination to address current concerns within the industry. A broker-dealer should keep in mind that an SRO's mindset is different in this context, it is not doing a general examination to test overall compliance but conducting a pointed inquiry to determine if the information it has received is credible and specific rule violations have occurred. As a result, a cause examination should be responded to much like the firm would respond to an SRO investigation and consider hiring outside counsel at the outset to assist it in its defense of the investigation or in conducting an internal investigation.

FOOTNOTES:

(n1)Footnote 1. Examination findings can be skewed by problems adjusting to new systems, locations or personnel. If possible, it is best to avoid examinations that will review the firm's performance during these disruptive events.



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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense § 25.04

AUTHOR: Michael D. Wolk and Richard G. Wallace

§ 25.04 SRO Investigations

[1] Commencement of SRO Investigation

An SRO investigation may arise from a number of different sources including, but not limited to, customer or industry member complaints, terminations for cause, automated surveillance breaks, findings arising out of routine examinations and inquiries, anonymous complaints, new regulatory initiatives, press articles, arbitration panel referrals and referrals from the SEC. Investigations may commence through oral or written contact from an SRO requesting information or an explanation of certain events.

A broker-dealer or associated person should not place any reliance on any representation by the staff that an investigation is informal or routine. Anytime a broker-dealer or associated person becomes aware that its conduct is being investigated, it should take such knowledge seriously and consider retaining counsel to assist it in its response.

Normally, the subject of an investigation will receive written correspondence from the SRO requesting documentary information and a written explanation about certain conduct. A careful reading of the request will not always provide the subject with knowledge of what the SRO is actually investigating since the focus of the investigation is not usually explained in its request for information. The subject or the subject's counsel should contact the SRO to attempt to obtain as much information about the focus of the investigation as the staff is willing to share and also, if necessary, to tailor the request for information to what the staff needs to conduct its inquiry and to establish a reasonable amount of time to respond to the inquiry. It is always better to have counsel conduct this inquiry as it will prevent the staff from engaging the broker-dealer or associated person in an informal interrogation about the matter being investigated.

The authority of each SRO to commence an investigation into the conduct of a broker-dealer or an associated person is wide reaching and limited only by certain jurisdictional requirements. For example, the SEC has approved FINRA disciplinary actions involving conduct related to insurance, tax shelters, and even to a member firm employee's improper use of a co-worker's credit card. n1

[2] SRO Investigative and Prosecutorial Jurisdiction

SROs have jurisdiction to investigate any member, member organization, allied member, and associated person

(registered or un-registered). Most importantly, this jurisdiction continues even after one of these entities withdraws or is expelled, terminated or barred. FINRA maintains jurisdiction over its members and associated persons for conduct while they were active for a period of two years. n2 Jurisdiction over an individual can attach upon the filing of a Form U-4, even if the individual never completes the registration process. n3 The two year period commences at the time of the withdrawal, termination, revocation or cancellation; however, any amendment to an associated person's Form U-5 (Notice of Termination) during that two year period that discloses that the person may have engaged in conduct that is actionable will recommence the running of that two year period from the filed date of the amendment. In the case of an unregistered associated person, the two year period commences at the date at which the person ceases to be associated. n4 Any complaint must be filed within this two year period.

Moreover, during this period of time, the broker-dealer or associated person is subject to and must comply with requests for information and testimony and failing to do so could result in the imposition of disciplinary action for that failure. n5

The NYSE has similar retention of jurisdiction rules. The period of retained jurisdiction is only one year but can be extended by serving a written notice that the Exchange is conducting an inquiry or by serving a Charge Memorandum. n6

[3] Statute of Limitations

There is no statute of limitations applicable to SRO proceedings and a SRO may investigate conduct years after its occurrence. In 2000 and 2002, respectively, however, the SEC and FINRA reversed SRO findings and sanctions because the lengthy delay between the investigation and the disciplinary proceeding was so long that it violated SEC rules requiring the SRO to establish a fair mechanism to discipline its members. n6 In the matter reversed by FINRA, the National Adjudicatory Counsel ("NAC") emphasized that length of delay alone is not necessarily a controlling factor and that adjudicators must look to traditional equitable concepts for guidance on whether the proceeding is fair under the circumstances.

In reaching its decision, the NAC found that the traditional equitable principles that should be considered are, among other things, whether the respondent had unreasonably caused a portion of the delay and whether the respondent was harmed by the alleged delay (although the NAC found that a showing of harm was not necessary).

FOOTNOTES:

(n1)Footnote 1. *In re Thomas E. Jackson*, 45 SEC 771 (June 16, 1975) (insurance application); *In re Ernest A. Cipriani, Jr.*, 51 SEC 1004 (February 24, 2001) (insurance premiums); *In re Daniel C. Adams*, 47 SEC 919 (June 27, 1983) (tax shelters); *In re DWS Securities*, 51 SEC 7814 (November 12, 1993) (general entrepreneurial activity); and *In re Daniel D. Manoff*, SEC Release No. 34-46708 (October 23, 2002) (use of co-worker's credit card).

(n2)Footnote 2. By-Laws of FINRA, Article IV, Section 6.

(n3)Footnote 3. *In re Howard Brett Berger*, C9B040069, FINRA NAC Decision (July 28, 2009) at 8.

(n4)Footnote 4. By-Laws of FINRA, Article V, Section 4.

(n5)Footnote 5. FINRA Rule 8210.

(n6)Footnote 6. NYSE Rule 477.

(n7)Footnote 6. *Jeffrey Hayden, Exch. Act Rel. No. 42772*, 2000 SEC LEXIS 946 (May 11, 2000) ; *NASD v. Morgan Stanley DW Inc.*, Disciplinary Proceeding No. CAF000045 (July 29, 2002).



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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense § 25.05

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§ 25.05 Power to Require the Production of Documents and Testimony

Pursuant to SEC Rule 17a-3 and 4 and SRO Rules that incorporate this rule, broker-dealers are required to preserve and maintain certain records and documents. These records and documents, pursuant to SRO Rules, must be produced to the SRO upon request. n1 Procedural Rule 8210 authorizes FINRA, in the course of its investigations, to require members to provide information orally, in writing, or electronically with respect to any matter involved in an investigation. Although Rule 8210 requires associated persons "to testify at a location specified by FINRA staff, often the staff will accommodate requests to testify at a FINRA office near the witness' place of business. As the SEC has emphasized, because FINRA lacks subpoena power over its members, a failure to provide information fully and promptly undermines FINRA's ability to carry out its regulatory mandate. n2 There is virtually no acceptable reason, other than privilege, that will serve as a justification for withholding requested documentation and doing so will be met with a severe disciplinary response up to and including expulsion.

Associated persons are also subject to the same requirements and are primarily subject to this through their contractual relationship with the SRO. An individual registered with FINRA agrees to abide by its rules, which are unequivocal with respect to the obligation to cooperate with FINRA. n3 Associated persons, while having the ability to assert their *Fifth Amendment* privilege against self incrimination, will be subject to being permanently barred from the industry if they do so. n4 Numerous courts have held that FINRA is not a state actor. n5 The courts and the Commission have also determined that SROs are not government actors with respect to the *Fifth Amendment*. n6

Comment

An argument can be made that these cases place excessive reliance on dated precedents, reflect an inadequate appreciation of the extent to which SROs now exercise governmental powers, and are entwined with the SEC.

Reliance on counsel is immaterial to an associated person's obligation to supply requested information to FINRA. n7 Persons subject to FINRA jurisdiction cannot take it upon themselves to determine whether information requested is material to a FINRA investigation of their conduct. n8 Further, FINRA's rules do not permit those subject to FINRA's jurisdiction to "second guess" FINRA's requests for information. n9

[1] Initial Steps in Responding to an Investigation

When the firm first becomes aware of an SRO investigation, inside counsel, if any, and senior management should be immediately informed. The firm's counsel should determine what the investigation is focused on and what, if any, potential disciplinary exposure exists. What area of conduct and the potential rule violations involved may not always be apparent from the SRO's first request for information and it may be productive to engage the investigators in a dialogue to attempt to determine the focus of their inquiry.

At this time, a decision should be made about retaining outside counsel. The broker-dealer should obtain counsel that is experienced in dealing with the SRO's staff and is familiar with its rules. A long held view is that one should not retain counsel early on in an investigation, or at least identify such counsel to the staff, for fear that this will give the staff an impression that the matter is serious and that the staff has identified a real concern. This belief is overstated, and firms and associated persons that have received investigatory requests for information and/or testimony should not shy away from engaging counsel early on in the process. Experience has demonstrated that the failure to engage counsel early on in the process could result in confusing and inadvertently misleading responses to the regulatory staff that result in a much more time and labor intensive investigation.

[2] Preservation of Documents

Once under investigation, a broker-dealer must preserve documentation relevant to the SRO's inquiry regardless of whether or not the rules or the firm's policies require it to do so. Destruction of documents could cause the SRO to refer the matter to the SEC or the United States Attorney's Office and gives the SRO staff an impression that the firm is guilty of the suspected violations, attempting to conceal its conduct and/or impede the SRO's investigation.

[3] Responding to an SRO Investigation

Matters related to responding to an SRO Investigation, such as alerting employees of the existence of the investigation, gathering information and conducting an internal investigation, representing individual associated persons, producing documents, preparing and representing witnesses in testimony before SRO staff, and preparing Wells Submissions are covered in greater detail in Chapters 8, 9, 10, 11 and 16.

[4] Wells Process

Most SROs provide a potential respondent with an opportunity to make a submission to the staff similar to a Wells Submission in an SEC investigation as an opportunity to explicitly lay out to the staff the potential respondent's views on the facts and the law and rules as they apply to those facts and explain why disciplinary action is unwarranted or that the sanctions being sought by the staff are inappropriate. The same considerations apply to the preparation of this type of submission as apply to the drafting of a Wells Submission in an SEC action. n10

FOOTNOTES:

(n1)Footnote 1. NASD Rule 8210.

(n2)Footnote 2. *Brian L. Gibbons*, 52 S.E.C. 791, 794 (1996) , *aff'd*, 112 F.3d 516 (9th Cir. 1997) .

(n3)Footnote 3. *Brian L. Gibbons*, 52 S.E.C. at 794 n.12 (quoting *Michael David Borth*, 51 S.E.C. 178, 180 (1992)) ; *Michael Markowski*, 51 S.E.C. 553, 557 (1993) , *aff'd*, 34 F.3d 99 (2d Cir. 1994) .

(n4)Footnote 4. *D.L Cromwell Investments, Inc., v. NASD Regulation, Inc.*, 2001 U.S. Dist LEXIS 1912 (S.D.N.Y. February 26, 2001) ; *In re Vladislav S. Zubkis*, Exch. Act Rel. No. 40409, n.2, 1998 SEC LEXIS 1904 (Sept. 8, 1998) .

(n5)Footnote 5. *First Jersey Sec., Inc. v. Bergen*, 605 F.2d 690, 698, 699 n.5 (3d Cir. 1979) , *cert. denied sub nom.*,

First Jersey Sec., Inc. v. Biunno, 444 U.S. 1074 (1980) ; *United States v. Shvarts*, 90 F. Supp. 2d 219, 222 (E.D.N.Y. 2000) (finding that "[i]t is beyond cavil that the NASD is not a government agency; it is a private, not-for-profit corporation").

(n6)Footnote 6. *Jones v. SEC*, 115 F.3d 1173, 1183 (4th Cir. 1997) (*Double Jeopardy Clause of Fifth Amendment* claim is rejected because NASD is a private corporation and not a governmental agency); *Daniel Turov*, 51 S.E.C. 235, 238 (1992) (*Fifth, Sixth, and Seventh Amendment* claims are not applicable to NYSE, which is not a government agency).

(n7)Footnote 7. *Michael Markowski*, 51 S.E.C. at 557 .

(n8)Footnote 8. *Brian L. Gibbons*, 52 S.E.C. at 794) ; *Michael David Borth*, 51 S.E.C. at 180 .

(n9)Footnote 9. *Joseph Patrick Hannan*, 53 S.E.C. 854 (1998) .

(n10)Footnote 10. See Chapter 16 for further guidance.



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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense § 25.06

AUTHOR: Michael D. Wolk and Richard G. Wallace

§ 25.06 Settlement Process

Counsel can engage the staff in settlement negotiations at any time during the examination and investigatory process, although the staff will generally not agree to do so until they believe their examination or investigation is substantially completed. n1

[1] General Considerations

There are certain general considerations that counsel should be aware of prior to engaging the staff in negotiations:

Certain SROs such as FINRA, publish sanction guidelines for a number of the most frequently found violations. These guidelines contain general and specific considerations that apply to all sanctions and lay out specific monetary and other types of sanctions that should be imposed for specified violations. Both the NYSE and FINRA have also published guidance for providing credit in determining sanctions for individuals and entities that provide extraordinary cooperation with an investigation. n2 Although such information is referred to as a guideline, counsel needs to be aware that SROs operate in a manner which reflects that with respect to the low end of the range of sanctions the guidelines are the gospel and can not be diverted from. SROs often show greater flexibility in going beyond the high end of the ranges specified in their sanction guidelines. In a situation where counsel is arguing for sanctions less than the guidelines call for, it is necessary to provide the staff with argument and facts that it can use to persuade the ultimate accepting body that will accept or reject the settlement to recognize that while the proposed sanction falls below what the guidelines call for it is appropriate in this circumstance. Moreover, counsel should review previous disciplinary matters brought by the SROs and others alleging the same conduct.

The staff has no power to bind the SRO and enter into a settlement. The proposed settlement must be presented to a specific committee, hearing panel or department for acceptance.

Any resolution will become part of the respondent's permanent disciplinary history and be considered in determining sanctions for future violations should they occur. n3

Counsel should consider the effects of publicity of the action. Any action involving a fine of \$10,000 or greater and/or a suspension will be publicized by FINRA. n4 Most other SROs publicize all disciplinary actions.

Counsel should consider the effect of any sanction or finding that will subject an individual to a "statutory disqualification." Although the list of events constituting a statutory disqualification is lengthy, particular attention should be paid to any bar from association with a member or findings that the individual made false statements to an SRO, willfully violated the federal securities or commodities laws, willfully aided and abetted, counseled, commanded, induced or procured such violations, or failed to supervise another who commits violations of such rules or laws. n5

Comment

Generally, publicity of SRO actions involves the preparation of a "squib" that briefly reflects a recitation of the rule violations. While, on a monthly basis, all disciplinary actions are provided directly to the membership, the press, and placed on SRO Web sites, the likelihood that an isolated action will appear in the press with any detail or fanfare is minimal. Counsel should always inquire, however, as to whether the SRO intends to issue a press release about the action, separate and apart from the process described above. While a separate release used to almost guarantee that there will be press coverage, in recent years press releases regarding some multi-million dollar settlements have generated very little press coverage. If the staff can not be dissuaded from issuing a separate release, counsel should make every effort to have some input into how it reads. While the staff is always reluctant to allow this, they will sometimes agree to provide a courtesy copy shortly before release for purposes of ensuring factual and legal accuracy and to allow the respondent and counsel to prepare for press inquiries. Counsel should ask the staff to ensure that the language of the press release conforms as much as possible to the negotiated language of the settlement.

Consider the settlement's effects on any private litigation matters or the collateral effects of statutory disqualification proceedings by states or other regulatory bodies. Although SRO staff is reluctant to do so, counsel should attempt to negotiate the language of any press release or publicity of the action.

[2] Forms of Settled SRO Actions

SROs provide a number of ways to resolve findings of violation from examinations and investigations that result in either informal or formal disciplinary action. Set forth below are these types of settled actions.

[a] *De Minimis* Letter

This is an informal action that is rarely, if at all, used anymore to resolve a proceeding and if it is, is issued by the staff prior to any settlement negotiations. The *De Minimis* letter is used by FINRA in very rare instances such as where a new rule is being implemented that is technologically, or otherwise, very difficult to comply with and a minimal amount of technical violations exist. It is a way for the staff to place members on notice that they have noticed violations and that the member should address this activity before further disciplinary action is warranted.

A *De Minimis* Letter does not require a response to the staff and merely serves as a warning to the member to correct the identified compliance deficiencies. While one can argue for such a resolution in settlement negotiations, the chances of the staff agreeing to such a sanction are remote, and this remedy will remain a seldom used resolution that will only be used at the staff's own initiative.

[b] Cautionary Action Letter

Most SROs issue some form of a Letter of Caution or Admonition to informally respond to what they consider to be minor rule infractions or rule infractions accompanied by significant mitigation. Cautionary Action Letters (fka Letters of Caution) issued to member firms and associated persons by FINRA staff are not considered formal disciplinary action and do not constitute a sanction within the meaning of FINRA Rules. Staff-issued Cautionary Action Letters are merely a vehicle for the staff to address a rule violation that does not warrant referral to the Department of Enforcement for formal disciplinary proceedings.

For some SROs, a Cautionary Action Letter must be responded to within a certain period of time, normally within 30 days, and such a response is required to acknowledge the receipt of the Cautionary Action Letter and provide the staff with a representation of what the recipient of the Cautionary Action Letter will do to prevent future violations. FINRA often requests some form of undertaking in connection with a Cautionary Action Letter such as a representation that the firm has revised its written supervisory procedures. Not all SROs require a response to this type of letter.

Although a Cautionary Action Letter is not considered a sanction, n6 it is considered by the staff as previous disciplinary action when it is determining whether to initiate disciplinary action for future violations and what type of sanctions to impose. For a relatively minor violation, the staff is more likely to seek formal disciplinary action, if the firm was previously issued a prior Cautionary Action Letter for a similar violation. As a result of the fact that a Cautionary Action Letter the firm on the first rung of the ladder to formal disciplinary action, a firm should take the issuance of a Letter of Caution seriously and respond to the allegations as if a formal disciplinary action was being taken.

There are no rules or processes that govern the issuance of Cautionary Action Letters and no formal appeal process if issued. Although no formal process exists, a firm can seek to have the Cautionary Action Letter withdrawn if it believes it has proof to refute the allegations. A written submission to the staff is appropriate in this instance; however, it is relief that is rarely granted.

[c] Compliance Conference or Staff Interview

A compliance conference or staff interview is viewed as the most severe form of informal disciplinary action that may be imposed by an SRO, although it is one that is infrequently used and only by FINRA. A compliance conference involves the senior management of a firm being summoned to the offices of FINRA where FINRA senior management and staff explain their concerns to the firm and what they expect the firm to do to address those concerns. Subsequent to this meeting, the firm must, within 30 days, satisfy FINRA that they implemented procedures and controls that will address the staff's concerns and prevent a recurrence of the same or similar violations.

[d] Minor Rule Violation Plan

All SROs have minor rule violation plans filed with the SEC that allow it to address certain decorum, technical and minor violations by the issuance of an action pursuant to the plan and delineate the types of rule violations that may be resolved in this manner. n7 A sanction imposed pursuant to the plan is not considered a "final action," and, as such, need not be reported on a firm's Form BD. The process for the initiation of this sanction varies among the SROs in the sense that most SROs view the imposition of such a sanction as a staff initiated action similar to the imposition of a Cautionary Action Letter while FINRA imposes a process that is essentially equivalent to the process involved in a settlement resulting in the issuance of a Letter of Acceptance, Waiver, and Consent described below. n8 A firm will enter into such a settlement without admitting or denying the allegations therein but consenting to the findings and the sanctions imposed. n9 Such sanctions may not exceed a monetary fine of \$2,500 (NYSE Rule 476 allows for a fine of up to \$5,000) and can not involve a suspension or other limitation on the member's or associated person's activities. n10

[e] Formal Disciplinary Consent Proceedings

For settlements involving violations that do not qualify for treatment under the Minor Rule Violation Plan or for which the SRO is unwilling to resolve by that procedure, formal consent proceedings are entered into with FINRA by the acceptance of a Letter of Acceptance, Waiver, and Consent ("AWC") or with other SROs by way of a Stipulation and Consent.

[3] Letter of Acceptance, Waiver and Consent

An AWC may be used by FINRA as a vehicle to settle any disciplinary matter short of the issuance of a complaint and may impose any type of appropriate sanction ranging from any amount of monetary fine, disgorgement, restitution, undertaking, suspension, bar, and expulsion. The process for the submission and acceptance of an AWC is provided for by FINRA Rule and like a Minor Rule Violation Letter involves the respondent consenting, without admitting or denying the allegations contained therein, to the findings and the sanctions imposed. Like the Minor Rule Violation Letter described above, the respondent waives certain rights including his right to appeal should the AWC be accepted. n11

The process by which an AWC and Minor Rule Violation Letter is approved involves the drafting of the document by the staff and providing it to the respondent for his review. A respondent will normally be provided approximately two weeks to execute or reject the proposal. While the majority of the document is boilerplate language and not subject to negotiation, counsel should assure that the description of the respondent and the respondent's relevant prior disciplinary history is accurate and necessary. Moreover, counsel should focus on the charges included and the way such charges are described to determine if it is necessary to negotiate the elimination of certain charges or seek to have them described in another manner to accurately reflect the conduct alleged and ensure that the respondent, although admitting to the findings of misconduct, will be viewed in the best light possible by any subsequent reader of the document. Finally, the sanctions reflected should accurately reflect what the staff agreed to in negotiations.

A respondent is provided the opportunity to submit a Statement of Mitigation and/or Statement of Corrective Action along with the AWC. The respondent may not deny the allegations or findings in either document or it will be rejected by the staff. A Statement of Mitigation will be reviewed by the staff and the accepting body, however, it will not become a permanent part of the document. On the other hand, a Statement of Corrective Action becomes a permanent part of the AWC and will be provided to the public pursuant to any request for a copy of the document. Either of these statements is necessary only in those circumstances where the staff has indicated that while they believe the AWC reflects an appropriate settlement, they have expressed a concern that the accepting body may not and reject it. Careful thought should be brought to the determination of whether to attach either statement as they will be viewed very closely in the determination of whether to accept this settlement and, more importantly, if subsequent actions occur.

Once the AWC is submitted to the staff, the staff prepares a memorandum to the Office of Disciplinary Affairs ("ODA") that explains the alleged conduct, violations, and proposed sanctions and an argument as to why it should be accepted. The ODA may accept the AWC on behalf of FINRA or reject it and submit it to the National Adjudicatory Counsel ("NAC") for further review. The NAC may reject or accept the settlement. If rejected, the staff will be directed to renegotiate the settlement consistent with the guidance the NAC may provide. If negotiations are unsuccessful, a complaint will be issued.

[4] Stipulation and Consent

The NYSE Stipulation and Consent process is very similar to the FINRA AWC process except for one very important aspect. The settlement proposal will be provided to a hearing panel convened for the purpose of hearing the action and that panel will determine whether to accept or reject the proposal. If rejected, the staff and the respondent could renegotiate a settlement containing terms acceptable to the panel or the staff could file a complaint, commence a formal hearing process, and hold a hearing before the panel. n12

FOOTNOTES:

(n1)Footnote 1. *See* Chapter 17 for further guidance.

(n2)Footnote 2. FINRA Regulatory Notice 08-70 "FINRA Provides Guidance Regarding Credit for Extraordinary Cooperation" (November 2008); *see*, NYSE Information Memorandum 05-65 (September 14, 2005).

(n3)Footnote 3. Pursuant to FINRA Sanction Guidelines, the remoteness of certain violations should be considered. For instance if the prior violations occurred more than three years prior to the conduct alleged in the instant action, it will not be considered as a prior violation.

(n4)Footnote 4. FINRA Rule 8313.

(n5)Footnote 5. FINRA By-Laws, Article III, Section 3. *See also*, FINRA Statutory Disqualification Process at [http://www.finra.org/Industry/Enforcement/Adjudication/NAC/Statutory DisqualificationProcess/](http://www.finra.org/Industry/Enforcement/Adjudication/NAC/Statutory%20DisqualificationProcess/)

(n6)Footnote 6. If the Cautionary Action Letter is issued pursuant to a decision by a hearing panel or the National Adjudicating Council, it will be viewed as a sanction pursuant to FINRA Rule 8310(a)(6). NASD Interpretive Letter from Shirley H. Weiss to Conrad C. Lysiak, Esq. dated August 2, 2001.

(n7)Footnote 7. For instance, pursuant to FINRA Procedural Rule 9217, FINRA provides a list of violations that may be resolved through the issuance of a Minor Rule Violation Letter.

(n8)Footnote 8. Most SROs, other than FINRA, issue such actions without negotiation with the potential respondent and provide that if the potential respondent refuses to accept, a complaint will be filed and formal disciplinary action commenced. FINRA does not impose the sanction in this manner and it is always issued as a result of negotiations with the staff.

(n9)Footnote 9. In accepting the sanction, the potential respondent gives up certain rights. As reflected in FINRA Procedural Rule 9216(b), the respondent gives up any right to claim bias or prejudgment and to claim that a person violated any *ex parte* prohibitions in connection with discussions regarding the terms and conditions of the Minor Rule Violation Plan Letter or other consideration of the minor rule violation plan letter, including acceptance or rejection of such minor rule violation plan letter.

(n10)Footnote 10. A censure will normally not be imposed because of the *de minimis* amount of the fine. In fact, FINRA has a policy of not issuing a censure for most actions involving a fine of \$5,000 or less. *See* NASD Notice to Members 99-59 (July 1999).

(n11)Footnote 11. FINRA Rule 9216.

(n12)Footnote 12. NYSE Rule 476(g).



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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense § 25.07

AUTHOR: Michael D. Wolk and Richard G. Wallace

§ 25.07 Formal Disciplinary Hearing Process

All SROs maintain procedural rules for the conduct of formal disciplinary hearings. Each provides for the commencement of the process by the filing and serving of a complaint or statement of charges upon the respondent(s). n1 The complaint or statement of charges must describe the facts and rule violations in reasonable detail; however, the staff is generally provided some latitude in this area. Respondents are provided 25 days in which to file an answer to the complaint or statement of charges. n2 The failure to file an answer to all, or part of, the allegations may be deemed by the SRO to be an admission of the charges and result in a default decision.

FINRA employs individuals who serve as professional hearing officers and serve no other function at the SRO. They are not involved in the investigation of the matter or determining whether disciplinary action should be initiated. These professional hearing officers serve on the hearing panel and their powers are generally consistent with that of an adjudicator in an administrative proceeding. One or two other industry participants are also appointed to the hearing panel to consider the evidence presented, ask questions, and reach a decision with the hearing officer. The hearing officer will conduct pre-hearing conferences and rule on his own on non-dispositive matters while engaging the entire panel to rule on dispositive matters. Other SROs rely solely on industry representatives to serve on their hearing panels. Generally, the presence of a professional hearing officer makes the true operation of the hearing less of a "businessman's" forum than it once was.

[1] Discovery

Unlike most other SROs, FINRA provides for some right to discovery. n3 Other SROs provide only for production of exhibits that the SRO intends to use at the hearing (production of such may be required only five days prior to the hearing) or discovery is left to the discretion of the hearing officer. In any event, inspection and examination reports, memoranda and other internal SRO documents are usually protected from production. In SROs that do not have explicit discovery rules, counsel will have to negotiate with the staff to inspect its files and attempt to review as much of the files as possible as far in advance of the hearing as possible. Staff reluctance to produce its files for inspection and copying is rare and will necessitate the filing of motions with the hearing panel to compel discovery.

Pursuant to FINRA Rule 9251, the staff must produce for inspection and copying, within 21 days of the filing of the last

answer, all documents prepared or obtained by the staff in connection with the investigation leading to the instant proceeding. n4 Additionally, if the staff obtains documentation subsequent to the filing of the complaint, it must be produced to the respondent within 14 days. n5 If the respondent requests at least 21 days prior to the hearing and can demonstrate that it needs documents and testimony material to the hearing that it can not otherwise obtain through other means and state that the custodian of the documents is the subject of FINRA jurisdiction, it may move the hearing panel to issue a FINRA Rule 8210 request to obtain the information. n6

[2] Hearing

If the respondent desires a hearing, he must explicitly request such at the time he files his answer. n7 A Notice of the time, place and date of the hearing must be served on the respondent, pursuant to FINRA Rule 9221 at least 28 days prior to the hearing date. n8 Prior to the hearing, the various SROs formally or informally provide for a period of time for motions to be considered and for holding pre-hearing conferences. At the hearing, both sides are given an opportunity to present their cases through the submission of relevant documents and witnesses. While the rules of evidence do not apply, hearing officers will look to the rules for guidance in making evidentiary rulings.

Subsequent to the hearing and any post-hearing submissions, if allowed, the panel will issue its decision making findings and imposing sanctions.

FOOTNOTES:

(n1)Footnote 1. FINRA Rule 9211; NYSE Rule 476(d).

(n2)Footnote 2. FINRA Rule 9215; NYSE Rule 476(d).

(n3)Footnote 3. FINRA Rule 9251.

(n4)Footnote 4. FINRA Rule 9251(d).

(n5)Footnote 5. FINRA Rule 9251(a)(2).

(n6)Footnote 6. FINRA Rule 9252.

(n7)Footnote 7. FINRA Rule 9221(a).

(n8)Footnote 8. FINRA Rule 9221(d).



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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense § 25.08

AUTHOR: Michael D. Wolk and Richard G. Wallace

§ 25.08 Sanctions

All SROs have enacted rules allowing them to impose any "fitting" sanction. Most formal proceedings will result in the imposition of a censure should the SRO find the respondent guilty of the alleged conduct and rule violations. Although not enumerated in the list of permissible sanctions, SRO settlements often include undertakings for members to revise supervisory procedures, hire an independent consultant, or make restitution. As discussed above, FINRA will not impose a censure for most violations when a fine of less than \$5,000 is levied or where there is a suspension or bar.

[1] Monetary Fines

All SROs issue fines for rule violations. Some are issued pursuant to published or unpublished sanction guidelines but other than that restriction there is no limitation on the amount of the fine that can be imposed. Additionally, if there are findings of conversion, monetary harm to investors or others or monetary benefit to the respondent, the SRO may factor that into the fine or imposes an amount of disgorgement or restitution equal to the extent of harm or benefit to the respondent.

[2] Suspension or Bar

The SRO may impose a suspension on an individual or a firm whereby the person or the firm is suspended from acting in all or specific capacities within the securities industry for a specified period of time. Once the period of suspension is completed, the person or firm may reenter the industry in good standing if all fines and other requirements have been satisfied. If a person has been suspended for more than two years, however, he or she will have to requalify for all registrations that are maintained with FINRA.

If an individual is barred or a firm is revoked or expelled, they are prohibited from acting in such capacity, permanently. They have the right to petition the SRO at a later time for re-entry through a statutory disqualification proceeding; however, such efforts are usually unsuccessful.



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CHAPTER 25 SRO REGULATORY MATTERS

2-25 Securities Enforcement: Counseling and Defense § 25.09

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§ 25.09 Appeals

Both the respondent and the staff have a right within certain specified time frames to appeal the decision of the hearing panel before an SRO governing body. n1 Additionally, the SRO governing body may call a case for review on its own initiative. n2 During the appeal, any sanctions imposed by the SRO are stayed. Such appeals will normally involve the submission of appellate briefs from both parties and oral arguments before a designated sub-committee of the governing body. The sub-committee will reach a tentative decision that must be approved by the entire governing body. In reaching its decision, the governing body may dismiss findings of violations, make findings of violation where the hearing panel dismissed the charge, and modify, in any way, the hearing panel's imposed sanctions.

Following the issuance of this decision, a respondent may appeal the matter to the SEC. An appeal to the SEC can only be maintained if the respondent has exhausted all review proceedings at the SRO. While either party may request oral arguments before the SEC, most SRO appellate proceedings are decided on the record and written briefs filed with the SEC. Additionally, the respondent must petition the SEC for a stay of sanctions imposed by the SRO during the course of the appeal to the SEC. If the respondent is unsuccessful at this level of review, it may be appealed to the United States Court of Appeals.

FOOTNOTES:

(n1)Footnote 1. FINRA Rule 9311(a) and NYSE Rule 476(f) provide that the respondent or the staff must file an appeal within 25 days of the date the hearing panel decision is served.

(n2)Footnote 2. FINRA Rule 9312 provides that the NAC must call the matter for review within 45 days of the date the hearing panel decision is served, while NYSE Rule 476(f) provides for a 25 day period.



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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense 26.syn

AUTHOR: Gordon Davenport III

§ 26.syn Synopsis to Chapter 26: INSURANCE

§ 26.01 Introduction

§ 26.02 Applicability of the Policy

§ 26.03 Meaning of "Claim"

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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense § 26.01

AUTHOR: Gordon Davenport III

§ 26.01 Introduction

One issue to consider in any SEC investigation is whether insurance may cover the costs of responding to the investigation. The type of insurance most likely to provide coverage is Directors and Officers ("D&O") insurance. Unlike many other types of insurance, D&O policies are not standardized. Policy forms and terms vary from company to company. Further, many insurance companies change the terms of their policies from time to time, and the pace of change has accelerated in recent years as insurance companies have responded to market conditions. As a result, it is always important to evaluate carefully the specific provisions of the particular policy involved.

Comment

Given the complexity of D&O insurance coverage issues, it is often prudent to consult with an attorney who has experience in those issues for assistance in evaluating coverage.

A detailed discussion of D&O insurance coverage issues is beyond the scope of this book. However, this chapter discusses some issues and considerations that may arise in connection with evaluating whether a D&O policy covers an SEC investigation.



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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense § 26.02

AUTHOR: Gordon Davenport III

§ 26.02 Applicability of the Policy

Since many companies change their D&O coverage from time to time, the question of which policy applies may arise. In most cases, it is the policy in effect at the time notice of the SEC investigation is received. Virtually all D&O policies are "claims-made" policies. This means that they cover claims that are asserted during the policy term. Therefore, the policy in effect at the time notice of the SEC investigation is first received is the most likely source of coverage.



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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense § 26.03

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§ 26.03 Meaning of "Claim"

Most D&O policies state that they cover "claims" and explicitly define what constitutes a "claim." A lawsuit is an obvious example of a claim. The issue of whether an SEC investigation constitutes a claim can be far more controversial. Indeed, this is often the key issue in determining whether there is coverage for an SEC investigation.

Some D&O policies explicitly grant coverage for securities-related claims. One example of policy language defining such a grant of coverage is as follows:

Securities Action Claim means any judicial or administrative proceeding initiated against any of the Directors or Officers... based upon, arising out of or in any way involving the Securities Act of 1933, the Securities Exchange Act of 1934, rules or regulations of the Securities and Exchange Commission under either or both Acts, similar securities laws or regulations of any state, or any common law relating to any transaction arising out of, involving or relating to the sale of securities in which they may be subjected to a binding adjudication of liability for damages or other relief, including any appeal therefrom. n1

This language specifically grants coverage for administrative and judicial proceedings involving securities matters. Nevertheless, the court in *Foster v. Summit Medical Systems, Inc.*, n2 interpreting this very language, held that the policy did *not* cover costs incurred in connection with an SEC investigation, because the investigation was not a proceeding in which the insureds could be subjected to "liability for damages or other relief."

Other D&O policy forms providing for securities claims coverage explicitly include SEC investigations in their definition of "claim," n3 while others explicitly include coverage of SEC investigations directed against directors and officers but *exclude* coverage of investigations directed against the corporation. n4

Thus, even under policies that are described as providing coverage for securities-related claims, it is necessary to evaluate the specific policy language, as well as the precise nature of the SEC investigation. Moreover, it is necessary to revisit this evaluation as the SEC investigation progresses. Even if the policy does not cover an informal inquiry, it might cover a formal investigation.

If the policy does not explicitly grant coverage for securities-related claims and investigations, the coverage issue can be more ambiguous. In such cases the SEC investigation must fit within the policy's general definition of a "claim." One example of such a definition is as follows:

[A]ny civil proceeding initiated against a DIRECTOR or OFFICER before any governmental body which is legally authorized to render an enforceable judgment or order for money damages or other relief against such DIRECTOR or OFFICER and shall include any appeal from such proceeding. n5

There is authority for the proposition that SEC investigations and other government actions fit within a general definition of "claim." In *Harbor Insurance Company v. Continental Illinois Corporation*, n6 the court held that costs incurred in connection with an SEC investigation were covered by a D&O policy, explaining:

The purpose of this type of insurance policy is to reimburse the insured when it is required to pay out money in defense of its officers and directors. A policy of not reimbursing the company when the charges are only threatened and not filed would encourage litigation and larger expenses. Indeed, failure to settle before a claim is officially filed would aggravate the amount of loss and could be grounds for charges of failure to mitigate damages. n7

Even if the SEC investigation is not itself covered by the policy, but there is parallel civil litigation, there is an argument that at least a portion of the costs of defending the SEC investigation should be covered as part of the defense of the civil lawsuit. The argument is that proceedings in the SEC investigation could have an impact on the civil lawsuit. For example:

- Evidence obtained by the SEC, including transcripts of SEC testimony, could be used by the plaintiffs in the civil lawsuit.
- If the SEC investigation leads to a contested enforcement proceeding that results in an adverse judgment, the plaintiffs in the civil lawsuit might be able to use that judgment to their advantage in the civil lawsuit.
- If the SEC investigation produces factual findings, those findings might be admissible in the civil lawsuit.

For these reasons, the costs of defending the SEC investigation may be covered as part of the defense of the parallel civil lawsuit. n8

FOOTNOTES:

(n1)Footnote 1. Underwriters at Lloyd's, London, policy form 0121, circa 2000.

(n2)Footnote 2. *Foster v. Summit Medical Systems, Inc.*, 610 N.W.2d 350 (Minn. Ct. App. 2000) .

(n3)Footnote 3. American International Companies, D&O policy form 72610, circa 1999.

(n4)Footnote 4. National Union Fire Insurance Company of Pittsburgh, Pa., D&O policy form 70320, circa 1998.

(n5)Footnote 5. Genesis Insurance Company, policy form GIC-7417, circa 2000.

(n6)Footnote 6. *Harbor Ins. Co. v. Continental Illinois Corp.*, No. 85 C 7081, 1989 U.S. Dist. LEXIS 14300 (N.D. Ill. Nov. 27, 1989) , *rev'd on other grounds*, 922 F.2d 357 (7th Cir. 1990) .

(n7)Footnote 7. *Harbor Ins. Co.*, 1989 U.S. Dist. LEXIS 14300 . *See also Polychron v. Crum & Forster Ins. Cos.*,

916 F.2d 461 (8th Cir. 1990) (grand jury subpoena directed to bank and questioning by federal prosecutor and Internal Revenue Service agents constituted "claim" against former bank president within meaning of policy); *Mount Hawley, Ins. Co. v. FSLIC*, 695 F. Supp. 469 (C.D. Cal. 1987) (Federal Home Loan Bank Board letters imposing restrictions and threatening enforcement action were a "claim").

(n8)Footnote 8. See *Pepsico, Inc. v. Cont'l Cas. Co.*, 640 F. Supp. 656 (S.D.N.Y. 1986) (costs of defending SEC and grand jury investigations covered by D&O policy, where the investigations and parallel civil litigation were each directed against same company, officers, directors and conduct).



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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense § 26.04

AUTHOR: Gordon Davenport III

§ 26.04 Covered Person or Entity

If the SEC investigation qualifies as a covered claim, the next issue is whether it is directed against a "person" or "entity" covered by the policy.

Most D&O policies cover (1) directors and officers, for claims asserted directly against them, and (2) the corporation, for amounts it pays to reimburse the directors and officers for claims asserted against those individuals. Some policies -- but not all -- also cover the corporation for claims asserted directly against it. Coverage for direct claims against the corporation is commonly called "entity coverage."

If the SEC investigation qualifies as a "claim" and is directed against officers or directors, they will be covered, and the corporation will be covered to the extent it reimburses (or pays directly) the officers' and directors' defense costs. If the SEC investigation is directed against the corporation, it will be covered *only* if the policy includes entity coverage. If the SEC investigation is directed against officers or directors *and* the corporation, and the policy does not include entity coverage, only a portion of the defense costs will be covered. The insurance company will seek to allocate the defense costs between the officers/directors and the corporation, and pay only the portion allocable to the officers/directors. The insurance company has the burden of proving what amount should be allocated to the non-covered portion of the matter.

n1

Comment

Purchasing entity coverage is a good way to reduce or eliminate allocation problems. However, it may also dilute the amount of coverage available to officers and directors, particularly if the policy has low limits of coverage.

FOOTNOTES:

(n1)Footnote 1. *Pepsico, Inc.*, 640 F. Supp. 656, 662 .



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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense § 26.05

AUTHOR: Gordon Davenport III

§ 26.05 Wrongful Act

Most D&O policies state that they cover claims based on "wrongful acts" and define what constitutes a "wrongful act." These definitions of wrongful acts vary, with some broader than others. An example of a relatively broad definition is as follows:

[A]ny actual or alleged error, omission, misstatement, misleading statement, neglect, breach of duty or negligent act by any of the Directors and Officers, while acting solely in their capacity as a director or officer of the Company. n1

Most SEC investigations are likely to satisfy this definition. As a general matter, even with more narrow definitions, the "wrongful act" provision should not be an impediment to coverage for SEC investigations.

FOOTNOTES:

(n1)Footnote 1. Underwriters at Lloyd's, London, policy form circa 2000.



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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense § 26.06

AUTHOR: Gordon Davenport III

§ 26.06 Exclusions

If all of the basic requirements for coverage are met (a claim during the policy period against an insured person or entity for a wrongful act), the next issue is whether the SEC investigation falls within any of the policy's exclusions. If it does, coverage will be partially or totally excluded.

D&O policies may contain a wide range of exclusions. They vary from insurer to insurer and from policy to policy. In addition, the wording of a given type of exclusion may differ from one policy to another. As a result, it is important to carefully evaluate the specific language of all potentially applicable exclusions.

One common exclusion that may come into play in connection with SEC investigations is the fraud/dishonest acts exclusion. This excludes from coverage claims based on fraudulent or dishonest acts, on the theory that insurance should not cover intentional wrongdoing. This can become an issue in connection with SEC investigations where, for example, it is alleged that the corporation or its officers/directors intentionally misrepresented the corporation's financial condition.

Some fraud/dishonest acts exclusions only apply if there is a final adjudication that fraud or dishonest acts did in fact occur. With this language, the insurance company will advance defense costs even if there is an allegation that fraudulent or dishonest conduct occurred. This is favorable to the insured, because coverage cannot be defeated at the outset by a mere allegation of fraud or dishonesty, as can happen with policies that do not include the "final adjudication" language. However, if there *is* a final adjudication of fraud or dishonesty, the insurance company may seek to recover all or a portion of any defense costs it has paid. n1

Another possible exclusion is the securities exclusion. This is uncommon in D&O policies covering public companies, because public companies face a greater risk of securities claims and therefore seek explicit coverage for such claims when purchasing D&O policies. The securities exclusion is more often seen in policies covering private companies.

Other common exclusions include those that rule out coverage for profits or benefits improperly obtained (e.g., insider trading), criminal proceedings (e.g., violations of securities laws with criminal penalties), and the "insured vs. insured" exclusion (which could come into play if the SEC investigation was triggered by a whistle blower who was or is an

officer or director). It is beyond the scope of this book to examine the details of these or other potentially applicable exclusions, but all such exclusions should be carefully considered in connection with any evaluation of D&O coverage for a particular SEC investigation.

FOOTNOTES:

(n1)Footnote 1. A related issue is whether fraud or dishonesty by one officer or director will defeat coverage for other innocent officers and directors. Under some policies, if the SEC appears to be investigating the possibility that an officer or director engaged in securities fraud or other intentional violations of the federal securities laws, the insurer is likely to argue that coverage is not available. In recent years many policies have eliminated this problem by including "severability" clauses, which provide that innocent officers and directors will not lose coverage as a result of intentional wrongdoing by other officers or directors. In many circumstances, it is difficult to ascertain with any degree of confidence which company directors, officers and employees, if any, the SEC is (and is not) investigating for intentional wrongdoing. This uncertainty can raise complex issues with respect to the availability of coverage.



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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense § 26.07

AUTHOR: Gordon Davenport III

§ 26.07 Rescission for Fraud

There is an increasing practice among some issuers of D&O policies, when confronted with claims, to investigate whether the policy can be rescinded altogether on the basis of fraud in the application. If the policy is rescinded, there is no coverage at all, regardless of the nature of the claim or the provisions of the policy.

Insurance policies can be rescinded for fraud in the application if the application contains fraudulent misstatements or omissions that are material to the insurer's decision to issue the policy. n1 A number of courts have held that the insurance company does not have to prove it relied on the misrepresentation by issuing the policy; the insurance company's reliance on the misrepresentation is presumed. n2

It is not uncommon for this issue to arise in connection with securities-related claims. Many securities claims, and likewise many SEC investigations, are based on allegations that the financial condition of the corporation was misrepresented or otherwise inaccurately reported. If the insurance company can demonstrate that it, too, was provided with inaccurate financial information at the time of the application, it may be able to prevail on a claim of fraud in the application. For example, in *Shapiro*, the corporation's president failed to disclose in the insurance application that the financial statements contained a misstatement of income. The court found this to be a material misrepresentation and voided the policy. n3

As with the fraud/dishonesty exclusion discussed above, there may be an issue as to whether fraud by the officer or director who signs the application will defeat coverage for other innocent officers and directors. n4 In recent years, many insurance companies have offered policies with severability provisions as to the application, which can result in fraud by one officer or director in completing the application not defeating coverage for his or her innocent colleagues. However, the language of these severability provisions varies widely. The details of the language should be carefully selected.

FOOTNOTES:

(n1)Footnote 1. See, e.g., *Shapiro v. American Home Ins. Co.*, 584 F. Supp. 1245 (D. Mass. 1984) (confirming longstanding rule that material misrepresentations in the application void the policy); *Bird v. Penn Central Co.*, 341 F. Supp. 291 (E.D. Pa. 1972) (same).

(n2)Footnote 2. *See, e.g., Bouley v. Continental Casualty Co., 454 F.2d 85 (1st Cir. 1972) .*

(n3)Footnote 3. *Shapiro, 584 F. Supp. at 1249 .*

(n4)Footnote 4. *See Bird v. Penn Central Co., 341 F. Supp. 291 (E.D. Pa. 1972) (D&O coverage voided as to innocent officers and directors, because of fraud in the application by chairman of the finance committee).*



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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense § 26.08

AUTHOR: Gordon Davenport III

§ 26.08 Extent of Coverage

Even if all requirements for coverage are met, a D&O policy will not cover all adverse consequences that may result from an SEC investigation. For example, deliberate criminal acts and liability resulting from those acts are not covered. Disgorgement of profits and benefits improperly obtained are generally not covered. Penalties and fines are also usually not covered.

In SEC investigations that have not advanced to the prosecution stage, the primary benefit of D&O coverage is payment of defense costs. However, such payment will be subject to the policy's deductible or self-insured retention ("SIR"), which means that the insurance company will not pay any defense costs until the costs paid by the insured reach the deductible or SIR amount. Many D&O policies have substantial deductibles or SIRs. Retentions of \$500,000 to \$1 million are not uncommon, but they often do not apply to the coverage of individual officers and directors. The specifics of the deductible or SIR should be examined carefully, because that amount will be the insured's responsibility.



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CHAPTER 26 INSURANCE

2-26 Securities Enforcement: Counseling and Defense § 26.09

AUTHOR: Gordon Davenport III

§ 26.09 Step-by-Step Process in Attaining Coverage

When notice of an SEC investigation is received, the D&O policy should be reviewed immediately to determine whether coverage may exist.

Comment

Because of the complexity of D&O insurance coverage issues, it may be prudent to consult an attorney with experience in these issues.

If it appears there is a possibility of coverage, notice of the SEC investigation should be given to the issuer of the D&O policy as soon as possible. If there is more than one layer of coverage, notice should be given on all policies. All D&O policies require the insured to give notice as soon as a claim is asserted. Even if a claim has not yet been asserted, but the insured learns of facts that may give rise to a claim, it may be advisable to give notice without waiting for the claim. Some D&O policies will cover the claim even if it is not asserted until after the policy has expired, provided notice of the facts that may give rise to the claim was given while the policy was in effect. Whether such notice should be given should be evaluated based on the terms of the specific policy involved.

If notice is not given in a timely fashion, the insurance company may deny coverage on the grounds it was prejudiced by the delay and will almost certainly take the position that any defense costs incurred before notice was given are not covered. Thus, prompt notice is extremely important. It should be given in writing so that a record exists.

Once notice has been given, the insurance company will evaluate whether the SEC investigation is covered by the terms of the policy. Upon completing this evaluation, the insurance company will generally advise the insured in writing of its coverage position. This may be an outright denial of coverage, or a "reservation of rights" letter in which the insurance company indicates that part or all of the matter may be covered but reserves its right to deny coverage based on potentially applicable policy terms and exclusions.

If coverage is not denied altogether, it will be necessary to arrange the defense of the SEC investigation in a manner that complies with the requirements of the D&O policy. Most D&O policies require the insured to conduct its own defense,

with the costs (attorneys' fees, disbursements, etc.) reimbursed by the insurance company after any deductible or self-insured-retention is satisfied. Some policies provide that the insured must select defense counsel from a panel of approved attorneys. Others allow the insured to select any attorney, subject to the insurance company's consent. The policy should be carefully reviewed to ensure that all requirements for selection of counsel and the conduct of the defense are met.

Some D&O policies obligate the insurance company to conduct the defense. In such cases, the insurance company selects and retains defense counsel and directly pays for the costs of defense.

It is possible that only a portion of the defense costs will be covered. This may occur where, for example, the SEC investigation is directed against both the corporation and its officers/directors, and the policy does not include entity coverage. In this situation it will be necessary to allocate the defense costs (and any ultimate liability) between the covered and non-covered portions of the matter, with the insurance company paying only the covered portion.

Whenever the insurance company denies coverage for all or part of a claim, there is the potential for disputes as to whether the denial is correct. Sometimes, it is possible to resolve these disputes by negotiation. If negotiations do not produce an acceptable result, litigation will be necessary. Such litigation is generally commenced in one of two ways: either the insured files a lawsuit against the insurance company seeking coverage, or the insurance company files a declaratory judgment lawsuit against the insured seeking a declaration by the court that there is no coverage.

Such litigation can be commenced immediately after the denial of coverage, or can await the conclusion of the SEC proceedings. Coverage litigation is expensive and time consuming, and the insured will be on its own for the defense of the SEC investigation unless and until the coverage dispute is resolved in its favor. For this reason, many insureds elect to bring a coverage lawsuit sooner rather than later, in the hope of securing coverage as soon as possible.

Coverage litigation can be extremely complex, and key strategic decisions can have a significant impact on the outcome of the case. For example, it is usually important to determine the preferred venue for the litigation. Because the laws governing insurance policies vary from state to state, choice of law becomes an important issue and the choice of venue can affect what law is ultimately determined to apply. This may prompt a strategic decision to file the coverage lawsuit quickly, in order to venue the case in a preferred location and prevent the adverse party from filing first in a less favorable location.

Comment

Because of the above issues and other complex issues, it is advisable to consult an attorney experienced in insurance coverage litigation as soon as a coverage dispute arises.



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CHAPTER 27 INTERNATIONAL ISSUES

2-27 Securities Enforcement: Counseling and Defense 27.syn

AUTHOR: Kenneth B. Winer

§ 27.syn Synopsis to Chapter 27: INTERNATIONAL ISSUES

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§ 27.02 Extraterritorial Application of the Federal Securities Laws

[1] Application of Section 10(b) to Extra-Territorial Transactions

[2] Personal Jurisdiction

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[1] Compulsory Process

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CHAPTER 27 INTERNATIONAL ISSUES

2-27 Securities Enforcement: Counseling and Defense § 27.01

AUTHOR: Kenneth B. Winer

§ 27.01 Introduction

The Securities and Exchange Commission ("SEC" or "Commission") operates in an interdependent, global marketplace. Foreign transactions in the United States equities markets increased from \$4.52 trillion in 1999 to \$7.04 trillion in 2000. n1 By the same token, U.S. transactions in foreign stocks increased from \$2.34 trillion in 1999 to \$3.6 trillion in 2000. n2 In this worldwide marketplace, the SEC's success in protecting U.S. investors and the integrity of the U.S. marketplace increasingly depend on international regulatory and enforcement initiatives. This chapter highlights some of the jurisdictional and procedural issues confronting the SEC as it seeks to enforce the federal securities laws in matters involving international transactions.

FOOTNOTES:

(n1)Footnote 1. Securities Industry Yearbook, 2001-2002.

(n2)Footnote 2. Securities Industry Yearbook, 2001-2002.



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CHAPTER 27 INTERNATIONAL ISSUES

2-27 Securities Enforcement: Counseling and Defense § 27.02

AUTHOR: Kenneth B. Winer

§ 27.02 Extraterritorial Application of the Federal Securities Laws

[1] Application of Section 10(b) to Extra-Territorial Transactions

The federal securities laws are silent regarding their extraterritorial application. n1 In 2010, the Supreme Court held, in the context of a private action, that Section 10(b) does not provide a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities listed on U.S. exchanges or the purchase or sale of any other security in the United States, even if the deception originated in the United States. The Dodd-Frank Act, which was enacted approximately one month after the Supreme Court issued its holding, limited the application of this holding by providing that federal district courts have jurisdiction over actions commenced by the SEC alleging violations of the securities laws' antifraud provisions "even if the securities transaction occurs outside the United States and involves only foreign investors," if it alleges conduct in the United States that constitutes "significant steps in furtherance of the violation" or conduct outside the United States that has a "foreseeable substantial effect within the United States." n2 n3-12 The Dodd-Frank Act also required the SEC to conduct a study to determine whether the extraterritorial jurisdiction of the federal courts should also be extended to private rights of action under the antifraud provisions.

[2] Personal Jurisdiction

Courts also have analyzed the degree to which they may exercise personal jurisdiction over foreign defendants who have violated the federal securities laws. This analysis turns on the degree of the defendant's minimum contacts with the United States. For example, in *SEC v. Unifund SAL*, n13 the Second Circuit considered whether U.S. courts had jurisdiction to issue a preliminary injunction against Unifund SAL, an investment company based in Lebanon and incorporated under Lebanese law, which had purchased stock in a U.S. company listed on the New York Stock Exchange ("NYSE") through the Beirut office of Merrill Lynch, Pierce, Fenner & Smith, Inc.

The SEC alleged that Unifund had made these purchases based on inside information regarding a potential merger between the U.S. company and a French company. The Second Circuit held that the U.S. courts had personal jurisdiction over Unifund because it had acted in such a way as to have caused consequences in the United States:

Since the Exchange Act permits the exercise of personal jurisdiction to the limit of the *Due Process*

Clause of the Fifth Amendment, the personal jurisdiction challenge raised by Unifund must be tested against due process standards. Those standards permit the exercise of jurisdiction over a defendant whose "conduct and connection with the forum State are such that he should reasonably anticipate being haled into court there." One circumstance making such anticipation reasonable is where a defendant has acted in such a way as to have "caused consequences" in the forum State.

Though not every casual connection between action abroad and ultimate injury to American investors will suffice, ... Unifund's transactions are alleged to have had a rather direct and an unmistakably foreseeable effect within the United States. It is alleged to have traded, on the basis of inside information, options of the United States corporation listed exclusively on a United States stock exchange. That activity created the near certainty that United States shareholders, who could reasonably be expected to hold Rorer securities, would be adversely affected. The casual relationship is far more direct than in *Bersch*. In that case we said there was no basis for believing that a Canadian brokerage firm had knowledge that some United States citizens would purchase shares of the Bahamian subsidiary of a Canadian corporation where the prospectus represented that the shares would not be offered in the United States. [*Bersch*, 519 F.2d 974, 980,1000] . n14

Similarly, in *SEC v. Carrillo*, n15 the Eleventh Circuit held that it had personal jurisdiction over a foreign corporate defendant because the corporation had sufficient minimum contacts with the United States to reasonably anticipate being haled into a U.S. court. Specifically, the corporation had (1) placed advertisements in two airlines' in-flight magazines; (2) mailed offering materials directly to U.S. investors; (3) maintained bank accounts in the United States to receive payments from investors; and (4) mailed at least one stock certificate to a U.S. investor. The court found that these contacts "related to and gave rise to" the SEC's claims that the defendant had violated federal securities laws because each of the contacts was a "step by which the allegedly fraudulent scheme was carried out." The court also found that, through these deliberate contacts, the corporation had purposefully availed itself of the privilege of doing business in the United States Based on these findings, the court concluded that the corporate defendant "should reasonably have expected to be haled into" a U.S. court, and was thus subject to personal jurisdiction in the U.S. n16

In *SEC v. Alexander*, n17 the district court recognized that some contacts simply are too attenuated to subject a foreign defendant to personal jurisdiction in the United States In *Alexander*, the court held that Ms. Gianna Toffoli, a non-English speaking Italian woman, allegedly trading on inside information, did not have minimum contacts sufficient to reasonably expect to be haled into a U.S. court. The court based its decision on several factors.

First, the court noted that the lone transaction at issue was initiated in Italy by an Italian bank and involved the securities of an Italian company. Furthermore, the court was convinced that Ms. Toffoli had no knowledge that her transaction would be effectuated via the sale of ADRs that were listed on the NYSE. The court also found that the amount of trading by Ms. Toffoli (allegedly avoiding losses of only \$20,250), was far below the amounts found in earlier cases to be sufficient to support a finding of sufficient minimum contacts. n18 Based on these facts, the court determined that Ms. Toffoli's contacts with the United States were so attenuated that she could not reasonably have expected to be haled into an American court.

FOOTNOTES:

(n1)Footnote 1. *See Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir. 1991) , cert. denied, 502 U.S. 1005 (1991) (citing 15 U.S.C.S. § 78aa (vesting federal district courts with exclusive original jurisdiction over violations of the Securities Exchange Act)).

(n2)Footnote 2. Dodd-Frank Act § 922P(b).

(n3)Footnote 3-12. [Reserved]

(n4)Footnote 13. *SEC v. Unifund SAL*, 910 F.2d 1028 (2d Cir. 1990) .

(n5)Footnote 14. *Unifund*, 910 F.2d at 1033 (citations omitted).

(n6)Footnote 15. *SEC v. Carrillo*, 115 F.3d 1540 (11th Cir. 1997) .

(n7)Footnote 16. *Carrillo*, 115 F.3d at 1542 .

(n8)Footnote 17. *SEC v. Alexander*, 160 F. Supp. 2d 642, 656-657 (S.D.N.Y. 2001) .

(n9)Footnote 18. The court in *Alexander* pointed to *SEC v. Euro Security Fund, Coim SA, No. 98 Civ. 7347, 1999 U.S. Dist. LEXIS 1537* (S.D.N.Y. Feb. 17, 1999) for the proposition that parties making substantial purchases of stock on an American exchange (e.g., \$6 million in a one month period), "should reasonably anticipate being haled into an American court." (citing *Euro Security Fund, 1999 U.S. Dist. LEXIS 1537* at *3) .



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CHAPTER 27 INTERNATIONAL ISSUES

2-27 Securities Enforcement: Counseling and Defense § 27.03

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§ 27.03 Gathering Evidence Abroad

[1] Compulsory Process

Jurisdictional issues also arise in the context of the SEC's subpoena powers. Courts have held that the SEC cannot compel the production of witnesses or documents from outside the United States by serving a subpoena on a person located outside the country n1 Accordingly, the SEC requires certain foreign issuers and securities professionals to designate it as their agent for service of process in matters arising under the federal securities laws. n2

In *In re SEC v. Knowles*, n3 the SEC had served an administrative subpoena on Gaye B. Knowles, a Bahamian citizen, outside his home in Nassau, Bahamas. Knowles challenged the subpoena on the grounds that the district court could not properly exercise jurisdiction over him because of his lack of personal contacts with the United States. The Tenth Circuit held that the district court had personal jurisdiction over Knowles. The appeals court noted that there are two sources of jurisdiction: specific and general jurisdiction. n4 It said:

Specific jurisdiction may be exercised where the defendant has "purposefully directed" its activities toward the forum jurisdiction and where the underlying action is based upon activities that arise out of or relate to the defendant's contacts with the forum. A nonresident defendant may be subjected to the forum's general jurisdiction even where the alleged activities of the defendant upon which the claims are based are unrelated to his contacts with the forum. The forum court's general jurisdiction may be invoked over the defendant on any matter if the defendant's unrelated contacts are sufficiently "continuous and systematic" that the exercise of jurisdiction is "reasonable and just." n5

In *In re Sealed Case*, n6 the D.C. Circuit reversed a district court order holding in contempt a witness for failing to comply with a grand jury subpoena calling for the production of documents in the possession of a foreign company that the witness allegedly controlled. The subpoena directed the witness to produce in his capacity as "custodian" various documents pertaining to the operations of eight foreign companies whose records he allegedly controlled. n7 The court held that because the subpoena was addressed to the witness in a representative capacity, it was enforceable only to the extent that the district court had jurisdiction over the individual companies. n8 The court also held that the witness's status as a U.S. citizen was irrelevant in establishing jurisdiction over the foreign companies. n9 The court stated that service of a subpoena on a corporate officer vacationing in the United States would not allow the grand jury to access

corporate records absent proof that a U.S. court had jurisdiction over the corporation itself. n10 The court noted that in the case of a foreign company that does business abroad, personal jurisdiction "may be founded on conduct abroad that causes injury within the United States," and held that the person seeking to enforce the subpoena had the burden of establishing such injury. n11

The federal securities laws authorize the SEC to compel the production of witnesses and documents "from any place in the United States" n12 Arguably, this provision authorizes the SEC to compel a person served with a subpoena within the United States to produce in the United States documents located outside the country. n13

The SEC arguably can perfect service upon the substantial number of foreign individuals and entities that have designated it as their agent for service for certain purposes. Foreign brokers and investment advisers registered with the SEC are required to appoint the SEC as their agent for service of process in matters arising under the federal securities laws. n14 Moreover, if such brokers and investment advisers do not maintain books and records in compliance with SEC rules within the United States, they must file a written undertaking that they will furnish such books and records to the SEC upon demand. n15 In addition, foreign issuers of securities registered under Regulation A of the Securities Act of 1933 must designate the SEC as their agent for service of process in matters arising from the offer of such securities. n16

In the Dennis Levine investigation, a prominent insider trading case in the mid-1980s, the SEC served a subpoena on an executive of a Bahamian bank while the executive was in the United States. Alternatively, the SEC could issue the subpoena to the U.S. branch of a foreign corporation. n17

[2] Foreign Non-Disclosure Laws

A number of foreign countries have nondisclosure laws, such as bank secrecy and blocking laws, which hamper the ability of the SEC to obtain information from abroad. Bank secrecy laws protect the confidentiality of information entrusted to banks by their customers. For example, a bank secrecy law might limit the ability of banks to produce information without the consent of the customer who confided that information to the bank. Blocking laws also foreclose or limit discovery regarding certain issues by making it illegal to provide certain information to foreign regulators.

The federal courts have taken three approaches to assessing whether a foreign nondisclosure law should protect information from compelled disclosure. In the early 1960s, the Second Circuit held on grounds of international comity that persons should not be ordered to disclose information in violation of foreign nondisclosure laws. n18 Even in some circumstances where it would be possible to circumvent the nondisclosure provisions, respect for these laws would still protect the desired information. n19

A second approach focuses on whether the recipient of the subpoena is acting in good faith. In *Societe Internationale, S.A. v. Rogers*, n20 the United States Supreme Court stated that the good faith of the recipient of the subpoena is an important factor in the decision whether to impose sanctions when foreign law prohibits the requested disclosure. The Supreme Court held that the recipient should not be sanctioned for not producing the subpoenaed records since (1) "fear of criminal prosecution constitutes a weighty excuse for non-production, and this excuse is not weakened because the laws preventing compliance are those of a foreign sovereign," and (2) the recipient had made extensive efforts at compliance. n21

A number of courts have applied the approach of balancing various factors, including the competing national interests involved. These courts look for guidance in § 40 of the *Restatement (Second) of Foreign Relations Law of the United States ("Restatement")* in determining whether a person should be ordered to produce information in the United States where the production of such information would expose that person to criminal prosecution by a foreign government. n22 In *SEC v. Banca Della Svizzera Italiana*, n23 the court ordered a bank to produce records in arguable violation of

Swiss bank secrecy laws after balancing a number of factors, including "[t]he strength of the United States' interest in enforcing its securities laws to ensure the integrity of its financial markets," the fact that the Swiss government had not intervened in order to oppose the disclosure of the secrets, and a provision of Swiss law relieving one of criminal liability for disclosing bank secrets if one disclosed the information in order to protect one's own good faith from an immediate danger for which one is not responsible. n24

In *United States v. Vetco, Inc.*, n25 the Ninth Circuit examined *Societe Internationale* and applied the balancing test in determining whether the recipient of an Internal Revenue Service subpoena should be sanctioned for not producing documents arguably protected by the Swiss penal code. The Ninth Circuit distinguished *Societe Internationale* on several grounds in reaching an opposite result. Specifically, the court noted that in *Vetco* that: (1) the recipient of the subpoena had not made extensive efforts to comply with the subpoena, (2) the Swiss government had made no effort to enjoin production of these records, and (3) the document request at issue here was a government subpoena exploring possible criminal conduct. It then looked to § 40 of the *Restatement* in balancing the conflicting interests, n26 held that the request engaged the more important U.S. national interest in detecting and preventing criminal conduct than the civil discovery order at issue in *Societe Internationale*, and imposed sanctions.

Comment

Given the expense, delays, uncertainty, and controversy involved in attempting to compel a foreign company to produce within the United States documents held in a foreign country, the SEC is reluctant to use its compulsory process to attempt to compel the production of materials from abroad, especially when the information is protected by foreign nondisclosure laws.

Many of the bank secrecy laws provide that the bank customer has the power to authorize the disclosure of information otherwise protected by the laws. The SEC has sought to overcome the impediments posed by such laws by seeking court orders compelling the suspected bank customer to waive the protections. n27

In *Doe v. United States*, n28 the Supreme Court held that a court order compelling a person to waive bank secrecy laws did not violate the person's *Fifth Amendment* right against self-incrimination, as long as the order did not compel the person to acknowledge ownership of the account or the existence of any documents. The court explained that such an order did not implicate the right against self-incrimination because the execution of a waiver was not testimonial, as long as neither the form nor the execution "communicates any factual assertions, implicit or explicit, or conveys any information to the Government." n29

Comment

In general, because blocking statutes purport to protect the interests of the state, individuals do not have the power to waive the protection of these statutes.

[3] Bilateral and Multilateral Agreements

Given these impediments to the use of its compulsory process abroad, the SEC has developed an ability to obtain cooperation from the governments of a number of foreign countries. In December 1989, the Commission created an Office of International Affairs, which has primary responsibility for negotiating and implementing information-sharing agreements, and for coordinating and assisting the response to requests for international assistance. In 2003, the SEC made 309 requests for assistance to foreign governments, while foreign authorities made 344 requests for assistance. n30

The SEC has the authority to initiate contacts with foreign authorities directly, without working through the Department of State. n31 SEC regulations specifically authorize its staff to discuss with representatives of foreign governmental

authorities and foreign securities regulators n32 "information obtained in individual investigations, including examinations and formal investigations pursuant to Commission order." n33

Usually, this cooperation consists of the foreign government obtaining and providing to the United States information (e.g., the identity of individuals with trading authority for foreign accounts) important to assembling a case. Sometimes, this cooperation consists of the foreign government's freezing or repatriating funds to the United States.

The SEC has entered into a series of direct, bilateral arrangements, known as memoranda of understanding ("MOU"), with many of its major foreign counterparts, including regulators in Canada, France, Germany, Italy, Japan, Mexico, Russia, Switzerland, and the United Kingdom. While not legally binding, these MOUs define and formalize procedures to request and provide information in connection with the efforts of the SEC and foreign regulators to administer and enforce their respective securities laws. Typically, MOUs address such matters as methods for gathering information, restrictions on the use of information received pursuant to an MOU, and the availability of compulsory process.

Generally, MOUs contemplate that the signatory authorities will utilize all available authority to assist each other. n34 Examples of assistance that could be provided include:

- providing access to information in files,
- questioning or taking the testimony of designated persons,
- conducting compliance inspections or examinations of investment businesses, and
- permitting the representatives of the requesting authority to participate in the conduct of inquiries made by the requested authority.

In many cases, the authorities have agreed to use compulsory process, where necessary, to obtain requested information. n35

In addition, if the SEC needs information from a country with which it does not have an MOU, the SEC is sometimes able to use certain mutual legal assistance treaties that provide for the exchange of information between domestic and foreign criminal authorities. There are important limitations on the utility of such agreements in that these treaties generally provide for the exchange of information only in criminal matters, and only if the violation under investigation would constitute an offense under the laws of both the United States and the country from which the information is sought.

Accordingly, many requests for assistance under these treaties can be denied, as the U.S. securities laws are broader than those of most countries from which assistance is sought. For example, the SEC has obtained information pursuant to the Treaty on Mutual Assistance in Criminal Matters, between the United States and Switzerland. n36 While Swiss law does not criminalize all the conduct prohibited by the federal securities laws, it does criminalize at least some forms of insider trading. Alternatively, the SEC can attempt to enter into an informal, case-specific arrangement with foreign authorities.

The securities authorities of a number of countries, including Argentina, Australia, Canada, Chile, France, Italy, Japan, Mexico, the Netherlands, and the United Kingdom, have the power to use compulsory process on behalf of the SEC.

The Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters provides for discovery in connection with litigation, but does not provide for discovery in connection with government investigations. Accordingly, there is a strong argument that the Hague Convention cannot be used by the Commission during either information inquiries or formal investigations.

FOOTNOTES:

(n1)Footnote 1. *See, e.g., SEC v. Zanganeh*, 470 F. Supp. 1307 (D.C. Cir. 1978) (refusing to enforce SEC subpoena served on an Iranian citizen living in Paris that was served by leaving the subpoena at the office of an Oklahoma corporation owned and organized by the respondent). *See also CFTC v. Nahas*, 738 F.2d 487, 492-493 (D.C. Cir. 1984) (holding that, in the absence of specific authority to the contrary, 7 U.S.C.S. § 15 did not empower the Commodity Futures Trading Commission to serve subpoenas on foreign nationals in foreign countries).

(n2)Footnote 2. *See 17 C.F.R. §§ 230.263(a), 240.15b1-5(a), 275.0-2(a)*.

(n3)Footnote 3. *In re SEC v. Knowles*, 87 F.3d 413 (10th Cir. 1996) .

(n4)Footnote 4. *Knowles*, 87 F.3d at 418 .

(n5)Footnote 5. *Knowles*, 87 F.3d at 418 .

(n6)Footnote 6. *In re Sealed Case*, 832 F.2d 1268 (D.C. Cir. 1987) .

(n7)Footnote 7. *Sealed Case*, 832 F.2d at 1270 .

(n8)Footnote 8. It appears that the witness was subpoenaed in his representative capacity rather than in a personal capacity in an unsuccessful effort to deny him the ability to decline to produce records on the grounds that the act of production would be self-incriminating. *Sealed Case*, 832 F.2d at 1274-1282 .

(n9)Footnote 9. *Sealed Case*, 832 F.2d at 1273 .

(n10)Footnote 10. *Sealed Case*, 832 F.2d at 1273 .

(n11)Footnote 11. *Sealed Case*, 832 F.2d at 1274 .

(n12)Footnote 12. *See, e.g., Exchange Act § 21(b)*.

(n13)Footnote 13. *See SEC v. Minas de Artemisa*, 150 F.2d 215 (9th Cir. 1945) (enforcing an investigative subpoena that required a Mexican corporation, which was owned and controlled by a U.S. corporation and which did business in the United States, to produce records located in Mexico). *See also CAB v. Deutsche Lufthansa Aktiengesellschaft*, 591 F.2d 951, 953 (D.C. Cir. 1979) (holding that the Civil Aeronautics Board had statutory authority to compel production of foreign documents under 49 U.S.C.S. § 1484(c), the language of which is quite similar to that of § 21(b) of the Exchange Act); *FMC v. DeSemdt*, 366 F.2d 464, 471 (2d Cir. 1966) , *cert. denied*, 385 U.S. 974 (1966) (construing § 27 of the Shipping Act of 1916, 46 U.S.C.S. § 826(a), as authorizing subpoenas that require a U.S. resident "to produce documents under his control wherever they are located.").

(n14)Footnote 14. *See 17 C.F.R. § 240.15b1-5; 17 C.F.R. § 275.0-2*.

(n15)Footnote 15. *17 C.F.R. § 240.17a-7(b)*.

(n16)Footnote 16. *17 C.F.R. § 230.263(a)*.

(n17)Footnote 17. *See, e.g., SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111 (S.D.N.Y. 1981) .

(n18)Footnote 18. *See Application of Chase Manhattan Bank*, 297 F.2d 611, 613 (2d Cir. 1962) ; *Ings v. Ferguson*, 282 F.2d 149 (2d Cir. 1960) ; *First Nat'l City Bank of New York v. IRS*, 271 F.2d 616, 619 (2d Cir. 1959) , *cert. denied*, 361 U.S. 948 (1960) .

(n19)Footnote 19. *See Application of Chase Manhattan*, 297 F.2d at 613 .

(n20)Footnote 20. *Societe Internationale, S.A. v. Rogers*, 357 U.S. 197 (1958) .

(n21)Footnote 21. *Societe Internationale*, 357 U.S. at 211 .

(n22)Footnote 22. See, e.g., *United States v. Rubin*, 836 F.2d 1096, 1100-1102 (8th Cir. 1988) (holding that Cayman Island bank need not produce information in response to subpoena in light of Cayman Island's interest in bank secrecy); *United States v. First Nat'l City Bank*, 396 F.2d 897, 903 (2d Cir. 1968) ; *Banca Della Svizzera Italiana*, 92 F.R.D. 111 (S.D.N.Y. 1981) .

(n23)Footnote 23. *SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111 (S.D.N.Y. 1981) .

(n24)Footnote 24. *Banca Della Svizzera Italiana*, 92 F.R.D at 117-119 .

(n25)Footnote 25. *United States v. Vetco, Inc.*, 691 F.2d 1281 (9th Cir. 1981) .

(n26)Footnote 26. *Vetco*, 691 F.2d at 1288 .

(n27)Footnote 27. See, e.g., *SEC v. Musella*, , [1983-1984 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 99,516* (S.D.N.Y. 1983) .

(n28)Footnote 28. *Doe v. United States*, 487 U.S. 201 (1988) .

(n29)Footnote 29. *Doe*, 487 U.S. at 215 .

(n30)Footnote 30. SEC 2003 Annual Report available at www.sec.gov/annrep03/ar03full.pdf.

(n31)Footnote 31. See Federal Republic of Germany, SEC No-Action Letter, [Current Binder] *Fed. Sec. L. Rep. (CCH) P 76,905 at 78,620* (Aug. 24, 1994) , citing 17 C.F.R. § 203.2.

(n32)Footnote 32. See 17 C.F.R. § 240.24c-1(b) (listing people with whom information may be discussed).

(n33)Footnote 33. 17 C.F.R. § 203.2.

(n34)Footnote 34. See generally, Caroline A.A. Greene, Note, *International Securities Law Enforcement: Recent Advances in Assistance and Cooperation*, 27 *Vand. J. Transnat'l L.* 635 (1994), for a more detailed discussion of the operation of memoranda of understanding.

(n35)Footnote 35. Federal Republic of Germany, [Current Binder] *Fed. Sec. L. Rep. (CCH) P 76,905 at 78,620* (Aug. 24, 1994) .

(n36)Footnote 36. Treaty on Mutual Assistance in Criminal Matters, Jan. 23, 1977, U.S.-Switz., 27 *U.S.T.* 2019 .



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CHAPTER 27 INTERNATIONAL ISSUES

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§ 27.04 Assisting Foreign Regulatory and Enforcement Authorities

Prior to 1988, the SEC lacked the statutory authority to use its compulsory investigative powers to obtain information relating to the violation of foreign securities laws, unless there was a basis for suspecting that the U.S. securities laws had been violated. Therefore, the SEC was limited to providing information that it had in its files or that it could obtain through its "best efforts."

In 1988, Congress authorized the SEC to use its compulsory process in order to assist foreign regulators of securities. n1 Section 21(a)(2) of the Exchange Act now authorizes the SEC to use its compulsory process:

[o]n request from a foreign securities authority, ... if the requesting authority states that [it] is conducting an investigation which it deems necessary to determine whether any person has violated, is violating, or is about to violate any laws or rules relating to securities matters that the requesting authority administers or enforces. The Commission may, in its discretion, conduct such investigation as the Commission deems necessary to collect information and evidence pertinent to the request for assistance. Such assistance may be provided without regard to whether facts stated in the request would also constitute a violation of the laws of the United States.

In deciding how to exercise the discretion, the SEC must consider:

Whether

(A) the requesting authority has agreed to provide reciprocal assistance in securities matters to the Commission; and

(B) compliance with the request would prejudice the public interest of the United States. n2

In 1990, Congress enacted the International Securities Enforcement Cooperation Act of 1990. n3 This statute granted the SEC the authority to make its nonpublic records available to foreign authorities and to sanction securities professionals based on a determination by foreign authorities that the professional had violated specified foreign laws.

A foreign securities authority seeking the SEC's assistance typically submits a written request detailing the facts that constitute potential violations of its laws and explaining how the requested information may be used. The Office of International Affairs at the SEC coordinates these requests. The SEC reviews the request and determines whether to provide the requested assistance. If it decides to authorize the use of its compulsory powers, the Commission issues a formal order designating members of the Division of Enforcement to conduct an investigation in the United States. Witnesses have all of the rights and privileges accorded to witnesses in investigations involving possible violations of the securities laws of the United States.

FOOTNOTES:

(n1)Footnote 1. *See* The Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, *102 Stat. 4677 (1988)*.

(n2)Footnote 2. Exchange Act § 21(a)(2), *15 U.S.C.S. § 78u*.

(n3)Footnote 3. International Securities Enforcement Cooperation Act of 1990, Pub. L. 101-550, *104 Stat. 2713, 2714 (1990)*.



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CHAPTER 27 INTERNATIONAL ISSUES

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§ 27.05 Discovery of Documents Produced to the SEC

A company outside the United States might decide to cooperate with the SEC by producing documents to the SEC even though the company is not subject to the personal jurisdiction of the SEC. The Second Circuit has held that if a company outside the United States sends documents to a law firm in the United States and the law firm, on behalf of the company, produces those documents to the SEC, then the documents are discoverable from the law firm in private litigation. n1

FOOTNOTES:

(n1)Footnote 1. *Ratliff v. Davis Polk & Wardwell*, 354 F.3d 165 (2d Cir. 2003) (holding that plaintiffs in a class action can discover from a law firm documents that law firm had voluntary produced to the SEC on behalf of a client outside the personal jurisdiction of the SEC).



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CHAPTER 28 SPECIAL ISSUES OF BROKER-DEALERS

2-28 Securities Enforcement: Counseling and Defense 28.syn

AUTHOR: Joseph D. Edmondson, Jr.

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CHAPTER 28 SPECIAL ISSUES OF BROKER-DEALERS

2-28 Securities Enforcement: Counseling and Defense § 28.01

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§ 28.01 Introduction

Each year a significant portion of the Securities and Exchange Commission's ("SEC" or "Commission") enforcement efforts are directed at registered broker-dealers. Although broker-dealers are often members of exchanges or other self-regulatory organizations ("SROs"), and all are members of the National Association of Securities Dealers, Inc. ("NASD"), which itself has broad enforcement authority, broker-dealers generally consider the SEC to be their "primary" regulator. Indeed, it is by virtue of their licensure through the acceptance by the SEC of an application on Form BD that a broker-dealer derives its ability to legally sell securities to the public. In addition to enforcement authority, the SEC has an active examination program through which it regularly conducts on-site inspections of broker-dealers. n1 Further, the SEC has a variety of programs by which it remotely performs surveillance of market activities, including those involving broker-dealers.

This chapter addresses three special issues frequently encountered by broker-dealers and persons associated with broker-dealers. First, the chapter briefly describes the SEC inspection process and the obligations of broker-dealers to furnish to the SEC materials requested by the SEC staff promptly. Second, the chapter discusses the potential liability of supervisors for the violative conduct of persons under their supervision. Third, the chapter discusses special reporting obligations applicable to broker-dealers.

FOOTNOTES:

(n1)Footnote 1. Chapter 29 discusses the SEC inspection process with respect to investment advisors and investment companies. Much of this discussion applies to SEC inspections of broker-dealers. The statutory bases for SEC inspections of broker-dealers is discussed in § 28.02, *below*.



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Securities Enforcement: Counseling and Defense

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CHAPTER 28 SPECIAL ISSUES OF BROKER-DEALERS

2-28 Securities Enforcement: Counseling and Defense § 28.02

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§ 28.02 SEC Inspection Process and Obligations of Broker-Dealers to Furnish Records Promptly

As a result of the SEC's broad oversight authority over broker-dealers in this variety of contexts, it is usually appropriate for broker-dealers and their employees to deal with the SEC Staff in a more cooperative, and less adversarial, manner than would otherwise be the case. This is particularly true with respect to requests for documents and testimony. In many cases, the SEC will seek information and documents from broker-dealers by way of informal requests, deemed "voluntary," rather than formal subpoenas. Counsel for a person associated with a broker-dealer may feel that their client would be more comfortable appearing for testimony voluntarily rather than by subpoena.

Section 17(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 17a-4 thereunder impose extensive record-keeping obligations on each registered broker-dealer, registered municipal securities dealer, registered transfer agent and registered clearing agency. n1 Section 17(b) of the Exchange Act provides that persons covered by Section 17(a) "are subject at any time ... from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission" ... Rule 17a-4(j) provides, "Every member, broker-dealer subject to this section shall furnish promptly to a representative of the Commission such legible, true and complete copies of those records of the member, broker-dealer, which are required to be preserved under this section, as are requested by the representative of the Commission." n2 In December 2002, the SEC imposed substantial civil penalties against a number of prominent investment banks based on charges that those banks had failed to maintain e-mails as required by Section 17(a) and Rule 17a-4 thereunder. n3 In March 2004, the SEC imposed a \$10,000,000 civil penalty against Banc of America Securities LLC ("BAS"), charging that

BAS failed in a timely manner:

- (i) to produce electronic mail, including a particular e-mail exchange relating to matters that BAS knew were under investigation,
- (ii) to produce certain compliance reviews after the Staff had requested them, and
- (iii) to produce compliance and supervision records concerning the personal trading activities of a former senior employee of the firm. n4

The Commission also charged that when questioned about certain production failures and delays, "BAS provided the staff with misinformation concerning the availability and the production status of such documents, and engaged in dilatory tactics that delayed the investigation." n5

The findings in the order are informative. "By letter dated November 8, 2001, the staff requested BAS to produce e-mails for seven senior managers for the period January 1, 1999 through November 8, 2001." n6 Obviously, such a request poses substantial burdens. It is not unusual for a senior manager to send and receive, on average, hundreds of emails each business day. Thus, the request could be calling for the review and production of over a million emails.

The Commission also found, among other things, that "in December 2001, BAS advised the staff that it could readily produce e-mails created after June 2001, but that recovery of e-mails before then would require restoration from back-up tapes that would cause BAS to incur an 'unreasonable amount of time, labor and expense.'" n7 The Commission found:

Notwithstanding its advice to the staff that it could not restore pre-June 2001 e-mail without incurring significant burden and expense, BAS promptly restored the specific backup tape that was determined to have the E-mail Exchange on it in order to identify the BCC recipients to the E-mail Exchange. Within one week, BAS obtained copies of the E-mail Exchange reflecting the identities of the BCC recipients. The e-mail retrieved from the backup tape was then deleted from the firm's computer system. After retrieving the E-mail Exchange and identifying the BCC recipients, BAS did not promptly produce that information to the staff. n8

The Commission's apparent indignation over the deletion of the e-mail exchange is understandable. Indeed, the deletion of the e-mail exchange could explain why the Enforcement Division selected BAS to be the first broker-dealer on which it imposed a substantial penalty for failing to cooperate in an Enforcement investigation. Nevertheless, the Commission chose not to emphasize this deletion in its summary of the enforcement proceeding. The decision by the Commission not to emphasize this point arguably suggests that the Commission and the Enforcement Division wanted to send a relatively clear message that substantial penalties could be imposed for failure by a broker-dealer promptly to produce requested records, even absent any deletion of the requested records.

Less understandable is the Commission's apparent indignation over BAS simultaneously (1) stating that restoring the backup tape from January 1, 1999 through June 2001 would require an "unreasonable amount of time, labor and expense" and (2) taking one week to pull an e-mail exchange poses a substantial challenge for defense counsel. Obviously, the fact that BAS could pull one e-mail exchange was perfectly consistent with BAS's position that it would be unduly burdensome to pull all of the e-mails for that 18-month period. In addition, if BAS produced to the Commission those e-mails that it selected for review, BAS would provide the Commission with a road map to the mental processes of its defense counsel, the heart of the attorney work product doctrine. The SEC routinely makes extremely broad discovery requests that it then narrows by negotiation. If the SEC was entitled to obtain all of the documents pulled by defense counsel, it would be able to track the defense efforts and profit by those efforts. Recognizing the importance of the adversarial system, the Supreme Court developed the work product doctrine in order to avoid precisely this abuse of the discovery process. n9

The BAS order is also interesting because of the concern expressed by the Commission that BAS did not promptly inform the SEC Staff regarding obstacles encountered in producing documents. For example, the Commission charged that in January 2003, "BAS learned that certain boxes which likely contained" responsive materials had been destroyed two months earlier and that, "while continuing to investigate which boxes had been destroyed and the extent to which they contained responsive materials, ... BAS asked the Staff to defer BAS's obligations with respect to" n10 the responsive materials without disclosing the destruction of the boxes. It is understandable that BAS wanted to learn the

scope of the issue, and confirm the existence of the issue, before notifying the SEC Staff. Indeed, BAS did later discover many of the materials that it had tentatively believed to have been contained in the destroyed boxes. It is understandable that the Staff would have wanted to learn this information earlier. In addressing such difficult situations, consideration should be given to the danger that the SEC Staff will feel misled if not promptly informed about evidence of possible document destruction.

The Commission began the "Legal Analysis" section of the BAS Order with a set of admonitions likely to be off quoted in future SEC enforcement matters.

Prompt access to a broker-dealer's books and records is fundamental to the Commission's ability to discharge its examination, investigative and law enforcement responsibilities. The Commission's authority to examine a broker-dealer's books and records is unconditional, and is subject only to the requirement that any such examination be reasonable. Prompt access to books and records is particularly critical during an enforcement investigation. When a broker-dealer unreasonably delays producing documents sought during an investigation, it impedes the staff's fact finding capability, can prevent the staff from determining whether violations of law have occurred or are occurring, and can interfere with the Commission's ability to prevent future harm to investors. Such misconduct compromises the integrity of the Commission's processes and warrants immediate, independent enforcement action. (footnotes omitted). n11

Regulated entities and their defense counsel should be mindful of these admonitions in responding to future SEC requests for materials and information. It is important to note that even "voluntary" communications with the SEC staff can be the basis of a criminal violation of the False Statements to Government Act. n12 Accordingly, parties responding to such requests should be mindful of their obligations. n13

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C.S. § 78q(a)* and *17 C.F.R. § 240.17a-4*.

(n2)Footnote 2. *15 U.S.C.S. § 78q(b)* and *17 C.F.R. § 240.17a-4*.

(n3)Footnote 3. *In re Deutsche Bank Sec., Inc., Admin. Proc. File No. 3-10957, SEC Rel. No. 34-46937, 2002 SEC LEXIS 308, *3* (Dec. 3, 2002) .

(n4)Footnote 4. *In re Banc of America Sec. LLC, Admin. Proc. File No. 3-11425, SEC Rel. No. 34-49386, 2004 SEC LEXIS 548, *4* (March 10, 2004) .

(n5)Footnote 5. *In re Banc of America Sec. LLC, SEC Rel. No. 34-49386, 2004 SEC LEXIS 548* .

(n6)Footnote 6. *In re Banc of America Sec. LLC, SEC Rel. No. 34-49386, 2004 SEC LEXIS 548, *6* .

(n7)Footnote 7. *In re Banc of America Sec. LLC, SEC Rel. No. 34-49386, 2004 SEC LEXIS 548, *8* .

(n8)Footnote 8. *In re Banc of America Sec. LLC, SEC Rel. No. 34-49386, 2004 SEC LEXIS 548, *8* .

(n9)Footnote 9. *See Hickman v. Taylor, 329 U.S. 495 (1947)* ; *see also Sporck v. Peil, 759 F.2d 312, 316 (3d Cir. 1985)* ("[T]he selection and compilation of documents by counsel ... in preparation for pretrial discovery falls within the highly-protected category of opinion work product.").

(n10)Footnote 10. *In re Banc of America Sec. LLC, SEC Rel. No. 34-49386, 2004 SEC LEXIS 548, *13* .

(n11)Footnote 11. *In re Banc of America Sec. LLC, SEC Rel. No. 34-49386, 2004 SEC LEXIS 548, *20-21* .

(n12)Footnote 12. *18 U.S.C.S. § 1001.*

(n13)Footnote 13. The SEC will accompany any informal request for documents or information with a disclosure document entitled SEC Form 1661: *Supplemental Information for Regulated Entities Directed to Supply Information Other Than Pursuant to a Commission Subpoena.* By contrast, a subpoena is accompanied by SEC Form 1662.



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CHAPTER 28 SPECIAL ISSUES OF BROKER-DEALERS

2-28 Securities Enforcement: Counseling and Defense § 28.03

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§ 28.03 Failure to Supervise

In addition to the SEC's other available remedies under various provisions of the federal securities laws, the SEC has unique enforcement authority over broker-dealers as set forth in Section 15 of the Exchange Act, entitled "Registration and Regulation of Brokers and Dealers." For example, Section 15(b)(3) renders certain requirements and prohibitions of the federal securities laws applicable to "registered broker-dealers, or any persons acting on behalf of such broker-dealers, irrespective of whether the violation involved the use of the mails or other instrumentalities of interstate commerce." n1

Section 15(b)(4) provides the Commission with authority to "censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer" as a sanction for a variety of different violations, if it finds that such a sanction is in the public interest. n2 Such provisions are applicable as sanctions for direct, or "primary" liability -- a "willful violation" of "any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, [the Securities Exchange Act of 1934], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board" n3 Such provisions are also applicable as sanctions for various forms of indirect, or "secondary" liability -- "willfully aided, abetted, counseled, commanded, induced, or produced the violation" of any of the same provisions listed in Section 15(b)(4)(D). n4 In addition, the statute provides a unique form of secondary liability known as "failure to supervise."

[1] Failure to Supervise under Exchange Act Section 15(b)(4)(E)

Section 15(b)(4)(E) of the Exchange Act provides the Commission with authority to seek sanctions against any broker-dealer or associated person who "has failed reasonably to supervise, with a view to preventing violations of the provisions of ... [the Exchange Act, the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodities Exchange Act, the rules or regulations under any of such statutes or the rules of the MSRB], another person who commits such a violation, if such other person is subject to his supervision." n5 The Section, however, provides the following exception:

no person shall be deemed to have failed to reasonably supervise any other person if --

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and systems without reasonable cause to believe that such procedures and system were not being complied with. n6

[2] The Duty to Supervise

Other than the duty to supervise implied from the SEC's sanction authority under Section 15(b)(4)(E), the Exchange Act does not prescribe the duties appurtenant to a "supervisor" in the broker-dealer context. As such, the SEC is only empowered to bring failure to supervise charges under Section 15(b) in connection with an independent primary violation of the securities laws. There are, however, substantive supervisory requirements found in the SRO rules, specifically the NASD Conduct Rules and the Rules of the New York Stock Exchange ("NYSE").

[a] NASD Conduct Rule 3010

Subsection (a) of Rule 3010 provides the following:

Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the rules of this Association. Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following:

(1) The establishment and maintenance of written procedures as required by paragraphs (b) and (c) of this Rule.

(2) The designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker/dealer is required.

(3) The designation as an office of supervisory jurisdiction (OSJ) of each location that meets the definition contained in paragraph (g) of this Rule. Each member shall also designate such other OSJs as it determines to be necessary in order to supervise its registered representatives and associated persons in accordance with the standards set forth in this Rule, taking into consideration the following factors:

(A) whether registered persons at the location are engaged in retail sales or other activities involving regular contact with public customers;

(B) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;

(C) whether the location is geographically distant from another OSJ of the firm;

(D) whether the member's registered persons are geographically dispersed; and

(E) whether the securities activities at such location are diverse and/or complex.

(4) The designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ

branch office with authority to carry out the supervisory responsibilities assigned to that office by the member.

(5) The assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities.

(6) Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

(7) The participation of each registered representative, either individually or collectively, no less than annually, in an interview or meeting conducted by persons designated by the member at which compliance matters relevant to the activities of the representative(s) are discussed. Such interview or meeting may occur in conjunction with the discussion of other matters and may be conducted at a central or regional location or at the representative's place of business. n7

(8) Each member shall designate and specifically identify to the Association one or more principals who shall review the supervisory system, procedures, and inspections implemented by the member as required by this Rule and take or recommend to senior management appropriate action reasonably designed to achieve the member's compliance with applicable securities laws and regulations, and with the Rules of this Association.

Subsection (b) of the rule requires each member to "establish, maintain and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of this Association." n8

Such written procedures must specify: (1) the supervisory system employed, and (2) the titles, registration status, locations and responsibility of supervisory personnel.

While the NASD Rule does not provide any specifics as to what the NASD believes effective supervision should be, subsections (c), (d), and (e), respectively, establish certain bright-line minimums, requiring member firms to conduct annual internal inspections, review transactions and correspondence, and conduct investigations of the qualifications of their employees.

[b] NYSE Rule 342

Rule 342 of the NYSE provides:

(a) Each office, department or business activity of a member or member organization (including foreign incorporated branch offices) shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility.

The person in charge of a group of employees shall reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees related to the business of their employer and compliance with securities laws and regulations.

(b) The general partners or directors of each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities' laws and regulations. This person shall:

(1) delegate to qualified principals or employees responsibility and authority for supervision and

control of each office, department or business activity, and provide for appropriate procedures of supervision and control.

(2) establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.

(c) The prior consent of the Exchange shall be obtained for each office established by a member or member organization, other than a main office.

(d) Qualified persons acceptable to the Exchange shall be in charge of:

(1) any office of a member or member organization,

(2) any regional or other group of offices,

(3) any sales department or activity.

(e) The amounts and types of credit extended by a member organization shall be supervised by members or allied members qualified by experience for such control in the types of business in which the member organization extends credit. n9

[3] Sufficiency of Written Supervisory Procedures

The first prong of the two-prong exception to liability for failure to supervise under Section 15(b)(4)(E) involves the establishment of written supervisory procedures. Other than the prescription that such procedures would "reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person," the statute is silent as to the structure and content of such procedures. As noted above, both the NASD, under Rule 3010, and the NYSE, under Rule 342, unlike Section 15(b)(4)(E), contain express *requirements* that member firms maintain written supervisory procedures. n10

In this context, the ABA and NASD have promulgated useful guidance as to the substance of such procedures. Recently, the SEC added its views by issuing guidance directed to small, remote branch offices.

[a] ABA Task Force Report on Broker-Dealer Supervision

In 1989, the ABA Task Force on Broker-Dealer Supervision published a report designed to summarize findings of supervisory deficiencies by the SEC and SROs and to assist broker-dealers in determining whether their supervisory procedures are adequate to survive regulatory scrutiny. n11

The Committee noted the following general SEC concerns, as expressed in various enforcement decisions:

1. inadequate emphasis on compliance procedures;
2. insufficient familiarity with compliance procedures on the part of personnel, including, at times, compliance offices and spanning across both branch and regional manager levels;
3. lack of follow-up procedures to assure that supervisory duties are carried out;
4. insufficient experience or qualifications of supervisors (in some cases the supervisors had either known administrative weaknesses or a history of commission sanctions);
5. lack of oversight of branch managers by regional managers;

6. inadequate resources of compliance departments;
7. lack of authority of compliance departments to deal with violations once detected (the absence of an effective mechanism to channel the findings of the compliance department to decision makers at the firm);
8. effectiveness of internal audits; and
9. lack of clear lines of authority between compliance, internal audit, and the operational management of the firm.

In addition, the Task Force identified several substantive areas that the SEC has singled out as often lacking adequate supervisory procedures:

1. customer account issues (suitability, authorization, churning);
2. trading in non-recommended securities and securities for which registered representatives are affiliated with the issuer;
3. transfers of funds and securities, trade corrections and check disbursements;
4. illegal profits; and
5. net capital requirements.

Although the Task Force's report is now over a decade and a half old, the issues identified by the Task Force remain among the most frequent subjects of enforcement actions by the SEC, NASD, and NYSE in the supervisory area. Broker-dealer firms would be well-advised to pay special attention to these substantive areas when periodically surveying the adequacy and effectiveness of their written supervisory procedures and systems.

[b] Initial NASD Guidance

In Notice to Members 98-96, issued in December 1998, the NASD provided detailed guidance as to the form and substance of written supervisory procedures for member firms. The NASD noted that the procedures should include: (a) specific identification of the individual(s) responsible for supervision (by name or by title and position); (b) the steps and reviews to be taken (e.g., exception reports) n12 or surveillance activities; n13 (c) report or other documents to be reviewed and the substantive area being reviewed; including automated systems; (d) the frequency of the reviews; and (e) the method for documenting the reviews.

[c] Supplemental Guidance from NASD

In June 1999, the NASD issued Notice to Members 99-45. One major purpose of the guidance was to clarify that the requirement that supervisory systems and written supervisory procedures under Rule 3010 be separate and apart from the practice and procedure manuals that set forth prohibited practices within the firm -- commonly referred to as "compliance manuals." n14

In the Notice, the NASD reminded firms that supervisory systems must be:

- tailored to the firm's business

- supported by written procedures
- reasonably designed to achieve compliance
- reviewed periodically
- subject to internal inspections
- part of the specific responsibilities of named supervisors
- implemented by qualified personnel
- augmented by annual compliance meetings

[d] Recent SEC Guidance on Supervisory Procedures

In March 2004, the SEC's Division of Market Regulation issued Staff Legal Bulletin No. 17 on the issue of supervisory procedures for small, remote branch offices. n15 In the bulletin, the Staff recognizes the importance of inspections, including unannounced inspections, of remote offices, including interviews of all employees (not only brokers), review of customer files, the signature guarantee log, correspondence and business records. The bulletin also points out how centralized technology can assist firms in monitoring trading and the handling of funds in remote offices. The bulletin represents an excellent checklist in assessing the supervisory procedures, including the procedures for following up on red flags, that can be used by all firms, not simply firms with remote offices.

[e] Role of Compliance Department in Establishing Procedures

A firm will typically turn to its experienced Compliance Department staff to recommend and implement appropriate written supervisory procedures. Compliance Department personnel may also play a direct role in surveillance and exception reporting or a more indirect role in ensuring that certain supervisory procedures are performed and documented by designated supervisors. On at least one occasion the SEC has sought to bring an enforcement action against a compliance official at least in part due to his role in drafting the relevant supervisory procedures. n16 The SEC sued Marion Bass Securities and its compliance officer, Mr. Gerald Chandik, in an administrative proceeding, alleging among other things, that the firm failed to have in place adequate policies and procedures designed to detect and deter mark-up violations in municipal and government securities transactions. The mark-ups and mark-downs in question occurred in 179 transactions and ranged between 4.07% and 17.9% for municipal securities and 3.26% and 4.41% for government securities. Mr. Chandik, the Compliance Officer, argued that the law governing the proper amount of mark-ups and mark-downs in municipal securities between March 1991 and March 1994 was not clearly definable, even by the most astute compliance professionals. In the absence of specific guidance in the area, Mr. Chandik adopted the NASD's 5% mark-up policy for equities, as applicable to municipal and government securities transactions. The Division of Enforcement disagreed, noting that it had repeatedly advised the industry that mark-ups and mark-downs on debt securities were to be considerably lower than those charged for equity securities. The firm, however, countered that there had never been specific guidance from the regulators as to what constitutes an acceptable level of mark-ups in municipal or government securities. Mr. Chandik also argued that even though he had responsibility for drafting the firm's mark-up policy, he was not the supervisor who oversaw the activities of the traders who applied the allegedly excessive mark-ups and mark-downs. Ultimately the firm and Mr. Chandik settled the case with the SEC. n17

[f] Enforcement against Firms with Allegedly Inadequate Procedures

The SEC has brought a number of cases alleging that broker-dealers had inadequate written supervisory procedures. Very often in settled cases involving such an allegation, the SEC and firm will agree that an independent consultant be retained to review the firm's procedures and make recommendations.

For example, in the case of *In re Certain Market Making Activities on Nasdaq*,ⁿ¹⁸ most of the 29 broker-dealer firms involved in the SEC's investigation into OTC trading practices were cited for inadequate supervisory policies and procedures. The SEC noted that some of the respondent firms' policies and procedures were inadequately documented, promulgated and enforced. In particular, the SEC focused on three main areas of deficiency. First, most respondent firms did not have procedures governing conversations with traders at other firms about quotations, requests to move quotations, or coordination of quotations. While some firms did have limited procedures regarding requests to move quotations, the SEC found such procedures to be inadequate in that they were either not in writing or were not disseminated to all relevant personnel and supervisors. Second, most respondent firms had no procedures for reviewing trading activity to uncover coordination or collaboration between market makers with respect to quotations. Again, although some firms did have certain limited review procedures with respect to quotation movements, the SEC found those procedures to be inadequate because they failed to address the potential problems that could arise. Third, the SEC found that in certain firms, the supervisors who oversaw the NASDAQ trading operations and the compliance departments themselves were not sufficiently familiar with NASDAQ market making to provide effective supervision. Thus, the supervisors had to rely on the head trader on the desk to perform supervisory functions and to notify his supervisors, in the event problems arose. The SEC found that such a system was flawed because there was no oversight of the activity of the head traders themselves. The SEC also criticized the amount of compliance resources devoted to overseeing NASDAQ trading. With respect to some of the respondents, the SEC detailed specific supervisory failures in the separate Orders Making Findings and Imposing Sanctions as to the individual respondent firms.ⁿ¹⁹

Another case involving inadequate procedures was *In re Prudential Securities Incorporated*.ⁿ²⁰ In *Prudential*, the firm consented to findings that it failed reasonably to supervise business operations of its retail collateralized mortgage obligation ("CMO") trading desk in violation of NYSE Rule 342. In particular, the firm's head CMO trader used the firm's electronic bulletin board to post information about CMOs that were in the firm's inventory, thereby providing information to the sales force. The analysis of the CMOs in the postings included predictions of prepayment speeds and corresponding average life information, all of which was important information for purchasing decisions and evaluating the risks of investing in the particular CMOs. Even though the firm had a particular research unit assigned to make such predictions based on complex models and formulas, the head trader could make (and did make) predictions that differed from those made by the research unit. Such predictions made the CMOs appear to be more attractive investments than they actually were. Significantly, the firm had no written or unwritten rules or procedures that required the head trader to use the predictions of the research unit, rather than his own predictions, in connection with the analyses contained in the postings. According to the Stipulation and Consent, the firm's "failure to provide for procedures and mechanisms for supervision of the offerings of the Desk to assure fair and accurate presentations to its retail sales force and to establish a system of follow-up and review of the Desk's activities was a failure by the Firm to reasonably supervise."ⁿ²¹ The Stipulation also detailed other supervisory failures relating to books and records and other sales and pricing activities. Accordingly, the Hearing Panel imposed, and the firm consented to, a censure, a \$500,000 fine, and an undertaking pursuant to which the firm would retain an independent consultant to review the firm's systems and procedures and make recommendations, if necessary.

Generally, the SEC will seek to impose sanctions against the firm, rather than individuals, for having inadequate procedures. Yet, it is not out of the question for individuals to be named in such cases. For example, *In re Marion Bass Securities Corp. and Gerald Chandik*,ⁿ²² the SEC did just that, suing not only the firm, but also its compliance officer, Mr. Gerald Chandik, in an administrative proceeding.ⁿ²³

[4] Enforcement Actions Alleging Failure to Supervise

In recent years, the SEC has added "failure to supervise" charges to most substantive charges against broker-dealer

firms almost as a matter of routine practice. Some would argue that such post-hoc approach charges firms with an impossible duty to use 20-20 hindsight to prevent and detect violations. On the other hand, the SEC's law enforcement mission is furthered by setting examples for other firms in the industry to follow. Some of the more high-profile failures to supervise cases are instructive.

In the case of *In re UBS PaineWebber, Inc.*,ⁿ²⁴ the firm settled an administrative proceeding whereby it consented to findings that it failed reasonably to supervise a former registered representative. The representative allegedly engaged in fraud involving investments of large portions of his clients' funds in to speculative gold mining firms, while receiving payment from the firms. He also allegedly misappropriated funds from client accounts and engaged in unauthorized trading. One of the representative's clients allegedly lost at least \$68 million as a result of the fraud. Respondent consented to findings that it failed to establish procedures to supervise the trading in question, in that the accounts were set up by the representative through Swiss-banks in an omnibus fashion such that the representative's supervisors did not know the identities of the ultimate clients and could not determine suitability. Further, the SEC pointed out that PaineWebber allowed the representative to conduct the trades through the omnibus accounts for over a year "without any written referral agreement that outlined the rights and responsibilities of the parties." As a result, PaineWebber consented to a censure and was ordered to pay a civil money penalty of \$500,000.

Similarly, in the case of *In re Lehman Brothers, Inc.*,ⁿ²⁵ the firm settled an administrative proceeding in which it consented to findings that it failed reasonably to supervise a former registered representative, Frank D. Gruttadauria. Gruttadauria was employed by Lehman for approximately 16 months as a registered representative and manager of Lehman's Cleveland office, after Lehman acquired certain assets of the retail brokerage business of SG Cowen Securities Corporation, which was also the subject of a failure to supervise proceeding relating to Gruttadauria's conduct. ⁿ²⁶ The SEC alleged that since 1987, Gruttadauria had been defrauding customers by lying to them about purchases and sales of securities and the performance of their accounts, misappropriating funds and securities (including using the misappropriated funds to pay the withdrawal requests of other customers), and falsifying account documents. The SEC noted that Lehman created an inherent risk that Gruttadauria would not be adequately supervised because he was a producing branch office manager with broad authority over personnel matters and compensation of employees, including the administrative manager and operations manager who were designated to review his daily activity and third-party disbursements, respectively. The specific supervisory failures included the failure of the firm to apply its correspondence review procedures to Gruttadauria, in light of the fact that he had access to the firm's fax machine and postage meter. This allowed him to send fraudulent documents to customers and sent falsified account statements. To perpetrate his concealment, Gruttadauria used a personal computer, but Lehman lacked supervisory procedures expressly for monitoring the use of personal computers. The Order also discussed other supervisory failures relating to third-party transfers and account documentation. As a result, the firm undertook to participate in a special arbitration process for customers allegedly harmed by Gruttadauria. Lehman was censured, ordered to cease-and-desist from future violations, and ordered to pay a civil money penalty of \$2.5 million (\$1.25 million to the Treasury and \$1.25 million to the NYSE).

The Gruttadauria case, in particular, has had a sweeping effect on the way firms view supervision. This is true even though deceptive conduct on the part of the employee has not historically been an excuse for a failure to detect the misconduct on the part of the firm. In the wake of the Gruttadauria case, the SEC promulgated guidance on how firms could better supervise remote branch offices, particularly with respect to the handing of customer funds. ⁿ²⁷

Other noteworthy enforcement actions against alleged failure to supervise are discussed below as illustrative important concepts related to the scope of the supervisory obligations of broker-dealers.

[5] System of Supervision

An appropriate system of supervision must cover all areas of the firm, not just retail operations and trading. For example, back office processing functions must be supervised. SEC Rule 10b-10 requires broker-dealers to generate

accurate confirmation statements; yet, in a highly-automated setting, mistakes might easily be overlooked in the absence of a formal procedure to check their accuracy. n28

The system must be periodically reassessed in light of changes in the nature and size of the firm's business. The SEC has, on numerous occasions, criticized firms for failing to devote adequate compliance resources and personnel to the task of supervision. n29

For example, in the case of *In re Dean Witter Reynolds, Inc.*, n30 the respondent firm together with a branch office manager, in a settlement with the Commission, consented to findings that they failed to reasonably supervise the activities of a registered representative who engaged in sales practice violations, including entering discretionary trades without authority, concentrating accounts in unsuitable securities, and using manipulative devices, including a "short squeeze." The Commission found that the firm had inadequate systems and that, in particular, a flaw in one of its supervisory procedures allowed certain trading misconduct to go undetected. In addition, the compliance department failed to prepare securities concentration reports during the height of the representative's misconduct. Notably, the representative had circumvented the firm's order processing system by giving oral orders to the firm's trader, a practice that was not prohibited by the firm. As a result, the trades did not appear on the daily trade activity report and, therefore, the branch manager did not have information that might have permitted him to detect the misconduct. The firm was censured, ordered to cease and desist future violations of record keeping provisions, and pay a civil money penalty of \$500,000. The branch manager was suspended from association with any broker or dealer in a supervisory capacity for nine months and was ordered to pay a civil money penalty of \$25,000.

Documentation of supervisory efforts taken pursuant to a supervisory system is highly important. Not only is it required by NASD and NYSE rules, but the creation of records ensures that oversight is occurring, while also providing the firm with crucial evidence to defend against an enforcement investigation. The absence of records of supervision has been sanctioned as a violation by the SROs. n31

The SEC has emphasized that a broker-dealer's supervisory/compliance system must be tailored to the particular needs of the firm. Two recent cases serve as noteworthy examples.

In the case of *In re Nationssecurities and Nationsbank, N.A.*, n32 the SEC charged Nationssecurities with failing reasonably to supervise registered representatives in connection with their sales activities with respect to two closed-end bond funds. The SEC found that some of the representatives made materially false and misleading statements including mischaracterizing the funds as ordinary government bond funds when, in fact, they were highly-leveraged and invested in derivative securities that were highly sensitive to interest rates. The SEC explained that the firm's use of a "hub and spoke" organizational structure, where branch managers (located in the hubs) supervised between fifteen and thirty representatives (located in the spokes), "increased the need for a more centralized and focused supervisory and compliance system." The SEC commented that the supervisory system put in place by the firm may have been suitable for a "traditional brokerage firm," but was not reasonably designed to detect and prevent improper sales practices under the circumstances in which it was utilized. In particular, the SEC pointed to the firm's lack of procedures to prevent "blurring" (investor confusion between bank products and the securities being offered). Further, the firm's supervisory and compliance system, which required only annual visits by branch managers to each spoke office, was deemed inadequate to provide timely detection or prevention of sales practice violations. The SEC noted that the supervisory and compliance systems were inadequate to prevent representatives from selling unsuitable securities to customers. Particularly, the firm failed to collect sufficient data on the risk tolerance and objectives of the customers, and failed to maintain the data that they did collect in a manner such that it was readily available to supervisors. Finally, the SEC noted that in the case of new accounts, initial trades were approved and executed before the branch manager had reviewed and signed-off on the new account form and initial trade ticket. Therefore, there was no effective control over the suitability of initial trades. In settlement of the matter, Nationssecurities accepted a censure, a cease and desist order, and a civil penalty of \$4 million.

Similarly, in *In re PFS Investments, Inc.*,ⁿ³³ the SEC charged the firm with failing reasonably to supervise four of its registered representatives, who engaged in fraudulent activities in connection with a Ponzi scheme. Specifically, the representatives sold unregistered securities and failed to reflect the transactions in the books and records of the firm. The firm had a compliance structure that enabled it to investigate complaints of wrongdoing and, separately, audit the activities of its employees in its various locations as necessary. The firm became aware of allegations of wrongdoing on the part of the representatives through a series of several complaints, all of which were investigated separately. One of the investigations resulted in a recommendation that an on-site audit be performed. The audit was pre-announced and the auditor reviewed documents and interviewed senior members of the sales force, but did not question the lower-level registered representatives or contact any customers about the alleged violations. The SEC criticized the compliance policies and procedures because they did not provide for any coordination in the case of multiple or related complaints. Instead, separate investigations could go forward, yet the investigating personnel could be completely unaware of the other complaints or the evidence gathered in the other investigations. Moreover, the investigative procedures were found to be inadequate because they did not provide for verification of information provided to the compliance departments, by, for example, contacting customers or other sales agents in the same supervisory hierarchy. The firm accepted a censure and a civil penalty of \$175,000.

[6] Delegation of Authority

It is well-established that the President of a broker-dealer is ultimately "responsible for the firm's compliance with all applicable requirements unless and until he ... reasonably delegated a particular function to another person in the firm, and neither ... [knew] nor ... [had] reason to know that such person ... [was] not properly performing his or her duties."ⁿ³⁴ Indeed, all but the smallest organizations would not be able to function if delegation of supervisory authority were not recognized as an appropriate management device. Implicit in the delegation of supervisory authority is the duty to follow-up to ensure that the delegated functions are being exercised properly.ⁿ³⁵ In that regard, the SEC has publicly stated: "Supervisory responsibility starts at the top; senior management must ensure that adequate procedures are in place, and that sufficient resources are devoted to the implementation of those procedures."ⁿ³⁶

The duty to follow-up to ensure that delegated functions are being fulfilled is usually referred to as a "System of Follow-up and Review." A leading SEC opinion on the issue is found in *In re Mabon, Nugent & Co.*ⁿ³⁷ In *Mabon, Nugent* the Commission stated that:

Effective supervision by broker-dealers is a critical element in the regulatory scheme and its importance has increased as firms have grown in size. As broker-dealers expand their activities, through the acquisition of branch offices or into new areas within the securities business, there must be a concomitant expansion of their supervisory procedures to insure regulatory compliance and sound, internal controls.

Apart from adopting effective procedures, broker-dealers must provide effective staffing, sufficient resources and a system of follow-up and review to determine that any responsibility to supervise delegated compliance officers, branch managers and other personnel is being diligently exercised.

The conduct at issue in the case occurred after Mabon, Nugent had acquired a branch office in Houston, Texas. A salesman in the Houston office engaged in prohibited transactions. Even though the compliance partner and staff in New York knew of the transactions, they did not perform reviews according to the firm's own procedures, which would have revealed the prohibited nature of the transactions. In addition, however, the New York office was not aware of certain facts -- largely due to its remote geographical location -- that might have raised suspicion concerning the particular salesman.

The delegation of supervisory authority must be to employees who are properly registered as Series 24 principals,ⁿ³⁸ and have the requisite experience to permit them to understand and effectively supervise the substantive area to which

they are assigned. n39

Other examples of SEC enforcement for lack of adequate follow-up and review are also instructive.

In the case of *In re Spear, Leeds & Kellogg, L.P.*, n40 the firm settled an administrative proceeding alleging that it failed to reasonably supervise certain employees with a view toward preventing them from aiding and abetting "marking the close" by Baron Capital, a "direct access" client of the firm, in stocks traded on the floor of the NYSE. The firm consented to findings that while it had adopted procedures designed to promote general compliance with regulations governing order execution, it lacked adequate procedures to monitor the specific practice of "marking the close." The procedures required any employee who became aware of any suspicious trades or a pattern of trading at or near the close to contact the compliance department. The procedures for review of trading were characterized by the Commission as "circular," in that the floor supervisor responsible for reviewing order tickets and daily activity reports was one of the floor brokers accepting Baron's "direct access" orders. Similarly, the floor supervisor was responsible for supervising the activities of the floor clerks, but in the absence of the floor supervisor, authority was delegated to the head floor clerk, who was also accepting Baron's "direct access" orders. As a result, the firm was censured and ordered to pay a civil money penalty of \$450,000 (\$225,000 to the Treasury and \$225,000 to the NYSE).

Similarly, in the case of *In re Prudential Securities, Inc.*, n41 the firm settled an administrative proceeding in which it consented to findings that it failed reasonably to supervise a registered representative who sold Class B shares in certain proprietary mutual funds to his customers without disclosing breakpoint discounts for large purchases. Although Prudential had procedures in effect concerning sales of mutual fund shares, it failed to adopt a system of follow-up and review to ensure the policies were enforced by the branch office manager. Prudential revised its policies in 2001 and included procedures to monitor compliance by branch office managers, including use of a "hard block" in its computer system to prevent execution of Class B share purchases of \$100,000 and new exception reports. As a result, Prudential was censured, ordered to pay disgorgement of \$82,000, and a civil money penalty of \$300,000, and ordered to comply with undertakings to maintain its revised policies and review with the assistance of outside counsel, its procedures and systems regarding the sale of Class B shares.

As noted above, the SEC has also focused on the lack of reporting exception as a basis for imposing failure to supervise liability against firms. n42 But, when a firm undertakes to assign surveillance activities, such as the review of exception reports, to its compliance department, adequate procedures must be put in place, and such procedures must be followed and the delegated duties must be diligently performed. Otherwise, the compliance department may be called upon to answer for the failure to supervise. n43

The case of n44 added to the SEC's strong view that follow-up and oversight is required for effective and legally-sufficient delegations of supervisory responsibility. In connection with a review of an NYSE disciplinary action, the Commission stated:

it is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention Implicit is the additional duty to follow-up and review that delegated authority to ensure it is being properly exercised.

In *Patrick*, the President was charged with the failure to supervise under NYSE Rule 342(a). Although he tried to distinguish his duties as President of the firm from those as a direct supervisor, the SEC concluded that the oversight duties of firm officials, including those of the President, were chargeable under Rule 342(a), which encompasses such activities as "failure to establish proper procedures, impose suitable intermediate structures, or draw upon the assistance of other firm personnel."

In the *A.S. Goldmen* case, n45 the President and sole owner of the firm was held responsible for violations on the firm's

trading desk. The National Adjudicatory Council found that:

as President, it was appropriate for Marchiano to delegate many of his responsibilities to Winkler, we also find that Marchiano, as Winkler's supervisor, should have established a system of checks and balances whereby he maintained some supervisory control over Winkler. He failed to do so. As a result, Winkler received no supervision whatsoever. Even though Winkler was a senior and powerful person at the Firm, he should not have been allowed to function without any oversight. Marchiano, as Winkler's superior, is responsible for this failure.

[7] Responding to "Red Flags"

A supervisor is responsible for responding vigorously to indications of possible wrongdoing, a.k.a. "red flags." n46 The *Gutfreund* case arguably remains the leading SEC pronouncement on the duty of a supervisor to effectively respond to red flags. As such, an understanding of the relevant facts is important to decoding the lessons to be taken for the case.

Mr. Gutfreund was the Chairman and Chief Executive Officer of Salomon Brothers when he became aware that the head of the Government Trading Desk at the firm had submitted a false bid in a Treasury Note auction and in doing so had potentially committed a criminal act. Mr. Gutfreund and other senior personnel at the firm took no action to investigate or report the matter to the government (reporting was not required, but in the opinion of the firm's counsel was advisable). Only after the head trader engaged in other violations of the same type in the succeeding months, did the firm communicate with the government, or conduct an internal investigation by outside counsel law firm (though only on the later violations). Moreover, no limitations were placed on the trader's activities, other than an instruction to keep a lower profile during the next Treasury action. In the internal investigation, counsel was asked to investigate only the later violations. In the investigations, counsel discovered the first false bid, as well as other violations about which the firm had not previously known.

In *Gutfreund*, the SEC reiterated the position that it had taken four years earlier in *In re Wedbush Securities, Inc.*: "In large organizations it is especially imperative that those, in authority, exercise particular vigilance when indications of irregularity reach their attention." n47 The *Gutfreund* order went on to explain:

The supervisory obligations, imposed by the federal securities laws, require a vigorous response even to indications of wrongdoing. Many of the Commission's cases, involving a failure to supervise, arise from situations where supervisors were aware only of "red flags" or "suggestions" of irregularity, rather than situations where, as here, supervisors were explicitly informed of an illegal act.

Even where the knowledge of supervisors is limited to "red flags" or 'suggestions" of irregularity, they cannot discharge their supervisory obligations simply by relying on the unverified representations of employees. Instead, as the Commission has repeatedly emphasized, "[t]here must be adequate follow-up and review when a firm's own procedures detect irregularities or unusual trading activity" Moreover, if more than one supervisor is involved in considering the actions to be taken, in response to possible misconduct, there must be a clear definition of the efforts to be taken and a clear assignment of those responsibilities to specific individuals within the firm. n48

The order pointed out numerous failures on the part of the management of the firm to investigate, limit the head trader's activities, and increase supervision immediately upon learning of the possible misconduct. With respect to Mr. Gutfreund, the order noted that, as Chairman and CEO of the firm, he bore "ultimate responsibility" for the investigation and for the discipline of employees.

In the wake of *Gutfreund*, the response to a "red flag" must include decisive action to detect and prevent future violations. n49 Firing an employee for the misconduct is not enough to satisfy supervisory responsibilities in wake of a "red flag," if the outstanding procedures, which the firm has in place to detect and deter future misconduct, are

inadequate.

For example, in *In re Merrill Lynch, Pierce, Fenner & Smith Incorporated*, ⁿ⁵⁰ Merrill Lynch consented to findings that it failed to have in place appropriate procedures for supervision and control, as well as a system of follow-up and review, to assure that block orders entered by registered representatives were properly time-stamped and allocated. Specifically, the firm maintained a trading procedure that gave representatives two options for entering orders. Under the first option, a representative would use his or her computer terminal to enter the trade and the customer information. The computerized system, however, permitted the entry of an order for only one account at a time. Under the second option, the representative could telephone the trading desk and enter a verbal order without customer information. At the same time, the representative was to prepare a written order ticket with the account numbers of the customers to whom the stock was to be allocated, and the ticket would be wired to the trading desk. In the case at issue, however, a registered representative -- in hundreds of trades -- used the telephone option but delayed the allocation of the trade to the customers' accounts for hours. Merrill Lynch learned of the representative's failure to assign account numbers to transactions in a timely manner through an internal review that was prompted by an anonymous tip to the firm's ethics hot line. The firm promptly terminated the representative as a result of the review. As a result of this conduct, however, and the firm's lack of procedures to prevent and detect it, the NYSE took the position that the firm failed to assure that future customers did not receive preferential treatment. Accordingly, the Hearing Panel imposed, and the firm consented to, a censure and an \$85,000 fine.

The SEC has taken the position that reliance upon the employee's version of events is insufficient. A supervisor must investigate and verify the true facts and circumstances. For example, in *In re Raymond A. Basile*, ⁿ⁵¹ the SEC charged Mr. Basile, a branch manager of a broker-dealer, with failing reasonably to supervise a registered representative with a view toward detecting and preventing the representative's operation of a fraudulent Ponzi scheme. The SEC found that Mr. Basile became aware of a "red flag" when an individual who provided financial services to the firm's clients reported that the registered representative had been selling fraudulent securities. Mr. Basile, however, did not take any steps to investigate the report, and merely relied upon the representative's unverified denial that he solicited or sold such securities. ⁿ⁵² As a result, Mr. Basile accepted a suspension from association with any broker or dealer for three months, a suspension from action in any supervisory or proprietary capacity for nine months, and a civil penalty of \$5,000. The SEC also instituted public administrative proceedings against Mr. Basile's supervisor for failing to supervise in light of the same "red flag," ⁿ⁵³ highlighting the importance of procedures designed to ensure that supervisors are, in fact, supervising.

Even fraudulent concealment of the misconduct by the employee does not relieve a supervisor from the duty to react to red flags. In *In re Susan L. Henry*, ⁿ⁵⁴ the SEC charged the respondent, the President and owner of a broker-dealer, with failing reasonably to supervise two of the firm's registered representatives, who sold high-risk securities to their customers without regard to their investment needs or objectives. The SEC found that the respondent failed to establish adequate written supervisory procedures which would have detected and prevented the violations. Moreover, she ignored "red-flags," in the form of obviously fictitious assets that had been added to one customer's financial statement, and a highly irregular letter that one representative asked several of his customers to write, which indicated their "accredited" status in order to conceal the fact that they were not qualified to purchase the securities. Even though the respondent reviewed the customer files maintained by the firm, she failed to conduct any effective follow-up investigation in light of indications that the qualifications of the customers were being overstated. In settlement of the matter, the respondent accepted a suspension from association with any broker, dealer, municipal securities dealer, investment advisor, or investment company, for a period of 12 months, and a bar from association with any such entity in a supervisory or proprietary capacity, with a right to reapply after three years, and payment of a civil penalty of \$5,000.

Similarly, in *In re Cortlandt Capital Corp.*, ⁿ⁵⁵ the SEC charged Cortlandt Capital Corp. and its President, Joseph Guccione, with failing reasonably to supervise the firm's head equities trader, who also served as a retail broker. The trader manipulated the market, in a particular stock, in a way that was detrimental to the firm's customers. The SEC

found that because Mr. Guccione worked with the trader at the trading desk, and directly supervised him, he and the firm either knew or should have known of the trader's conduct. Moreover, Mr. Guccione and the firm failed to maintain or enforce a reasonable system of supervision or of internal controls over the trader. For example, Mr. Guccione failed to appoint a replacement compliance officer during the period that the regular officer was out of the office and hospitalized, whose absence, among other things, enabled the trader to abuse his position and manipulate the market. The SEC also pointed to several "red flags," which it contended Mr. Guccione and the firm ignored. For example, they knew that the trader had been a respondent in an NASD disciplinary proceeding regarding parking and other trading violations, while at his prior employer. They knew of customer complaints concerning the trader's unauthorized purchase of stock. They knew that some of the traders' customers failed to pay for their purchases and had opened accounts at other broker-dealers. In settlement of the matter, Mr. Guccione accepted a bar from association with any broker, dealer, municipal securities dealer, investment advisor or investment company, with the right to reapply after four years, a cease and desist order, and a civil penalty of \$20,000. The firm accepted a cease and desist order and the revocation of its registration.

Firms should consider placing employees under heightened supervision when "red flags" arise. n56 In *In re Payne & Thornton*, the SEC considered misconduct by a registered representative whose Form U-5 from her prior firm disclosed the existence of two separate customer complaints, only one of which was disclosed by the representative on her Form U-4. Moreover, the day after she joined the firm she was sued in a Florida state court (also disclosed on the U-5), and the next year a class action lawsuit was filed against her for allegedly selling unsuitable investments to customers. The President of the firm, Mr. Thornton, had reviewed the forms, but misread the information relating to the misconduct. The firm also received a "tip" from one of the representative's former co-workers that they might have "a major compliance problem" with the representative. Later the representative declared bankruptcy. In light of these problems, Mr. Thornton never made any effort to audit her client accounts, inspect her offices, interview her employees and salespeople, contact her clients or otherwise inquire about her investment recommendations. The visits he did claim to make were announced in advance and, in any event, all but one was not shown in the firm's records. Only after Mr. Thornton "accidentally" encountered two of the representative's problems, did he modify the firm's procedures with regards to sales and suitability. Still, he never imposed any heightened supervision over the representative's activities, such as on-site auditors and unannounced inspections.

In a particularly poignant concurring opinion, Commissioner Unger railed against Mr. Thornton's failures, exclaiming that, after eight previous disciplinary cases by the NASD and state securities regulators, "Thornton has shown repeatedly, an utter lack of even the most rudimentary grasp of what it means to supervise reasonably." Commissioner Unger distinguished the case from those in which the supervisor acted diligently:

I view the case quite differently from those situations where a supervisor either fails to uncover misconduct despite the proper discharge of his supervisory duties, or uncovers misconduct and takes quick, effective action to remedy the situation. The duty to exercise reasonable, effective supervision has never been construed to be an absolute guarantee against every malfeasance by errant subordinates. Rather, the Commission has always viewed the disposition of failure-to-supervise charges as requiring a fact-specific inquiry, and the identification of specific lapses in supervision. I believe the Commission must exercise continuing vigilance to resist the pitfall of mistaking the cleverness of a wrongdoer in eluding appropriate supervisory measures for a failure at the supervisory level. Such a practice would only serve as a deterrent to supervisors who are inclined to "do the right thing" by alerting regulators when misconduct is detected. n57

[8] Who is a Supervisor?

It is often a critical threshold question: which individuals in the firm may be charged with supervisory responsibility? The leading case in which the SEC attempts to answer that question is *In re Arthur James Huff*. n58 In that case, the Commission concluded that in the absence of other facts that link the compliance officer with direct control over the

subordinate's activities, a compliance officer will not be deemed a supervisor.

The Commission decided that Mr. Huff, who was the compliance officer for PaineWebber Incorporated, did not fail reasonably to perform his supervisory duties. The case is notable, and somewhat controversial, because of confusion over whether Mr. Huff allegedly had a duty of supervision because of the fact that he had been delegated such responsibilities or because of his role in the compliance department. In a concurring opinion, two of the Commissioners found that Mr. Huff was not a supervisor. They explained that in the context of "line" supervisors, employees who supervise generally have the power to hire or fire, and to reward and punish, which, they noted, are "a very substantial part" of the meaning of supervision. The Commissioners went on to point out the dearth of cases in which the SEC had proceeded against persons other than line supervisors under Section 15(b). Moreover, in each such case, the specific non-line employee in question had the ability "to control at least some critical aspects of the behavior of the persons supervised." Turning to Mr. Huff, the Commissioners found that he was not in the line of authority to hire, fire, reward or punish the subordinate, nor did he know or have reason to believe that he had such authority. Finally, the Commissioners stated that they would not find that Mr. Huff was the subordinate's supervisor "merely because of [his] position as a staff compliance officer."

The SEC addressed the question again a year later in a separate portion of the Gutfreund order denominated as a Section 21(a) report of investigation. n59 Although not a respondent in the enforcement action, Donald Feuerstein, Salomon Brothers' chief legal officer and head of its Compliance Department, was criticized by the SEC in light of his failure to direct the commencement of an inquiry, to recommend the institution of appropriate procedures to detect and prevent future misconduct, to impose limitations on the head trader's activities, or to inform the Compliance Department of the misconduct. While the SEC noted that "[e]mployees of brokerage firms who have legal or compliance responsibilities do not become supervisors' for purposes of sections 15(b)(4)(E) and 16 (b)(6) *solely because they occupy those positions*," under certain circumstances, supervisory liability over such a person can be found if the person has the "requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue." (emphasis added). In Feuerstein's case, the SEC believed he was a supervisor because he was, in fact, part of management's "collective response" to the problem and largely directed the response. Thus, the SEC concluded:

Once a person in Feuerstein's position becomes involved in formulating management's response to the problem, he or she is obligated to take affirmative steps to ensure that appropriate action is taken to address the misconduct. For example, such a person could direct or monitor an investigation of the conduct at issue; make appropriate recommendations for limiting the activities of the employee or for the institution of appropriate procedures, reasonably designed to prevent and detect future misconduct; and verify that his or her recommendations, or acceptable alternatives, are implemented. If such a person takes appropriate steps but management fails to act and that person knows or has reason to know of that failure, he or she should consider what additional steps are appropriate to address the matter. These steps may include disclosure of the matter to the entity's board of directors, resignation from the firm, or disclosure to regulatory authorities.

The issue was revisited in the case of *In re Patricia Ann Bellows*, n60 in which the Commission reviewed an Administrative Law Judge's ("ALJ") order dismissing proceedings against a compliance officer. In its dismissal order, the ALJ made the following statement:

The Division's contention, that [respondent] Bellows' position in 1992 and 1993 as compliance officer created supervisory responsibility over [registered representative] Moses, is not well taken. Indeed, this idea that any compliance department personnel acts as supervisor has been rejected by the Securities Industry Association. Task Force on Broker-Dealer Supervision and Compliance of the Committee on Federal Regulation of Securities of the American Bar Association, *Broker-Dealer Supervision of Registered Representatives and Branch Office Operations*, 44 *Bus. Law.* 1361, 1373 n.58 (Aug. 1989). The fact that Bellows later in 1993 and 1995 was promoted to executive vice president and

to a membership in the executive committee does not per se create supervisory responsibility either. n61

Ms. Bellows had been charged with failure reasonably to supervise a registered representative. At the administrative hearing, the ALJ concluded that Ms. Bellows did not fail to supervise because the registered representative was not subject to her supervision. The ALJ also found, nevertheless, that even if the registered representative was subject to Ms. Bellows' supervision, she reasonably delegated her supervisory authority to other employees and had good reason to conclude that the employees properly discharged their obligations. Accordingly, the ALJ dismissed the proceeding.

On appeal, the SEC did not overturn the opinion, and instead harmonized it with long-standing SEC principles. The Commission noted that the paragraph did not contradict the well-established principles that (1) one who exercises compliance responsibilities in a brokerage firm may be subject to liability under Section 15(b) of the Exchange Act for failing reasonably to supervise the activities of the firm's employees, and (2) determining if a particular person is a "supervisor" depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue.

In the wake of these cases, there remains significant tension over the definition of "supervisor" for the purposes of assigning liability in the enforcement context. It is clear that even individuals who do not wear a formal supervisory title, by designation, delegation, or otherwise, may nevertheless be subject to supervisory liability because of their duties, responsibilities or the role they play in dealing with a particular issue or situation.

Whether or not a particular individual is deemed a supervisor in an enforcement action for failure to supervise is of critical importance given the range of sanctions available to the SEC. The SEC will typically seek to impose a civil money penalty against individuals, and in a settlement context require that such penalty be paid personally by the individual and not indemnified by the firm or reimbursed by an insurer. In addition, the SEC will typically seek "time out," as it is referred to colloquially, in the form of a suspension for a particular time period or a bar from association with a broker-dealer in either all capacities, or just in a supervisory capacity. Under the tenure of former SEC Chairman Arthur Levitt, the Commission appeared to adopt a policy of imposing suspensions or bars in both capacities as a sanction for supervisory failures. For example, a supervisor might be barred permanently from serving as a supervisor, and also serve a six-month suspension from association with a broker-dealer. This makes sense because counsel opposing such a severe sanction might argue that the deficiencies that might cause one to perform less than ably as a supervisor do not necessarily render one a danger to the investing public so as to justify a suspension or bar from association in all capacities.

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C.S. § 78.*

(n2)Footnote 2. Chapter 18 contains a discussion of the remedies available to the SEC under § 15(b) of the Exchange Act.

(n3)Footnote 3. Section 15(b)(4)(D).

(n4)Footnote 4. Section 15(b)(4)(E).

(n5)Footnote 5. Section 15(b)(4)(E).

(N6)Footnote 6. Section 15(b)(4)(E).

(n7)Footnote 7. NASD Conduct Rule 3010, *available at* <http://www.nasd.com>.

(n8)Footnote 8. NASD Conduct Rule 3010, *available at* <http://www.nasd.com>.

(n9)Footnote 9. NYSE Constitution and Rule 342. Offices -- Approval, Supervision and Control, *available at* http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_5&manual=/nyse/nyse_rules/nyse-rules/.

(n10)Footnote 10. *15 U.S.C.S. § 78.*

(n11)Footnote 11. ABA Task Force on Broker-Dealer Supervision and Compliance of the Committee on Federal Regulation of Securities, *Report on Broker-Dealer Supervision of Registered Representatives and Branch Office Operations*, 44 *Bus. Law.* 1361 (1989).

(n12)Footnote 12. The SEC has stressed, in the context of enforcement actions, the important role that exception reports play in the supervisory function. *See, e.g., In re FSC Sec. Corp., SEC Rel. No. 34-40765, 1998 SEC LEXIS 2651, 68 SEC Docket 2219* (December 9, 1998) (finding that respondent failed reasonably to supervise a representative who operated a one-person office of supervisory jurisdiction, where among other things, the firm did not generate an exception report for its supervisory personnel that could detect mutual fund switching).

(n13)Footnote 13. When a firm undertakes to assign surveillance activities to its compliance department, adequate procedures must be put in place, the procedures must be followed, and the delegated duties must be diligently performed. Otherwise, the compliance department may be called upon to answer for the failure to supervise. *See In re Thomson McKinnon Sec., Inc., SEC Rel. No. 34-20908, 1984 SEC LEXIS 1671, 30 SEC Docket 488* (April 30, 1984) .

(n14)Footnote 14. *See also In re Gary E. Bryant, SEC Rel. No. 34-32357, 1993 SEC LEXIS 1347, 51 S.E.C. 463* (May 24, 1993) (firm procedures that provided a list of things not to do, but did not provide a mechanism for ensuring compliance, found to violate Rule 3010).

(n15)Footnote 15. Staff Legal Bulletin No. 17: Remote Office Supervision, March 19, 2004, *available at* www.sec.gov/interps/legal/mrslb17.htm.

(n16)Footnote 16. *In re Marion Bass Sec. Corp. and Gerald Chandik, SEC Rel. No. 7929 and SEC Rel. No. 43754, 2000 SEC LEXIS 2806* (Dec. 20, 2000) . *See also Marion, SEC in Markups Discussion, The Bond Buyer*, Jan. 19, 1999, p. 1.

(n17)Footnote 17. *SEC Rel. No. 34-43754, 2000 SEC LEXIS 2806* (Dec. 20, 2000) .

(n18)Footnote 18. *In re Certain Market Making Activities on Nasdaq, SEC Rel. No. 40900, 1999 SEC LEXIS 64* (Jan. 11, 1999) .

(n19)Footnote 19. *SEC Rel. Nos. 34-40901 through 34-40930, 1999 SEC LEXIS 34-63* (January 11, 1999) .

(n20)Footnote 20. *In re Prudential Sec. Inc., NYSE Disc. Action 98-88, 1998 NYSE Disc. Action LEXIS 95* (August 26, 1998) .

(n21)Footnote 21. *In re Prudential Sec. Inc., NYSE Disc. Action 98-88, 1998 NYSE Disc. Action LEXIS 95* .

(n22)Footnote 22. *In re Marion Bass Sec. Corp. and Gerald Chandik, SEC Rel. No. APR-560, 1998 SEC LEXIS 493, 66 SEC Docket 1059* (February 9, 1998). *See also Marion, SEC in Markups Discussion, The Bond Buyer*, Jan. 19, 1999, p. 1.

(n23)Footnote 23. *See § 28.03[3][e], above.*

(n24)Footnote 24. *In re UBS PaineWebber, Inc., SEC Rel. No. 34-48371, 2003 SEC LEXIS 1990* (Aug. 20, 2003) .

(n25)Footnote 25. *In re Lehman Brothers, Inc., SEC Rel. No. 34-48336, 2003 SEC LEXIS 1950* (Aug. 14, 2003) .

(n26)Footnote 26. See *In re SG Cowen Sec. Corp.*, SEC Rel. No. 34-48335, 2003 SEC LEXIS 1949 (Aug. 14, 2003) .

(n27)Footnote 27. See SEC Staff Legal Bulletin No. 17, 2004 SEC No-Act LEXIS 487 (March 2004).

(n28)Footnote 28. See, e.g., *In re Lee E. Meyer*, Exchange Hearing Panel Decision 99-74 (June 28, 1999) (NYSE sanctioned supervisor for failing to supervise and control accounting department employees and employees responsible for preparation of FOCUS reports and net capital computations). By way of further example, firms have been criticized for not supervising their risk management function. Joint Statement: Broker-Dealer Risk Management Practices, Office of Compliance, Inspections and Examinations, SEC, NYSE, NASD Regulation, Inc., available at www.sec.gov/news/studies/bdriskp.htm, July 29, 1999 (failure to monitor trading risk because of "poor supervisory structures, the inconsistent use of date, and employment of inappropriate risk measurement tools").

(n29)Footnote 29. See *In re U.S. Bancorp Piper, Jaffray*, SEC Rel. No. 34-46770, 2002 SEC LEXIS 2807 (Nov. 5, 2002) (firm consented to findings that it failed to supervise a registered representative in connection with a scheme to mark the close, also finding that the firm's surveillance procedures were deficient, including its system for supervising producing branch managers; firm did not have an exception report capable of identifying trades occurring at the end of the trading day; instead relying upon ordinary order ticket review and approval; civil penalty of \$100,000); *In re First Colonial Sec. Group, Inc.*, SEC Rel. No. 34-43349, 2000 SEC LEXIS 2024 (Sept. 26, 2000) (failed to have procedures in place to detect prior disciplinary histories of new hires, and failed to devote enough resources to the compliance function "despite the sizeable expansion of the firm.").

(n30)Footnote 30. *In re Dean Witter Reynolds, Inc.*, SEC Rel. No. 34-46578, 2002 SEC LEXIS 2489 (Oct. 1, 2002) .

(n31)Footnote 31. See, e.g., *In re Crowell, Weedon & Co.*, Exchange Hearing Panel Decision 99-67 (June 17, 1999) (firm violated NYSE Rule 342.16 by failing to require, in its written procedures or otherwise, branch office managers to memorialize steps taken in connection with supervision of active accounts).

(n32)Footnote 32. *In re Nationssecurities and Nationsbank, N.A.*, SEC Rel. Nos. 33-07532 and 34-39947, 1998 SEC LEXIS 833 .

(n33)Footnote 33. *In re PFS Inv., Inc.*, SEC Rel. No. 34-40269, 1998 SEC LEXIS 1547, 67 SEC Docket 1502 (July 28, 1998) .

(n34)Footnote 34. *In re Rita H. Malm*, SEC Rel. No. 34-35000, 1994 SEC LEXIS 3699 (Nov. 23, 1994) .

(n35)Footnote 35. *In re Rita H. Malm*, SEC Rel. No. 34-35000, 1994 SEC LEXIS 3699 .

(n36)Footnote 36. SEC Press Release, *SEC Takes Action Against Four Broker-Dealer Firms and Seven Associated Persons for Failing to Supervise Remote Branch Offices*, 2000 SEC NEWS LEXIS 1890 (Sept. 27, 2000), available at <http://www.sec.gov/news/press/2000-143.txt>.

(n37)Footnote 37. *In re Mabon, Nugent & Co.*, SEC Rel. No. 34-19424, 1983 SEC LEXIS 2641, 26 SEC Docket 1684 (January 13, 1983), order vacated, SEC Rel. No. 34-27301, 1989 SEC LEXIS 1865 (September 27, 1989).

(n38)Footnote 38. District Business Conduct Committee for District No. 2 v. Glikzman, 1999 NASD Discip. LEXIS 12 (March 31, 1999) (delegation to an OSJ office manager who was not Series 24 qualified and did not perform routine activities of a supervisor was insufficient delegation; president of the firm held to retain supervisory tasks, the performance of which, without access to customer files and other information from the branch office, was unacceptable supervision).

(n39)Footnote 39. See, e.g., District Business Conduct Committee for District No. 10. v. A.S. Goldmen & Co., Inc., 1999 NASD Discip. LEXIS 18 (May 14, 1999) (delegation of supervisory authority to inadequately trained head trader resulted in the head trader's supervisor being responsible for violations of employees under the head trader's supervision); *In re Application of Castle Securities Corporation*, SEC Rel. No. 34-39523, 1998 SEC LEXIS 24, 66 SEC Docket 531 (January 7, 1998) (affirming NASD censure, fine and suspension because of delegation to an inexperienced compliance officer, without monitoring his performance or taking steps to ensure that he understood the nature of his responsibilities). *Market Regulation Committee v. La Jolla Capital Corp.*, 1998 NASD Discip. LEXIS 26 (February 27, 1998) (home office personnel failed to check up on inexperienced branch manager in far-away office and duties are heightened when a firm opens an office that is geographically distant from the firm's headquarters and compliance personnel, and when the firm staffs such office with inexperienced personnel), *affirmed*, *In re La Jolla Capital Corp.*, SEC Rel. No. 34-41755, 1998 SEC LEXIS 1642 (August 18, 1999) .

(n40)Footnote 40. *In re Spear, Leeds & Kellogg, L.P.*, SEC Rel. No. 34-48199, 2003 SEC LEXIS 1685 (July 21, 2003) .

(n41)Footnote 41. *In re Prudential Sec., Inc.*, SEC Rel. No. 34-48149, 2003 SEC LEXIS 1614 (July 10, 2003) .

(n42)Footnote 42. See, e.g., *In re FSC Sec. Corp.*, SEC Rel. No. 34-40765, 1998 SEC LEXIS 2651, 68 SEC Docket 2219 (Dec. 9, 1998) (finding that firm did not generate an exception report for its supervisory personnel that could detect mutual fund switching.)

(n43)Footnote 43. See, e.g., *In re Thomson McKinnon Sec., Inc.*, SEC Rel. No. 34-20908, 1984 SEC LEXIS 1671, 30 SEC Docket 488 (April 30, 1984) .

(n44)Footnote 44. *In re Stuart K. Patrick*, Admin. Proc. File No. 3-7715, SEC Rel. No. 34-32314, 1993 SEC LEXIS 1213, 54 SEC Docket 230 (May 17, 1993) .

(n45)Footnote 45. District Business Conduct Committee for District No. 10, 1999 NASD Discip. LEXIS 18.

(n46)Footnote 46. *In re John H. Gutfreund*, SEC Rel. No. 34-31554, 1992 SEC LEXIS 2939, 52 SEC Docket 2849 (Dec. 3, 1992) .

(n47)Footnote 47. *In re Wedbush Sec., Inc.*, SEC Rel. No. 34-25504, 48 S.E.C. 963, 967 (1988) .

(n48)Footnote 48. *Gutfreund*, 1992 SEC LEXIS 2939, *35 .

(n49)Footnote 49. See, e.g., *In re Christopher J. Benz*, 52 S.E.C. 1280 (1997) , *aff'd*, *Benz v. SEC*, 168 F.3d 478 (3d Cir. 1998) (finding that President of firm ignored "red flags"); *In re Michael H. Hume*, SEC Rel. 34-35608, 1995 SEC LEXIS 983 (April 17, 1995) ; *In re Houston A. Goddard*, SEC Rel. No. 34-35008, 51 S.E.C. 668, 672 (1993) (sustaining sanctions imposed on principal and compliance officer who failed to adequately follow up on red flags); *In re Edwin Kantor*, SEC Rel. 34-32341, 1993 SEC LEXIS 1240, 54 SEC Docket 293 (May 20, 1993) ("Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review."); *In re Frederick H. Joseph*, SEC Rel. No. 34-32340, 1993 SEC LEXIS 1239, 54 SEC Docket 283 (May 20, 1993) ; *In re Wedbush Secs., Inc.*, 48 S.E.C. at 967 .

(n50)Footnote 50. *In re Merrill Lynch, Pierce, Fenner & Smith Inc.*, NYSE Disc. Action 98-89, 1998 NYSE Disc. Action LEXIS 96 (Aug. 26, 1998).

(n51)Footnote 51. *In re Raymond A. Basile*, SEC Rel. No. 34-39930, 1998 SEC LEXIS 793, 67 SEC Docket 65 (April 29, 1998) .

(n52)Footnote 52. See also *In re NYLife Sec., Inc.*, SEC Rel. 34-40459, 1998 SEC LEXIS 2000, 68 SEC Docket

103 (September 23, 1998) (a system of supervision that relied upon interviews of representatives by a supervisor without a supporting review of customer files amounted to insufficient supervision); *In re First Capital Strategists*, SEC Rel. No. 1648, 1997 SEC LEXIS 1646 (August 13, 1997) (a supervisor's reliance on the trustworthiness of a trader without the independent review of the trader's positions is insufficient); *In re Schneider Sec., Inc.*, SEC Rel. No. 33-7530, 1998 SEC LEXIS 1091, 67 SEC Docket 34 (April 29, 1998) (holding supervisor responsible because he asked the representative, who was responsible for orders in a stock, to explain his relationship to the account but made no effort to verify the representative's assurance that he was not affiliated with the account, which turned out to be false).

(n53)Footnote 53. *In re George J. Kolar*, SEC Rel. No. 34-39812, 1998 SEC LEXIS 537, 66 SEC Docket 2026 (March 27, 1998) .

(n54)Footnote 54. *In re Susan L. Henry*, SEC Rel. No. 34-40183, 1998 SEC LEXIS 1403, 67 SEC Docket 1098 (July 9, 1998) .

(n55)Footnote 55. *In re Cortlandt Capital Corp.*, SEC Rel. No. 34-40101, 1998 SEC LEXIS 1215, 67 SEC Docket 811 (June 19, 1998) .

(n56)Footnote 56. *See, e.g., In re Thornton*, SEC Rel. No. 34-41007, 1999 SEC LEXIS 220 (Feb. 1, 1999) ,

(n57)Footnote 57. *In re Thornton*, SEC Rel. No. 34-41007, 1999 SEC LEXIS 220 (Feb. 1, 1999) .

(n58)Footnote 58. *See In re Arthur James Huff*, SEC Rel. No. 34-29017, 1991 SEC LEXIS 551, 48 SEC Docket 767 (March 28, 1991) .

(n59)Footnote 59. *In re Gutfreund*, SEC Rel. No. 34-31554, 1992 SEC LEXIS 2939, 52 SEC Docket 2849 (Dec. 3, 1992) .

(n60)Footnote 60. *In re Patricia Ann Bellows*, SEC Rel. No. 34-40411, 1998 SEC LEXIS 1892 (Sept. 8, 1998) .

(n61)Footnote 61. SEC Rel. No. ID-128, 1998 SEC LEXIS 1521, 67 SEC Docket 1426 (July 23, 1998) (initial ALJ decision) .



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CHAPTER 28 SPECIAL ISSUES OF BROKER-DEALERS

2-28 Securities Enforcement: Counseling and Defense § 28.04

AUTHOR: Joseph D. Edmondson, Jr.

§ 28.04 Reporting and Disclosure of Regulatory Violations

As a regulated entity, a broker-dealer, together with associated persons, is subject to significant special disclosure requirements in connection with SEC enforcement actions and other reportable events. These requirements include disclosing certain events of which the SEC or SRO may or may not already be aware, such as internal discipline, customer complaints or litigation. In such instances, firms should exercise special care to accurately and completely report the facts, as such reporting may lead to routine inquiries through which additional information may be requested by the SEC or SRO. Moreover, firms should prepare for the possibility of a follow-up inquiry by the regulators and retain all relevant documentation.

[1] NASD Rule 3070

Originally adopted in 1995, Rule 3070 provides that: "Each member shall promptly report to the Association whenever such member or person associated with the member:

(1) has been found to have violated any provision of any securities law or regulation, any rule or standards of conduct of any governmental agency, self-regulatory organization, or financial business or professional organization, or engaged in conduct which is inconsistent with just and equitable principles of trade; and the member knows or should have known that any of the aforementioned events have occurred;

(2) is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery;

(3) is named as a defendant or respondent in any proceeding brought by a regulatory or self-regulatory body alleging the violation of any provision of the Act, or of any other federal or state securities, insurance, or commodities statute, or of any rule or regulation thereunder, or of any provision of the By-laws, rules or similar governing instruments of any securities, insurance or commodities regulatory or self-regulatory organization;

(4) is denied registration or is expelled, enjoined, directed to cease and desist, suspended or

otherwise disciplined by any securities, insurance or commodities industry regulatory or self-regulatory organization or is denied membership or continued membership in any such self-regulatory organization; or is barred from becoming associated with any member of any such self-regulatory organization;

(5) is indicted, or convicted of, or pleads guilty to, or pleads no contest to, any felony; or any misdemeanor that involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities, or a conspiracy to commit any of these offenses, or substantially equivalent activity in a domestic, military, or foreign court.

(6) is a director, controlling stockholder, partner, officer or sole proprietor of, or an associated person with, a broker, dealer, investment company, investment advisor, underwriter or insurance company which was suspended, expelled or had its registration denied or revoked by any agency, jurisdiction or organization or is associated in such a capacity with a bank, trust company or other financial institution which was convicted of or pleaded no contest to, any felony or misdemeanor;

(7) is a defendant or respondent in any securities or commodities-related civil litigation or arbitration which has been disposed of by judgment, award or settlement for an amount exceeding \$15,000. However, when the member is the defendant or respondent, then the reporting to the Association shall be required only when such judgment, award, or settlement is for an amount exceeding \$25,000;

(8) is the subject of any claim for damages by a customer, broker, or dealer which is settled for an amount exceeding \$15,000. However, when the claim for damages is against a member, then the reporting to the Association shall be required only when such claim is settled for an amount exceeding \$25,000;

(9) is associated in any business or financial activity with any person who is subject to a "statutory disqualification" as that term is defined in the Act, and the member knows or should have known of the association. The report shall include the name of the person subject to the statutory disqualification and details concerning the disqualification;

(10) is the subject of any disciplinary action taken by the member against any person associated with the member involving suspension, termination, the withholding of commissions or imposition of fines in excess of \$2,500, or otherwise disciplined in any manner which would have significant limitation on the individual's activities on a temporary or permanent basis.

The Rule requires persons associated with a member to report the existence of any of the ten items to the member promptly, and the member, in turn, to report such existence to the NASD within ten business days after the member "knows or should have known" of the item or items. n1 The Rule also requires members to report statistical and summary information regarding customer complaints on a quarterly basis, but defines customer complaints in a broader manner than would trigger ordinary reporting under the section (a) of the Rule, or on an associated person's form U-4 or U-5. n2

Notably, the Rule was amended effective May 2003 to require members to file with the NASD certain specified documents evidencing criminal and civil complaints and related items. n3

Firms that are subject to reporting requirements of the NYSE are exempt from reporting requirements under Rule 3070.

[2] NASD Forms U-4 and U-5

The NASD also requires the amendment of a registered representative's Form U-4 upon the occurrence of certain events described on the form. In the case of an individual whose employment is voluntarily or involuntarily terminated, Form U-5 also requires reporting of certain events described on that form. Disclosure of the relevant specifics of the reportable events on Forms U-4 and U-5 is required on separate Disclosure Reporting Pages or "DRPs."

Forms U-4 and U-5 are presented in a question and answer format. Question 14G is particularly notable in the context of an SEC investigation. It asks: "Have you been notified, in writing, that you are now the subject of any: (1) regulatory complaint or *proceeding* that could result in a 'yes' answer to any part of 14C, D or E? ... or (2) *investigation* that could result in a 'yes' answer to any part of 14A, B, C, D or E?" Questions 14A and B deal with criminal proceedings and Questions 14C-E deal with regulatory proceedings.

According to the instructions to Forms U-4 and U-5, the terms "investigation" and "proceeding" are defined as follows:

INVESTIGATION includes: (a) grand jury investigations; (b) U.S. Securities and Exchange Commission investigations after the "Wells" notice has been given; (c) NASD Regulation, Inc. investigations after the "Wells" notice has been given or after a person associated with a member, as defined in the NASD By-Laws, has been advised by the staff that it intends to recommend formal disciplinary action; (d) formal investigations by other *SROs*; or (e) actions or procedures designated as investigations by *jurisdictions*. The term *investigation* does not include subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, "blue sheet" requests or other trading questionnaires, or examinations.

PROCEEDING includes a formal administrative or civil action initiated by a governmental agency, *self-regulatory organization* or *foreign financial regulatory authority*, a *felony* criminal indictment or information (or equivalent formal charge), or a *misdemeanor* criminal information (or equivalent formal charge), but does not include an arrest or similar charge effected in the absence of a formal criminal indictment or information (or equivalent formal charge). NOTE: *Investment-related* civil litigation, other than that specified above, is reportable under Question 14H on Form U-4. An *investigation* is reportable under Question 14G on Form U-4.

[3] NYSE Rule 351

Rule 351 of the New York Stock Exchange provides:

Each member not associated with a member organization and each member organization shall promptly report to the Exchange whenever such member or member organization, or any member, allied member or registered or non-registered employee associated with such member or member organization:

(1) has violated any provision of any securities law or regulation, or any agreement with or rule or standards of conduct of any governmental agency, self-regulatory organization, or business or professional organization, or engaged in conduct which is inconsistent with just and equitable principles of trade or detrimental to the interests or welfare of the Exchange;

(2) is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery;

(3) is named as a defendant or respondent in any proceeding brought by a regulatory or self-regulatory body alleging the violation of any provision of the Securities Exchange Act of 1934, or of any other Federal or state securities, insurance or commodities statute, or of any rule or regulation thereunder, or of any agreement with, or of any provision of the constitution, rules or similar governing instruments of, any securities, insurance or commodities regulatory or self-regulatory organization;

(4) is denied registration or is expelled, enjoined, directed to cease and desist, suspended or otherwise disciplined by any securities, insurance or commodities industry regulatory or self-regulatory organization, or is denied membership or continued membership in any such self-regulatory organization; or is barred from becoming associated with any member or member organization of any such self-regulatory organization;

(5) is arrested, arraigned, indicted or convicted of, or pleads guilty to, please no contest to, any felony; or any misdemeanor that involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities, or a conspiracy to commit any of these offenses, or substantially equivalent activity in a domestic, military or foreign court;

(6) as a director, controlling stockholder, partner, officer or sole proprietor of, or an associated person with, a broker, dealer, investment company, investment advisor, underwriter or insurance company which was suspended, expelled or had its registration denied or revoked by any agency, jurisdiction or organization or is associated in such a capacity with a bank, trust company or other financial institution which was convicted of, or pleaded no contest to, any felony or misdemeanor;

(7) is a defendant or respondent in any securities or commodities-related civil litigation or arbitration which has been disposed of by judgment, award or settlement for an amount exceeding \$15,000. However, when a member organization is the defendant or respondent, then the reporting to the Exchange shall be required only when such judgment, award or settlement is for an amount exceeding \$25,000;

(8) is the subject of any claim for damages by a customer, broker or dealer which is settled for a amount exceeding \$15,000. However, when the claim for damages is against a member organization, then the reporting to the Exchange shall be required only when such claim is settled for an amount exceeding \$25,000;

(9) is, or learns that he is associated with any business or financial activity with any person who is, subject to a "statutory disqualification" as that term is defined in the Securities Exchange Act of 1934;

(10) is the subject of any disciplinary action taken by the member or member organization against any of its associated persons involving suspension, termination, the withholding of commissions or imposition of fines in excess of \$2,500, or any other significant limitation on activities.

Like NASD Rule 3070, Rule 351 requires associated members and employees, among others, to report the existence of the foregoing items to the member or member organization. n4 Reporting to the NYSE is accomplished on Form RE-3 and must, according to the Form and instructions published by the NYSE, be accomplished within thirty days of the date of the reportable event.

Also like NASD Rule 3070, Rule 351 also includes a periodic statistical reporting requirement for customer complaints. n5 Such reports must be filed with the NYSE quarterly. n6

[4] SEC Form BD

The SEC, NASD and state securities regulators all use SEC Form BD as the application and registration document for broker-dealer firms. Form BD is filed with the SEC and must be amended when any number of reportable events occurs. Similar to the Form U-4, Form BD is set out as a series of questions and answers. Question 11C deals specifically with SEC actions: n7

Has the SEC or the Commodity Futures Trading Commission ever:

- (1) found the applicant or a control affiliate to have made a false statement or omission?
- (2) found the application or a control affiliate to have been involved in a violation of its regulations or statutes?
- (3) found the applicant or a control affiliate to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked or restricted?
- (4) entered an order against the applicant or a control affiliate in connection with investment-related activity?
- (5) imposed a civil money penalty on the applicant or a control affiliate, or ordered the applicant or a control affiliate to cease and desist from any activity?

Question 11G asks whether the applicant or a control affiliate is now the subject of any regulatory proceeding that could result in a "yes" answer to any part of 11C. But, the definitions in the instructions to Form BD define "proceeding" as "a formal administrative or civil action initiated by a governmental agency" and "[d]oes not include other civil litigation, investigations, or arrests or similar charges effected in the absence of a formal criminal indictment or information (or equivalent formal charge)." As such, a "Wells" call from the SEC does not subject the firm to regulatory disclosure.

[5] Practical Considerations

Because a Wells call triggers disclosure requirements for individuals on Forms U-4 and U-5 and may also cause a firm to consider a report to the NYSE on Form RE-3, it is often beneficial for the subject of an enforcement investigation to engage the SEC Staff in substantive discussions far in advance of when a formal Wells call would be expected. In some cases, the Staff may be willing to discuss the status of their evaluation of the evidence with a view to possible charges, even though they have not reached a conclusion that would trigger a Wells call. Such insight can provide a valuable opening for settlement negotiations, or preliminary advocacy designed to correct any misapprehensions of fact on the part of the Staff.

If the broker-dealer firm is also registered as, or is affiliated with, a registered investment adviser under the Investment Adviser's Act of 1940, it should also evaluate whether disclosure of an enforcement investigation, action or settlement is required on its Form ADV. Similarly, broker-dealers who are affiliated with other licensed entities, such as banks or insurance companies, should determine whether their state regulators require an investigation, action or settlement to be reported or disclosed. Finally, broker-dealers who are public companies, or affiliated with public companies, should consider whether disclosure is required in Exchange Act filings or in connection with future offerings of securities.

FOOTNOTES:

(n1)Footnote 1. NASD Conduct Rule 3070(b), *available at* <http://www.nasd.com>.

(n2)Footnote 2. NASD Conduct Rule 3070(c), *available at* <http://www.nasd.com>.

(n3)Footnote 3. NASD Notice to Members 03-23 (May 2003), *available at* http://www.nasd.com/web/graps/rules_regs/documents/notice_to_members/nasdw_003305.pdf.

(n4)Footnote 4. NYSE Rule 351(b), *available at* <http://rules.nyse.com>.

(n5)Footnote 5. NYSE Rule 351(d), *available at* <http://rules.nyse.com>.

(n6)Footnote 6. NYSE Informational Memo 94-38.

(n7)Footnote 7. Other subsections of Question 11 deal with issues involving other federal regulatory agencies, state regulatory agencies, foreign financial regulatory authorities, SROs and commodities exchanges.



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CHAPTER 29 SPECIAL ISSUES OF INVESTMENT ADVISERS AND INVESTMENT COMPANIES

2-29 Securities Enforcement: Counseling and Defense 29.syn

AUTHOR: Julie A. Smith

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CHAPTER 29 SPECIAL ISSUES OF INVESTMENT ADVISERS AND INVESTMENT COMPANIES

2-29 Securities Enforcement: Counseling and Defense § 29.01

AUTHOR: Julie A. Smith

§ 29.01 Introduction

Investment advisers and investment companies today are facing unprecedented Congressional, regulatory, and public scrutiny. The intense scrutiny began in late 2003 when New York Attorney General Elliot Spitzer shocked the investing public by alleging that certain participants in the mutual fund industry were permitting hedge funds to engage in abusive market timing and late trading of their shares. In the weeks and months that followed, the growing mutual fund scandal has tarnished the reputations of some of the most prominent names in the mutual fund industry and has led to numerous Congressional and regulatory proposals for reform.

No doubt stung by Spitzer's sharp criticism that "heads should roll" n1 at the Securities and Exchange Commission ("SEC" or "Commission") for its failure to detect and quickly act to address the alleged abuses, the SEC has embarked on an aggressive campaign to ferret out and remedy potential conflicts of interest and abuses in the mutual fund industry. The fruits of its efforts are reflected in some of the largest civil penalties ever imposed by the SEC, some amounting to hundreds of millions of dollars.

In this increasingly aggressive regulatory environment and amidst great suspicion of the mutual fund industry, many companies that have not previously encountered an enforcement inquiry may need to prepare to face one now. The need for these companies to work with knowledgeable counsel to prepare and implement appropriate compliance procedures, to properly handle regulatory investigations, and to respond to enforcement inquiries and actions has never been greater.

FOOTNOTES:

(n1)Footnote 1. Patrick McGeehan, *With Critics at the Door, Funds Propose Cleaning Own House*, N.Y. Times, Oct. 31, 2003, at C.



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CHAPTER 29 SPECIAL ISSUES OF INVESTMENT ADVISERS AND INVESTMENT COMPANIES

2-29 Securities Enforcement: Counseling and Defense § 29.02

AUTHOR: Julie A. Smith

§ 29.02 Examinations

[1] General

Although tips can sometimes prompt an SEC enforcement inquiry of an investment adviser or investment company, such inquiries are more likely to come about as the result of SEC inspections or examinations. n1

[2] Authority for Examinations

The SEC's authority to examine investment advisers and investment companies resides in the books and recordkeeping requirements of the Investment Advisers Act and Investment Company Act, respectively (collectively, the "Investment Acts;" each, an "Investment Act"), and the regulations thereunder. This authority is distinct from, and arguably more circumscribed than, the authority of the SEC to *investigate* regulated entities pursuant to the issuance of a formal order, as discussed in Chapter 5.

[a] Authority Under the Investment Advisers Act

Section 204 of the Investment Advisers Act provides that all records of investment advisers "are subject at any time, or from time to time, to such reasonable *periodic, special, or other* examinations by representatives of the Commission as the Commission deems necessary or appropriate in the public interest or for the protection of investors." n2 The foregoing authority only applies to investment advisers that are required to be registered under the Investment Advisers Act. Thus, Section 204 does not confer on the SEC the authority to inspect, for example, hedge fund advisers that are exempt from registration under the Investment Act. n3

The SEC interprets Section 204 to give it authority to inspect all records of a registered investment adviser, irrespective of whether the SEC has adopted a recordkeeping requirement for such records. n4 A "record" for purposes of Section 204 is defined by reference to the Securities Exchange Act of 1934 ("Exchange Act") definition to mean "accounts, correspondence, memorandums, tapes, discs, papers, books, and other documents or transcribed information of any type, whether expressed in ordinary or machine language." n5

[b] Authority Under the Investment Company Act

The SEC acknowledges that its inspection authority for investment company records is limited to those that are required to be maintained and preserved pursuant to Section 31 of the Investment Company Act. n6 Section 31(b) of the Investment Company Act provides that all records *required to be maintained by Section 31(a)* of the Act "shall be subject at any time and from time to time to such reasonable periodic, special, and other examinations by the Commission, or any member or representative thereof, as the Commission may prescribe." n7 Section 31(a) of the Investment Company Act requires each registered investment company, and each underwriter, broker, dealer, or investment adviser that is a majority-owned subsidiary of such a company, "to maintain and preserve such records ... for such period or periods as the Commission, by rules and regulations, may prescribe as necessary or appropriate in the public interest or for the protection of investors." n8 In addition, Section 31(a) requires each investment adviser that is not a majority-owned subsidiary of a registered investment company, each depositor of any registered investment company, and each principal underwriter for any registered investment company other than a closed-end company, to "maintain and preserve for such period or periods as the Commission shall prescribe by rules and regulations, such records as are necessary or appropriate to record such person's transactions with such registered company." n9 Like the Investment Advisers Act, the Investment Company Act defines "record" by reference to the definition contained in the Exchange Act. n10

Section 31(a)(2) requires the SEC to take such steps that it deems "necessary and appropriate, consistent with the public interest and for the protection of investors, to avoid unnecessary recordkeeping by, and minimize the compliance burden on," investment companies and their affiliates. n11 These steps include considering and requesting public comment on: (1) feasible alternatives that would minimize recordkeeping burdens, (2) the necessity of such records in view of the public benefits derived from the independent scrutiny of such records through the SEC's examination program, (3) the costs associated with maintaining the required information, and (4) the effects that a proposed recordkeeping requirement would have on internal compliance policies and procedures.

Section 31(b)(2) of the Investment Company Act requires persons subject to the requirement to "make available to the Commission or its representatives any copies or extracts from such records as may be prepared without undue effort, expense, or delay as the Commission or its representatives may reasonably request." n12 The Section limits the SEC's ability to require registrants to exert undue effort or expense in responding to inspection requests for copies of required records. The Section does not define "undue effort, expense, or delay" and what those terms mean will necessarily depend on the facts and circumstances of the particular request and the registrant. For example, the SEC Staff may ask registrants to produce copies of records, such as e-mails, in electronically searchable format. There is, however, no uniform standard as to what constitutes "electronically searchable." In addition, while such a format obviously would be convenient to the SEC Staff, it is not one that a registrant can necessarily produce promptly or without significant allocation of resources. n13 In many cases, producing documents in such a format, particularly to include appropriate confidentiality requests pursuant to the Freedom of Information Act and Rule 83 of the SEC's rules on information and requests, n14 may require the assistance or expertise of outside vendors who themselves may have capacity issues. Accordingly, registrants who receive a request to produce copies or excerpts of particular records in a particular format should consider the burdens associated therewith, discuss the feasibility of producing such records in such format with the SEC Staff, and, if producible without undue effort or expense, outline a reasonable timetable for production.

Section 31(b)(3) of the Investment Company Act requires the SEC to "exercise its authority under this subsection with *due regard* for the benefits of internal compliance policies and procedures and the effective implementation and operation thereof." n15 Congress enacted this section in recognition of the "vital significance" internal compliance systems and the fact that such systems "generally function most effectively when they operate in an atmosphere of openness and candor, which is best fostered when internal audit reports are utilized by, and are not routinely made public to third parties or requested by regulatory authorities." n16 The Section does not define "due regard," however, the legislative history of the Section reflects Congress' expectation that the SEC would review internal audit and similar reports on a *selective* basis, i.e., "only insofar as necessary to determine whether the internal compliance policies of the fund or other examined persons are in place, whether procedures to effect and enforce the policies have been

implemented, and whether the compliance policies and procedures are reasonably designed to detect compliance problems and address them in an appropriate fashion." n17 The legislative history of the Section makes clear that Congress expected that "the Commission staff would seek to review a sample of an examined person's internal audit reports adequate to form a basis of concluding that the compliance policies and procedures are achieving these objectives." n18 Congress did not want the SEC Staff "simply to duplicate the role played by a funds' internal compliance staff. If the fund has a well-functioning system of internal controls, the [SEC's] limited resources could be directed to other areas of fund operations or to other funds." n19

To address the potential chilling effect on registrants who may be concerned over the disclosure of potentially sensitive information contained in an internal audit, Congress enacted Section 31(c) of the Investment Company Act, which provides that "[n]otwithstanding any other provision of law, the Commission shall not be compelled to disclose any internal compliance or audit records, or information contained therein, provided to the Commission under this section." n20 Section 31(d)(1) of the Investment Company Act defines the term "internal compliance policies and procedures" to mean "policies and procedures designed by subject persons to promote compliance with the Federal securities laws" whereas Section 31(d)(2) of the Act defines the term "internal compliance and audit record" to mean "any record prepared by a subject person in accordance with internal compliance policies and procedures."

[3] Office of Compliance Inspections and Examinations

The SEC's Office of Compliance Inspections and Examinations ("OCIE") serves as the "eyes and ears" n21 of the SEC and is responsible for conducting the SEC's examination programs for regulated entities, including investment advisers and investment companies. n22 The SEC created OCIE in 1995 to increase the efficiency of the examinations process by integrating the inspection operations and personnel of the Division of Market Regulation and the Division of Investment Management. n23 SEC Staff in OCIE and in the SEC's 11 regional and district offices conduct the examinations. Currently, there are approximately 500 staff positions (including supervisors, examiners, and support staff) to conduct examinations of investment advisers and investment companies. n24

Examiners have a wide variety of backgrounds and experience. Junior examiners may be recent college graduates and may have some specialized experience, such as experience working at an investment advisory firm or investment company organization, a state or self-regulatory agency. In some cases, they may have securities investment experience at a bank or insurance company, or may have professional experience as an accountant or auditor. More senior examiners can be expected to have a greater degree of knowledge of the structure, operations, and practices of investment advisers and investment companies. Some examiners may have law degrees, though they are more likely to have accounting or auditing backgrounds. Given the wide variety of backgrounds and experience among examiners, a registrant should not assume that an SEC examiner in the field will necessarily understand the registrant's business or operations or its compliance with a particular federal securities law requirement. n25 Registrants, therefore, should be mindful of the need to carefully frame their responses (and keep a record of such responses, including any oral responses) when communicating with SEC examiners during the course of an inspection to avoid any misimpressions or misunderstandings, or worse, accusations that it misled the SEC Staff.

OCIE acts as liaison with the other Divisions of the SEC, including the Divisions of Enforcement, Investment Management, and Market Regulation, as well as other regulators. OCIE also conducts field work and document review on special studies in areas of interest or concern to the SEC. n26

[4] Types of Examinations

OCIE primarily conducts three types of examinations of investment advisers and investment companies, as described below. n27

[a] Routine

Routine examinations are by far the most common type of examination that OCIE conducts. n28 Routine examinations of investment advisers and investment companies occur on a cyclical basis, generally every two to four years depending on the registrant's risk profile. n29 Routine examinations are risk-based in that they focus on areas that the SEC Staff has identified as posing the greatest compliance risk generally or for the particular registrant being examined.

Onsite field work for routine examinations can take as little as a couple of days or as long as several weeks, primarily depending on the size and scope of the registrant's activities and the findings made. Offsite review of the information gathered by the SEC Staff can take weeks and in some cases months, during which time the Staff may issue supplemental requests for information before completing its examination.

[b] Sweep

OCIE is increasingly conducting so-called "sweep" or "mini-sweep" examinations to determine a particular industry practice or to assess industry compliance with respect to a particular issue of concern to the SEC. In some cases, OCIE may conduct a sweep examination in conjunction with the Division of Enforcement. Although sweep examinations historically have been the least frequent type of examination conducted by OCIE, n30 they will likely become much more frequent as OCIE, in furtherance of the SEC's risk assessment initiative, attempts to detect problems before they become widespread.

When conducting a sweep examination, the sampling of registrants that the SEC Staff may take may be small (e.g., fewer than 10) or large (e.g., hundreds), depending on the particular industry practice or issue. An initial sweep request for information may be followed by one or more supplemental requests or by an onsite examination, depending on the responses the SEC Staff receives. Recently, OCIE has conducted or commenced sweeps concerning market timing and late trading, "shelf-space" payments, soft dollar practices by index funds, pricing and valuation of bond funds, fair value pricing, and so-called "pay-to-play" practices of pension plan consultants.

Sweep examinations, because of their targeted nature, should be taken very seriously. Indications of problems at a registrant in response to a sweep examination may very well lead to an enforcement referral. Accordingly, registrants may find it prudent to consult with competent legal counsel early on in developing effective responses to sweep examination requests.

[c] Cause

OCIE may conduct a cause examination of a registrant if it suspects that a registrant may have engaged in a violation of the federal securities laws. Cause examinations can be prompted by a number of sources, such as investor complaints, tips from informants, stories in the financial press, or some other indication of wrongdoing. OCIE generally conducts cause examinations on a "surprise" basis. Unlike a routine examination, a cause examination is specifically directed to determining whether the registrant has violated the federal securities laws and, as one might imagine, the SEC Staff may already be heavily inclined to believe that a violation has occurred. The Staff of the Division of Enforcement ("Enforcement Staff") may be involved from the outset of the examination and may request testimony from one or more persons associated with the registrant. A registrant facing a cause examination, therefore, would be well-advised to treat it in the same way it would treat a formal SEC investigation and should engage experienced outside counsel at the outset.

[5] Possible Examination Outcomes

Registrants can generally expect one of three possible outcomes to result from an examination, as discussed below.

[a] Deficiency Letter

A deficiency letter historically has been the most common result of an examination. n31 A deficiency letter sets out the SEC Staff's examination findings, which may include assertions that, in the view of the SEC Staff, the registrant has or may have violated one or more provisions of applicable law. A deficiency letter also may include statements that the SEC Staff has observed material weaknesses or deficiencies in the registrant's internal controls or other procedures. A deficiency letter ordinarily will ask a registrant to take corrective action and to confirm in writing to the SEC that it has taken such action within 30 days of the date of the letter.

There are many types of corrective action that a registrant may decide to take in response to -- or in anticipation of -- a deficiency letter, including steps such as the adoption of new policies and/or procedures, refinements or enhancements to existing procedures, and disclosure changes. A registrant should promptly communicate with the Staff if it believes additional time may be necessary to respond to the deficiency letter. Although the Staff generally applies a rule of reason, a registrant should not count on receiving an extension.

If a registrant disagrees with a particular finding, it should provide the SEC Staff with a thorough explanation of the factual and legal bases for its position. Deficiencies asserted by the SEC Staff are by no means cast in stone and a more comprehensive explanation of the facts, or effective advocacy regarding a point of law, may resolve an issue to the SEC Staff's satisfaction without the need for the registrant to take any corrective action, or may result in the taking of lesser corrective action. In no case should a registrant take any finding of a deficiency lightly; a registrant should respond to each and every deficiency cited in the letter.

In cases where the SEC Staff finds what it perceives to be a serious deficiency, it may request a special meeting or telephone conference with a registrant's senior management to discuss the matter and to determine what immediate corrective action the registrant intends to take prior to the issuance of a deficiency letter. In some cases, the SEC Staff may bring perceived deficiencies directly to the attention of a registrant's board of directors. A registrant should take steps to immediately address SEC Staff concerns, whether by taking appropriate corrective action or, if the registrant disagrees with the Staff, by engaging the Staff in a candid and complete discussion of the issues raised. Serious issues raised during an examination will be reviewed by senior examination, regulatory, and Enforcement Staff to ensure appropriate follow-up. Accordingly, registrants may find it prudent to involve outside counsel to discuss the issues raised. Registrants must be careful to memorialize and fulfill any oral undertakings to take any corrective action made during such a call or meeting. To avoid misunderstandings, registrants should consider sending the SEC Staff a written communication confirming the nature of any undertakings made orally. The SEC Staff will expect such undertakings to be satisfied.

Although a deficiency letter generally indicates that the SEC Staff does not intend to make an enforcement referral, in some cases the SEC Staff may send a deficiency letter and make an enforcement referral. n32 The failure to correct previously cited deficiencies or to respond adequately to currently cited deficiencies will increase the likelihood of an enforcement referral.

[b] Closing Letter

If the SEC Staff finds no deficiencies, then it generally, but not always, will issue a letter to the registrant indicating that it has closed the examination. The SEC Staff has stated that registrants should not view a closing letter as a "clean bill of health," but merely an indication that the Staff did not find violations during the examination. n33

[c] Enforcement Referral

The SEC Staff may refer a matter to the Division of Enforcement if it finds a serious violation of the law. The decision to make an enforcement referral will naturally depend on the particular facts and circumstances and the nature of the alleged violation. Findings of fraud, intentional wrongdoing, or significant investor losses will often lead to an enforcement referral. The OCIE Staff will consult with the Enforcement Staff in deciding whether to make an

enforcement referral and, as noted above, the Enforcement Staff may be involved at the outset in the case of a cause examination. The Enforcement Staff will determine if further investigation is appropriate and whether it will recommend enforcement action to the SEC.

According to the SEC Staff, approximately 3.5% of the investment adviser examinations performed in 2003 (55 out of 1556 examinations) resulted in the discovery of serious violations warranting enforcement referrals. n34 In the same year, approximately 5% or 14 out of 265 investment company examinations warranted referrals for further investigation by the Enforcement Staff. n35 These figures correspond roughly to the historical number of examinations resulting in enforcement referrals during the five-year period 1998 to 2003. n36

[6] Preparing for and Handling an Examination

[a] Planning Ahead

The scope of an SEC examination will depend in significant measure on the quality of a registrant's compliance program. n37 Factors suggesting increased compliance risks can lead to more comprehensive or more frequent examinations by the SEC Staff. Such factors may include a poor or ineffective internal control environment, the absence of a strong commitment to compliance by an organization's leadership, the absence of or weaknesses in policies or procedures, sloppy recordkeeping, or prior findings of similar or other types of deficiencies. n38

Given the SEC Staff's risk-based approach, the best way to plan ahead for an SEC examination is to develop and implement an effective compliance program. With the recent adoption by the SEC of new rules governing compliance programs for investment advisers and investment companies, n39 there is no time like the present for registrants to ensure that the compliance side of their houses are in order. The new compliance program rules require each investment adviser and investment company registered with the SEC to adopt and implement written policies and procedures that are reasonably designed to assure compliance with the federal securities laws (in the case of investment advisers, these laws include the Investment Advisers Act and regulations thereunder; in the case of investment companies, these laws include the Securities Act of 1933 ("Securities Act"), the Exchange Act, the Investment Company and Investment Adviser Act, the Sarbanes-Oxley Act of 2002, n40 Title V of the Gramm-Leach-Bliley Act, n41 applicable provisions of the Bank Secrecy Act, n42 and regulations thereunder). The compliance programs must be reviewed at least annually for adequacy and effectiveness. In addition, the compliance programs must be administered by a designated compliance officer whose designation, removal, and compensation is, in the case of an investment company, subject to the approval of the company's board, including a majority of its disinterested directors. In addition, under the new rules, the books and records of investment advisers and investment companies must include not only a copy of the policies and procedures that constitute the compliance program, but also must include records documenting the required annual reviews and, in the case of an investment company, copies of materials provided to its board of directors in connection with its approval of the compliance program, as well as copies of reports provided to the board regarding the operation of the program and any material compliance matters. The new rules also require investment companies to consider the compliance programs of their investment advisers, principal underwriters, administrators, and transfer agents.

The new rules provide investment advisers and investment companies with an opportunity to comprehensively revisit, and if need be, revamp their compliance programs. Notably, under the new rules, the failure of an investment adviser or investment company's compliance program to meet the requirements of the new rules can constitute independent grounds for the finding of a securities law violation. In other words, inadequate compliance programs can constitute grounds for a securities law violations even in the absence of any harm to a client or investor.

Advance preparation and a good compliance program will allow a registrant to convey a strong first impression to an SEC examiner, which may help to head off a lengthier and more comprehensive examination. Early detection and resolution of issues can prevent minor matters from becoming big problems. To this end, registrants may find it advisable to proactively seek the advice of experienced outside counsel who can provide insights into the nature and

scope of an inspection inquiry and who can assist with the preparation and planning for an SEC Staff examination by, for example, conducting "mock" inspections.

[b] Managing the Process

[i] Designated Contact

Following receipt of an inspection notice, or in anticipation thereof, a registrant should designate a specific individual to serve as the central contact point for the SEC Staff examiners and to coordinate the allocation of internal and external resources for the examination. The designated contact ideally would be the chief compliance officer or someone who reports to such officer and who is familiar with the examination process and registrant's compliance program. To the extent the SEC Staff gives advance notice, the designated contact should work with the SEC Staff to coordinate the details of the Staff's onsite visit and the availability of individuals who the SEC Staff would like to interview. The designated contact and registrant's counsel should prepare the individuals being interviewed as if they were giving formal testimony. They also should attend the interviews to represent the registrant's interests and to create a record of the matters discussed. In addition, the designated contact should review, or coordinate the review, of all documents being produced for privilege, for confidential treatment, and to keep a record of what documents have been produced.

[ii] Designated Workroom

Once the SEC Staff arrives on a registrant's premises, the registrant should provide the Staff with a designated office, conference room, or other workroom in which it can review documents and conduct interviews. Providing a designated workroom will help to facilitate the delivery of files and other documents for the SEC Staff's review, and will avoid having the Staff walk the hallways to interview each person in his or her office. Generally, the sooner the SEC Staff can accomplish its examination and leave, the more quickly a registrant can focus its attention or resources on other matters.

[c] Document Production

The SEC Staff will frequently provide a registrant with a document list a week or so in advance of its onsite visit. The SEC Staff will often ask to see many of the same types of documents from examination to examination. Registrants can expect the SEC Staff to ask to see its internal audit reports and records of internal investigations. To the extent a registrant desires to protect a document from production, it should plan to take appropriate steps to protect the same with an applicable privilege. All documents should be reviewed for privilege prior to producing them to the SEC. In addition, a registrant should request confidential treatment of the documents that are produced, as appropriate, under the FOIA.

[d] Communication and Cooperation

The SEC Staff has acknowledged that "[a]side from providing their books and records for examination, registrants have no legal obligation to volunteer information about the existence of violations or compliance problems to examiners." n43 Nevertheless, the SEC Staff will frequently request the voluntary production of data or analyses not specifically required to be maintained by registrants, and will seek to engage registrants in an open dialogue about matters covered by the examination. In addition, the SEC Staff ordinarily will ask to meet with senior management to ascertain the registrant's "tone at the top" or "culture of compliance." n44 The SEC Staff also may ask to interview the registrant's employees.

Generally, registrants are well-served by voluntarily cooperating with such requests. Refusing to produce information or provide access to personnel will only create suspicion in the mind of the SEC Staff and prolong the examination. n45 If the SEC Staff wants information or wants to talk to a particular individual, it could refer the matter to the Enforcement Staff, which could then seek to subpoena the information or individual's testimony in appropriate cases. Obviously, there are some cases where resisting production would be appropriate, such as matters involving the production of

privileged information. In such cases, registrants should continue to maintain an attitude of cooperation and seek to resolve its concerns regarding the requested production at the appropriate levels within the SEC.

A registrant should provide candid and complete responses to all SEC Staff's questions so that the Staff can complete its examination inspection promptly. The need for candor cannot be overemphasized. The SEC has noted candor, or the lack thereof, in orders imposing remedial sanctions. n46 In this regard, the SEC Staff has observed that criminal penalties may apply "for lying to a federal government official or concealing material facts in any matter within the jurisdiction of the federal government." n47

Maintaining an ongoing dialogue with the SEC Staff without question helps to facilitate the examination process and may provide opportunities for the registrant to obtain from the SEC Staff a preliminary indication of whether it has found violations of the law. Registrants should, through their designated contacts, take advantage of such opportunities to explain or defend the legality of its practices and/or take immediate remedial steps, if possible or appropriate. By providing an adequate explanation of a seemingly non-compliant practice or transaction, or by taking immediate remedial steps, a registrant can sometimes head off further inquiry and possibly avoid the inclusion of the matter in a deficiency letter.

The SEC Staff will often ask for a tour of the premises to get a sense of how an organization, for example, processes a transaction or otherwise conducts its business. Registrants should cooperate with such requests, but should not allow the SEC Staff to roam freely throughout its premises or allow unfettered access to people and information. In addition, a registrant should respectfully point out to an examiner when his or her presence or request may be interfering with the registrant's day-to-day operations.

[e] Exit Interviews

The SEC Staff may provide a registrant with an exit interview prior to leaving the registrant's premises. During the interview, the Staff may discuss some or all of the deficiencies found as well as work out with the registrant a timetable for the production of any remaining documents. n48 The registrant's chief compliance officer, general counsel (or representative from the registrant's office of general counsel), senior management familiar with registrant's operations, and the designated contact person (if different) all should participate in the interview. n49 An exit interview gives a registrant the opportunity to explain any facts that the Staff may not have considered, to flag for the Staff any immediate remedial steps that it may have taken during the period of the examination, and to discuss its views on particular legal requirements, all with a view to avoiding a deficiency letter or an enforcement referral. After completing its examination, but prior to issuing a deficiency letter, the SEC Staff may give registrants an opportunity to discuss the Staff's findings by telephone. This "exit call" is like an exit interview insofar as it provides registrants with an opportunity to try to change the views of the SEC Staff by presenting additional information or analysis. Registrants should take advantage of an opportunity to explain their cases in an exit interview or call. Responses made during an exit interview or call, however, are not a substitute for any written responses that may be required by a deficiency letter.

[7] Current Areas of Examination Focus

During the past year, the SEC Staff's examination program of investment advisers and investment companies focused on several major areas, as discussed below. According to the SEC Staff, the examinations for the most part resulted in registrants taking corrective action, though some findings resulted in enforcement actions. The topics discussed below would appear to relate primarily to matters covered in routine examinations, as distinct from the topics covered in OCIE's recent sweep examinations, described in § 29.02[4][b] above.

[a] Investment Adviser Examination Focus

According to the SEC Staff, the topics covered in an examination of an investment adviser may include, without

limitation, the following:

- (1) the fair allocation of blocked trades and initial public offerings consistent with disclosures;
- (2) the accurate pricing of client assets;
- (3) the delivery to clients of periodic account statements from third parties;
- (4) the protection of information from unauthorized alteration and destruction;
- (5) the consistency of portfolio management decisions with applicable client mandates;
- (6) the maintenance of client funds and assets;
- (7) the maintenance of a strong compliance culture;
- (8) the minimum ability of a dominant individual to override control systems;
- (9) the placement of trade orders consistent with the investment adviser's obligation to seek best execution; and
- (10) the fair presentation of performance information to clients. n50

According to the SEC Staff, the "most common problems referred to Enforcement related to conflicts of interest, misleading performance calculations, Form ADV/brochure disclosure and delivery, internal controls and books and records." n51

[b] Investment Company Examination Focus

According to the SEC Staff, investment company registrants can expect to see a wide range of topics covered in their examinations, including, without limitation, the following:

- (1) the consistency of portfolio management decisions with investment company mandates;
- (2) the regular reconciliation of custodian records with investment company and investment adviser's records, with all reconciling items resolved;
- (3) the protection of information from unauthorized alteration and destruction;
- (4) investment company/shareholder order processing and cash-book reconciliation;
- (5) the safety of clients' funds and assets;
- (6) the pricing of fund assets and accurate calculation of net asset values;
- (7) the personal trading of access persons;
- (8) the fair allocation of blocked and IPO trades;
- (9) the consistency of order placement practices with seeking best execution and with public disclosures;

- (10) the accuracy and fairness of performance information;
- (11) corporate governance matters affecting the investment company; and
- (12) the delivery by a third party of periodic account statements to clients. n52

According to the SEC Staff, "[t]he most common problems referred to Enforcement related to conflicts of interest, boards of directors, books and records, custody, and execution of trades." n53

FOOTNOTES:

(n1)Footnote 1. For convenience, this chapter refers to inspections and examinations interchangeably.

(n2)Footnote 2. *15 U.S.C.S. § 80b-4* (emphasis added). Section 204 requires "every investment adviser who makes use of the mails or of any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser (other than one specifically exempted from registration pursuant to [Section 203(b) of the Investment Advisers Act]," to "make and keep for prescribed periods such records ..., furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors."

(n3)Footnote 3. In recent congressional testimony, SEC Chairman Donaldson stated that he had asked the SEC Staff to "move forward with a rulemaking proposal that would enhance the Commission's ability to prevent, detect and deter abusive, fraudulent conduct in the hedge fund segment of the investment management industry." Testimony of William H. Donaldson, SEC Chairman, Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry, Before the Sen. Comm. on Banking, Housing and Urban Affairs (Apr. 8, 2004). On July 14, 2004, the SEC proposed for public comment a proposal that would require hedge fund advisers to register under the Investment Advisers Act. *Registration under the Advisers Act of Certain Hedge Fund Advisers*, Adv. Act Rel. No. 2266, 2004 SEC NEWS LEXIS 1545 (July 20, 2004) (proposing release).

(n4)Footnote 4. SEC Form 1661 (April 2003). The specific books and records that registered advisers are required to keep under the Investment Advisers Act are set out in Rule 204-2 (*17 C.F.R. § 275.204-2*). Rule 204-2 requires registered advisers to make and keep true, accurate and current specific books and records relating to its investment advisory business, such as journals, ledgers, memoranda concerning securities orders, records concerning client accounts, and powers of attorney. Notably, the Rule does not require registered advisers to maintain copies of all customer communications. The Rule only requires registered advisers to keep originals of "all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security." In addition, the Rule does not require registered advisers to keep any "unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser." Further, if the adviser "sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if such notice, circular or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of such notice, circular or advertisement a memorandum describing the list and the source thereof."

(n5)Footnote 5. *15 U.S.C.S. § 78c(a)(37)*.

(n6)Footnote 6. SEC Form 1661 (April 2003).

(n7)Footnote 7. *15 U.S.C.S. § 80a-30(b)(1)* (emphasis added).

(n8)Footnote 8. *15 U.S.C.S. § 80a-30(a)(1)*. Congress intended this provision to "enable the Commission to require investment companies to maintain the records necessary for examiners to conduct a thorough examination of a company's operations and thereby ensure that the investment company and its related entities are in compliance with all applicable statutes (sic) and regulations (whether or not records concerning these matters are necessary to support financial statements)." H.R. Rep. No. 104-622 at 47.

(n9)Footnote 9. *15 U.S.C.S. § 80a-30(a)(1)*. Rules 31a-1, 31a-2, and 31a-3 under the Investment Company Act (*17 C.F.R. § 270.31a-1, 31a-2, 31a-3*) set out the applicable books and recordkeeping requirements. The legislative history of Section 31(a)(1) indicates that Congress intended to expand the authority of SEC examiners to inspect records that may not be required by SEC rules, but that already exist and are relevant to the operations of the investment company and transactions between the investment company and its investment adviser and principal underwriters. House Report at 48.

(n10)Footnote 10. *15 U.S.C.S. § 78c(a)(37)*.

(n11)Footnote 11. *15 U.S.C.S. § 80a-30(a)(2)*.

(n12)Footnote 12. *15 U.S.C.S. § 80a-30(b)(2)*.

(n13)Footnote 13. Recognizing the burdens that may be associated with maintaining electronic records, the SEC deleted a proposed electronic recordkeeping requirement when it adopted the new code of ethics requirement for registered investment advisers. SEC Open Meeting (May 26, 2004).

(n14)Footnote 14. *5 U.S.C.S. § 552* and *17 C.F.R. § 200.83*.

(n15)Footnote 15. *15 U.S.C.S. § 80a-30(b)(3)* (emphasis added).

(n16)Footnote 16. H.R. Rep. No. 104-22 at 49.

(n17)Footnote 17. H.R. Rep. No. 104-622 at 49.

(n18)Footnote 18. H.R. Rep. No. 104-622 at 49.

(n19)Footnote 19. H.R. Rep. No. 104-622 at 49.

(n20)Footnote 20. *15 U.S.C.S. § 80a-30(c)*. The Section provides, however, that the SEC may not rely on it to withhold information from Congress or from complying with an information request from a federal department or agency or court. In addition, an administrative law judge has ruled that the SEC may not expansively read Section 31(c) to bar the production of documents responsive to a subpoena, absent a showing necessary to invoke that Section. *In re Putnam Investment Management, LLC, Administrative Proceedings Rulings Rel. No. 613, 2004 SEC LEXIS 1096* (Mar. 26, 2004). In that case, Putnam sought by subpoena several categories of documents relating to the SEC's regulation in the area of market timing, including: (a) all communications on and after January 1, 1999, between the SEC and any person concerning whether such person is obligated [to] make any disclosure in a public filing with the SEC concerning "market timing" trading or "excessive short term trading and (b) all communications on and after January 1, 1999, between the SEC and any person concerning any actions that such person might undertake in order to supervise persons in his employ or associated with him with respect to "market timing" trading or "excessive short term trading." The SEC's Office of Compliance Inspections and Examinations ("OCIE") tried to invoke Section 31(c) to prevent the production of responsive documents. The administrative judge stated that to invoke Section 31(c), OCIE must (1) conduct a comprehensive review of its files and assemble all of the responsive documents that it believes are subject to Section 31 of the Investment Company Act; (2) provide a detailed index of the responsive documents that were "provided to the Commission" by a "subject person," and that it wishes to withhold; (3) if the OCIE intends to argue that Section 31(c) "necessarily applies" to documents prepared by the SEC's Staff, provide a separate detailed index of

such responsive documents; (4) provide an affidavit from a responsible management official in OCIE, stating that he or she has personally reviewed each of the responsive documents for which Section 31(c) protection is claimed. Notably, the judge stated that an affidavit from the SEC's Office of General Counsel would not suffice for these purposes.

(n21)Footnote 21. *The SEC Speaks in 2004* (Mar. 2004) at 522.

(n22)Footnote 22. Other regulated entities would include broker-dealers, transfer agents, clearing agencies, and self-regulatory organizations ("SROs").

(n23)Footnote 23. *Establishment of Office and Delegation of Authority to Administer Functions, Exch. Act Rel. No. 36031, 1995 SEC LEXIS 1869* (July 28, 1995) .

(n24)Footnote 24. *SEC Operations: Oversight of the Mutual Fund Industry Presents Management Challenges*, GAO Study (2004) at 9.

(n25)Footnote 25. The SEC Staff has noted that "many questions are asked [during an examination] not because the examiner suspects wrongdoing, but because he or she simply does not understand what a record means." *SEC Speaks, above* at 528.

(n26)Footnote 26. *E.g., Implications of the Growth of Hedge Funds*, SEC Staff Report to the SEC (Sept. 29, 2003).

(n27)Footnote 27. As discussed elsewhere in this book, the SEC also conducts comprehensive examinations of broker-dealers, as well as oversight examinations of SROs and broker-dealers. In addition, in recent testimony before Congress, Lori Richards, the Director of OCIE, stated that OCIE is adopting a program of "benchmark examinations," which are intended to test the assumptions used in its routine risk-based examinations. According to Richards, "each year, we will conduct comprehensive 'wall-to-wall' examinations of a select number of firms to test the assumptions used in our risk-based exams and to benchmark our procedures. These comprehensive reviews should identify weaknesses in our risk-based models and allow us to expand, as needed, our review of risky activities." Testimony of Lori A. Richards before the Sen. Comm. on Banking, Housing, and Urban Affairs (Mar. 10, 2004).

(n28)Footnote 28. According to the SEC Staff, during the five-year period 1998 to 2003, routine examinations accounted for approximately 92% and 85% of all investment adviser and investment company examinations, respectively. Richards Testimony, *above* at 15.

(n29)Footnote 29. In prior years, routine examinations were conducted in many cases on a five-year cycle. The SEC Staff has sought to shorten the inspection cycle for registrants following the receipt of additional budgetary resources in 2003 and to apply more of a risk-based approach to scheduling examinations, with the largest (top 20) fund groups and high risk profile funds and advisers being examined every two years, all other fund groups being examined every four years, and all other advisers (not a high risk or part of a fund group) being examined every four to five years. Richards Testimony, *above* at 9.

(n30)Footnote 30. According to the SEC Staff, during the five-year period 1998 to 2003, sweep examinations accounted for approximately 1% and 4% of all investment adviser and investment company examinations, respectively. Richards Testimony, *above* at 15.

(n31)Footnote 31. According to the SEC Staff, during the five-year period 1998 to 2003, deficiency letters accounted for approximately 90% and 85% of the results of all investment advisory and investment company examinations, respectively. Testimony of Lori A. Richards before the Sen. Comm. on Banking, Housing, and Urban Affairs, 16 (Mar. 10, 2004). These figures correspond roughly to the approximate number of routine examinations performed, and there is likely a high degree of overlap.

(n32)Footnote 32. *Informal Guidance Program for Small Entities, Adv. Act Rel. No. 1624, 1997 SEC LEXIS 686*

(Mar. 27, 1997) .

(n33)Footnote 33. The SEC Speaks in 2004 (Mar. 2004) at 529.

(n34)Footnote 34. SEC Speaks, *above* at 537.

(n35)Footnote 35. SEC Speaks, *above* at 537.

(n36)Footnote 36. During that period, approximately 4% and 6% of all investment adviser and investment company examinations, respectively, concluded with enforcement referrals. Richard's Testimony, *above* at 16.

(n37)Footnote 37. The SEC Speaks in 2004 (Mar. 2004) at 527.

(n38)Footnote 38. Testimony of Lori A. Richards before the Sen. Comm. on Banking, Housing, and Urban Affairs, 16 (Mar. 10, 2004).

(n39)Footnote 39. *Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Adv. Act Rel. No. 2204, 2003 SEC LEXIS 2980* (Dec. 17, 2003) .

(n40)Footnote 40. Pub. L. 107-204, *116 Stat. 745* (2002).

(n41)Footnote 41. Pub. L. No. 106-102, *113 Stat. 1338* (1999).

(n42)Footnote 42. *31 U.S.C.S. §§ 5311-5314; 5316-5332*.

(n43)Footnote 43. Testimony of Lori A. Richards before the Sen. Comm. on Banking, Housing, and Urban Affairs, 13 (Mar. 10, 2004).

(n44)Footnote 44. L. Richards, *Put the Compliance Rule to Work: IA Compliance Best Practices Summit* (Mar. 15, 2004).

(n45)Footnote 45. According to the SEC Staff, "Stonewalling merely creates the impression that the registrant has something to hide" whereas clarifying matters, which initially may appear suspicious, "allows the process to continue." SEC Speaks, *above* at 528.

(n46)Footnote 46. *See, e.g., In re Monetta Financial Services, Inc., Adv. Act Rel. No. 2136, 2003 SEC LEXIS 1377* (June 9, 2003) .

(n47)Footnote 47. Richards Testimony, *above* at 13 (*citing 18 U.S.C.S. § 1001*).

(n48)Footnote 48. SEC Speaks, *above* at 529.

(n49)Footnote 49. According to the SEC Staff, "[e]xaminers frequently request the attendance of registrant personnel with personal knowledge about or responsibility for the entity's operations, such as the Compliance Director, or General Counsel." SEC Speaks at 529.

(n50)Footnote 50. SEC Speaks, *above* at 537.

(n51)Footnote 51. SEC Speaks, *above* at 537.

(n52)Footnote 52. SEC Speaks, *above* at 535.

(n53)Footnote 53. SEC Speaks, *above* at 535.



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CHAPTER 29 SPECIAL ISSUES OF INVESTMENT ADVISERS AND INVESTMENT COMPANIES

2-29 Securities Enforcement: Counseling and Defense § 29.03

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§ 29.03 Investment Adviser and Investment Company Enforcement Matters

[1] Introduction

The SEC is committed to vigorously enforcing the securities laws and regulations applicable to investment advisers and investment companies. Recent headlines reflect the SEC's significant enforcement focus on the role of investment advisers in the market timing and late trading scandal involving mutual funds. However, the SEC's enforcement of other aspects of investment adviser and investment company regulation continues unabated. With the additional resources that the SEC has received and the imposition of new regulatory requirements, n1 the SEC's enforcement in this area is likely to grow significantly in the coming years.

Today, the regulatory pendulum has clearly swung towards more aggressive enforcement, particularly for investment advisers to mutual funds. Therefore, it is imperative for investment advisers and investment companies to take or continue to take proactive steps such as carefully reviewing their compliance programs with the assistance of knowledgeable counsel, to ensure compliance with the Investment Acts.

[2] Enforcement Authority

[a] Federal Court Actions

Both the Investment Advisers Act and the Investment Company Act authorize the SEC to bring an action in federal court to enforce compliance with the applicable provisions thereof against any person who has engaged or is about to engage in any act or practice in violation of the Investment Acts or any rule, regulation or order thereunder, and to enjoin any such act or practice. n2 The Investment Advisers Act, but not the Investment Company Act, also expressly authorizes the SEC to proceed against a person who "is engaged" in a violation of the Investment Advisers Act. Both Investment Acts empower the SEC to investigate the facts and circumstances of any violation of any provision of the Act or any rule or regulation thereunder, n3 and, in the case of refusal to obey a subpoena issued to any person, to seek the aid of the federal courts in requiring attendance and testimony of witnesses and the production of books, correspondence, and other records. n4 Both Investment Acts authorize the SEC to bring an action in federal district court to seek, upon a proper showing, a civil monetary penalty against the person who commits a violation of the Investment Acts, the regulations thereunder, or a cease-and-desist order issued by the SEC pursuant to the Investment

Acts. n5

[b] Administrative Proceedings

[i] Under the Investment Advisers Act

Apart from enabling the SEC to seek relief in federal court, the Investment Advisers Act commands the SEC to "censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any investment adviser" if it finds, after notice and opportunity for hearing, (a) that such enforcement action is in the public interest, and (b) that such investment adviser, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associated, has engaged in certain unlawful acts or omissions, or is the subject of certain types of convictions, injunctions, orders, or associational bars. n6 The types of unlawful acts or omissions that might serve as a basis for a censure, limitation, or suspension include, for example:

- willfully making false or misleading statements in filings with the SEC; n7
- willfully violating any provision of the Securities Act, the Exchange Act, the Investment Company Act, the Investment Advisers Act, the Commodity Exchange Act, the rules and regulations thereunder, or any rule of the Municipal Securities Rulemaking Board ("MSRB"), or in ability to comply with the foregoing; n8
- willfully aiding, abetting, counseling, commanding, inducing, or procuring a violation by any other person of any provision of the foregoing laws and regulations; n9 or
- failing reasonably to supervise, with a view to preventing violations of the provisions of the foregoing laws and regulations, another person who commits such violation if such person is subject to his supervision. n10

The types of convictions that might serve as a basis for a censure, limitation, or suspension include, for example:

- a felony conviction within ten years preceding the filing of a registration application or at any time thereafter that are punishable by imprisonment for one or more years (or a substantially equivalent criminal conviction by a foreign court), n11
- a felony or misdemeanor conviction (or a substantially equivalent criminal conviction by a foreign court):
 - (A) that involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, or any substantially equivalent activity under foreign law, or conspiracy to commit any such offense;
 - (B) that arises out of the conduct of business as a broker-dealer, investment adviser, insurance company, fiduciary transfer agent, and other specified capacities, including foreign persons performing a substantially equivalent function;
 - (C) that involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; or substantially equivalent activity under foreign law; or
 - (D) that involves a violation of a violation of certain enumerated federal laws or substantially equivalent

foreign statutes. n12

The types of injunctions, orders, or associational bars that might serve as a basis for a censure, limitation, or suspension include, for example:

- any order by any U.S. or foreign "court of competent jurisdiction" permanently or temporarily enjoining a person:
 - ▶ from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, transfer agent, or other enumerated person, including an affiliated person or employee of any investment company, bank, insurance company, or foreign entity substantially equivalent to the foregoing, or
 - ▶ from engaging in or continuing any conduct or practice in connection with any such activity, or
 - ▶ in connection with the purchase or sale of any security. n13
- an SEC order barring or suspending the right of the person to be associated with an investment adviser; n14 or
- an order from a state securities, banking, or insurance authority, or the National Credit Union Administration, that bars such person from association with an entity regulated by such authority or that bars such person from engaging in the business of securities, banking, insurance or savings association or credit union activities or that constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct. n15

The Investment Advisers Act also commands the SEC to "censure or place limitations on the activities of any person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated with an investment adviser, or suspend for a period not exceeding twelve months or bar any such person from being associated with an investment adviser," if it finds (a) that such remedial steps are in the public interest and (b) that such person has engaged in any of the acts or omissions, or the subject of a conviction or injunction, enumerated in Section 203(e). n16

As with federal court actions, the Investment Advisers Act authorizes the SEC to impose a civil money penalty in any administrative proceeding instituted pursuant to Sections 203(e) or (f) of the Investment Advisers Act against any person if it finds (a) that such penalty is in the public interest and (b) that such person has:

- (A) has willfully violated any provision of the Securities Act, the Exchange Act, the Investment Company Act, the Advisers Act, or the rules or regulations thereunder;
- (B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;
- (C) has willfully made false or misleading statements in filings with the SEC; or
- (D) has failed reasonably to supervise, within the meaning of Section 203 (e)(6) of the Advisers Act, with a view to preventing violations of the provisions of this subchapter and the rules and regulations thereunder, another person who commits such a violation, if such other person is subject to his

supervision. n17

Finally, Section 203(k) of the Investment Advisers Act authorizes the SEC to issue a cease-and-desist order against any person who is violating, has violated, or is about to violate any provision of the Investment Advisers Act or rules thereunder. n18

[ii] Under the Investment Company Act

The Investment Company Act grants the SEC similar authority to bring administrative proceedings to enforce the Act. Specifically, Section 9(b) of the Investment Company Act provides that the SEC may, after notice and an opportunity for hearing, issue an administrative order prohibiting either conditionally or unconditionally, and either permanently or temporarily for such period of time as it deems appropriate in the public interest, any person from serving or acting as a director, officer, employee, advisory board member, investment adviser, or depositor or, or principal underwriter for, any investment company or any affiliated person of such investment adviser, depositor, or principal underwriter, if such person:

- (1) has willfully made or caused to be made false or misleading statements in any registration statement, application or report filed with the SEC under the Investment Company Act;
- (2) has willfully violated any provision of the Securities Act, the Exchange Act, the Investment Company Act, the Advisers Act, the Commodity Exchange Act, n19 or of any rule or regulation under any of such statutes;
- (3) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the foregoing;
- (4) has been found by a foreign financial regulatory authority to have (A) made or caused false or misleading statements to be filed with a foreign securities authority; (B) violated any foreign statute or regulation regarding securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade; or (C) aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the foregoing;
- (5) within 10 years has been convicted by a foreign court of competent jurisdiction of a crime that is substantially equivalent to an offense set forth in Section 9(a)(1) of the Act; or
- (6) by reason of any misconduct, is temporarily or permanently enjoined by any foreign court of competent jurisdiction from acting in any of the capacities set forth in Section 9(a)(2) of the Act or a substantially equivalent foreign capacity, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security. n20

Like the Investment Advisers Act, the Investment Company Act authorizes the SEC to order civil money penalties against any person if it finds, after notice and opportunity for hearing, (a) that such penalty is in the public interest and (b) that such person has:

- (A) willfully violated the Securities Act, the Exchange Act, the Investment Company Act, the Investment Advisers Act, or the rules or regulations thereunder;
- (B) willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person; or
- (C) willfully made or caused to be made a false or misleading statement in any registration statement, application, or report required to be filed with the SEC under the Investment Company Act.

In addition, like the Investment Advisers Act, the Investment Company Act authorizes the SEC to issue a cease-and-desist order against any person who is violating, has violated, or is about to violate any provision of the Act or rules thereunder. n21

[3] Persons Potentially Subject to Enforcement

[a] Definition of "Person"

Both Investment Acts define "person" to mean a natural person or a company. n22 Thus, when enforcing compliance with the Investment Advisers Act, the SEC may proceed not only against an investment advisory firm or investment company, but also against an individual, n23 such as a director, officer, partner, or employee, who may be a "person associated with an investment adviser" n24 or an "affiliated person" of an investment company. n25 A review of the historical enforcement of the Investment Acts reveals that the SEC will frequently proceed against an advisory firm in its capacity as such, but rarely against an investment company such as a mutual fund. This result no doubt follows from the fact that the assets of a mutual fund belong to their shareholders, such that an action against a fund generally would serve to penalize the fund's shareholders, who ultimately may be the victims of the misconduct giving rise to the action.

[b] Control Persons and Affiliates

Unlike the Securities Act and Exchange Act, neither the Investment Advisers Act nor the Investment Company Act contains a provision expressly specifying liability for control persons. n26 However, both Investment Acts prohibit persons from doing indirectly what they are not permitted to do directly. n27 Thus, under either Investment Act could a person avoid liability by doing through a controlled entity what that person could not do directly.

In addition, the SEC has stated that an "associated person may be charged as a primary violator under Section 206 [of the Investment Advisers Act] where the activities of the associated person cause him or her to meet the broad definition of 'investment adviser.'" n28 Thus, the SEC has found an associated person liable as an investment adviser where he controlled the investment adviser and was himself an investment adviser. n29 The SEC also has proceeded against majority owners, principals, and others in a position to control or influence the adviser as aiders and abettors. n30

Moreover, many provisions of the Investment Company Act apply directly to control persons of investment companies by reason of the Act's provisions applicable to "affiliated persons," which the Act defines to include, among others, "any person directly or indirectly controlling, controlled by, or under common control with" the investment company. n31 These same provisions also apply to investment company affiliated persons who directly or indirectly own, control, or hold five percent or more of the outstanding voting securities of an investment company. n32

[c] Independent Contractors

Neither the Investment Advisers Act nor the Investment Company Act refers to "independent contractor." Accordingly, a person's status as an "independent contractor" for contractual or other purposes can be expected to have little or no effect on the person's status or responsibilities under either Act, which depend on the functions performed by that person, not their employment status. Mutual fund advisers, for example, often include clauses in their advisory agreements with the funds which state that provide that they are "independent contractors." However, because of the significant role investment advisers typically perform in managing the day-to-day operations of their fund clients, their status as an independent contractors has not prevented the SEC from proceeding against them for violations of the Investment Acts.

[d] Compliance Personnel

It goes almost without saying that when the SEC identifies a breakdown in compliance, it will frequently proceed

against the individuals it believes were responsible for ensuring compliance. n33 It is important to note, in this regard, that upper management cannot avoid liability under the Investment Acts merely by delegating compliance responsibilities to an individual within the organization. The SEC, as noted earlier, frequently examines the "tone at the top" to determine whether an investment adviser has a strong compliance culture. Likewise, the SEC has repeatedly emphasized the important role of mutual fund directors, particularly disinterested directors, under the Investment Company Act. n34 Therefore, directors and officers of investment advisers and investment companies must take care, in exercising their authority and fulfilling the obligations of their positions, to be sensitive and responsive to the need to ensure their organizations' compliance with applicable provisions of the Investment Acts.

In addition, compliance persons at investment advisers and investment companies should take note that as a result of the SEC's new compliance program requirements, the failure to maintain adequate compliance policies and procedures would itself constitute a violation under either Act, even where no investor has been harmed or where there has been no violation of one of the substantive provisions of the Investment Acts.

[e] Unregistered Persons

The SEC has construed the remedial provisions of the Investment Advisers Act to apply to, and therefore be enforceable against, any person acting as an investment adviser, whether or not registered with the SEC. n35 The SEC has proceeded not only against persons for failing to register as investment advisers, n36 but also against persons who, while not required to be registered as such, nevertheless violated the anti-fraud or other applicable provisions of the Investment Advisers Act. n37 The SEC also has scrutinized arrangements between registered investment advisers and their unregistered affiliates to determine whether personnel of an unregistered entity may be indirectly providing investment advisory services, thereby doing indirectly what it could not do without registration if it engaged in such activities directly. n38 In addition, the SEC has proceeded against persons who, while not registered with the SEC under the Investment Advisers Act, were nevertheless registered with one or more states. n39

The SEC has proceeded against investment companies for failing to register under the Investment Company Act. n40 An operating company can sometimes find itself inadvertently running afoul of the Act by failing to monitor its portfolio securities holdings. A hedge fund can lose its ability to rely on an exclusion from registration under the Act by failing to monitor the number or type of investors participating in the funds. A structured financing entity can run afoul of the Investment Company Act because of poor planning or by failing to monitor its activities. Because of the severity of the consequences of failing to register as an investment company, consulting with knowledgeable counsel regarding these matters can be critical to avoiding an SEC enforcement action. In addition, the Investment Company Act is very complicated, and not all areas of the Act have commonly agreed upon interpretations. In some areas, such as those pertaining to face-amount certificate companies, the SEC and its Staff have issued very little in the way of interpretations. Thus, when confronted with the prospect of responding to an SEC investigation or defending an SEC enforcement action in this area, it would be wise to consult with knowledgeable counsel to determine, for example, whether an overlooked exclusion from the Act might apply, or whether the SEC Staff's position would withstand SEC or judicial scrutiny.

[f] Foreign Persons

The SEC, with specific exceptions, has interpreted the Investment Advisers Act to apply to any non-U.S. investment adviser that uses jurisdictional means to offer investment advisory services to U.S. persons. n41 In addition, the SEC interprets the Investment Company Act to prohibit foreign investment companies from publicly offering their securities in the United States or to U.S. persons unless the SEC issues an exemptive order permitting the company to register under the Investment Company Act. n42 Accordingly, foreign advisers and investment companies should consult with competent counsel to discuss their potential compliance obligations under the Investment Acts when considering working with U.S. investors. In addition, U.S. advisers should not make the mistake of assuming that putting their U.S. clients in unregistered offshore investment companies will provide any measure of relief from the need to comply with

the Investment Acts. n43

[4] Cornerstones of Enforcement

Fraud, breaches of fiduciary duty, conflicts of interest, and conduct giving rise to secondary liability provide the cornerstones of many SEC enforcement actions under the Investment Acts.

[a] Fraud

Both Investment Acts contain provisions prohibiting fraudulent conduct. For example, Section 206 of the Investment Advisers Act makes it unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly:

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative. n44

In addition, the SEC has adopted rules pursuant to Section 206(4) that address a number of investment adviser activities and responsibilities, including: (1) advertisements, n45 (2) custody or possession of client funds and securities, n46 (3) cash payment for client solicitations, n47 (4) disclosure of financial and disciplinary information, n48 (5) proxy voting, n49 and (6) compliance programs. n50

The Investment Company Act also contains several provisions designed to prevent fraudulent conduct. Section 34(b) of the Investment Company Act makes it unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, record, or other document filed or transmitted pursuant to the Investment Company Act or the keeping of which is required by the Investment Company Act. n51 The Section also prohibits the omission of statements necessary to prevent the statements made materially misleading. The SEC has adopted Rule 34b-1 under the Investment Company Act, which deems advertising and sales literature to be materially misleading unless it contains certain information specified in the Rule. n52 Section 35(a) of the Investment Company Act makes it unlawful for any person issuing or selling any registered investment company security to represent or imply that the security or company is (a) guaranteed, sponsored, recommended, or approved by the U.S. government, or any agency, instrumentality or officer of the U.S.; (b) has been insured by the Federal Deposit Insurance Corporation, or (c) is guaranteed by or is otherwise an obligation of any bank or insured depository institution. n53

Section 35(d) of the Investment Company Act makes it unlawful for any registered investment company to use as part of its name or the name of any of its securities any word or words that the SEC finds "materially deceptive or misleading." n54 The SEC has adopted Investment Company Act Rule 35d-1, which treats as materially deceptive or

misleading for purposes of Section 35(d) investment company names that suggest a guarantee or approval by the U.S. government. n55 The Rule similarly treats as materially deceptive or misleading names suggesting investment in certain investments or industries, names suggesting investment in certain countries or geographic regions, or names suggesting that distributions from a mutual fund are tax exempt, unless certain conditions are complied with in each case.

[b] Breach of Fiduciary Duty

Although the Investment Advisers Act does not expressly impose a fiduciary duty on investment advisers, the Supreme Court has interpreted the anti-fraud provisions of Section 206 of the Act to impose a fiduciary duty on investment advisers. n56 This fiduciary duty imposes upon investment advisers an affirmative obligation of utmost good faith, and full and fair disclosure of all material facts to an investment adviser's clients. n57 As fiduciaries, investment advisers must act with care for the benefit of their clients, and have a duty to put their clients' interests above their own. Allegations of breaches of this fiduciary duty are a common theme in SEC enforcement action against investment advisers. n58

The Investment Company Act expressly authorizes the SEC to bring an action in federal court against directors, officers, and advisory board members of an investment company and its investment advisers and principal underwriters if they engage or are about to engage in conduct that constitutes a breach of fiduciary duty involving personal misconduct. n59 Section 36(b) of the Act provides that an investment adviser of a registered investment company "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser." n60 Allegations of breaches of fiduciary duty under the Investment Company Act are a common theme of SEC enforcement actions relating to investment companies. n61

[c] Conflicts of Interest

Both the Investment Advisers Act and the Investment Company Act contain several provisions that are aimed at addressing many of the potential conflicts of interest that can arise in the course of an investment adviser's or investment company's business. The Investment Advisers Act, for example, generally makes it unlawful for an investment adviser to enter into a contract under which it can receive compensation based on the capital gains or appreciation of a client's account. n62 This prohibition prevents an adviser from taking undue risks with a client's money in furtherance of its own interests. The Investment Company Act, for example, generally prohibits certain affiliated persons of an investment company, and in some cases affiliated persons of such persons, from buying or selling property or securities from or to an investment company, or borrowing money from or lending money to an investment company. n63

The SEC, in its administration of the Investment Acts, has promulgated regulations in an effort to police these conflicts as well as facilitate their avoidance. Under the Investment Advisers Act, for example, the SEC has adopted a rule designed to address the conflicting loyalties and interests that an adviser may face when, as a registered broker-dealer, it executes agency cross transactions. n64 Under the Investment Company Act, for example, the SEC has adopted a rule that prohibits certain "joint transactions" between an investment company and certain affiliated persons, except as permitted by the rule. n65

The SEC, in enforcing these laws and regulations, has brought many proceedings against investment advisers, including mutual fund advisers, for failing to disclose or manage conflicts of interest. n66 In addition, in what may portend the direction of future enforcement actions, the SEC has recently emphasized that the Investment Company Act "relies heavily on fund boards of directors to manage conflicts of interest that the fund adviser inevitably has with the fund." n67 Similarly, the SEC has begun to use the phrase "unmanageable conflicts" in describing areas that may prove to be a source of future enforcement inquiry and action. For example, in proposing a ban on directed brokerage, it has stated

that it believes "that the way brokerage has been used to pay for distribution involves *unmanageable conflicts* of interest that may harm funds and fund shareholders." n68 The SEC also has adopted a new code of ethics requirement for investment advisers that will require them to adopt procedures that are intended to address potential conflicts of interest that may arise from the personal securities trading activities of its employees. n69 This new code of ethics requirement will undoubtedly serve as the basis for future enforcement inquiry and possibly action.

[d] Secondary Liability

Apart from proceeding against wrongdoers for primary violations of the Investment Acts, the SEC routinely seeks to impose secondary liability on individuals on the theory that they either aided and abetted or caused a violation of an investment advisory firm or investment company firm.

[i] Aiding and Abetting

To establish aiding and abetting liability under the Investment Acts, the SEC must establish three elements: first, that another party committed a primary or independent violation; second, that the aider and abettor was aware or knew that his or her role was part of an overall activity that was improper (also conceptualized as scienter in aiding and abetting antifraud violations); and three, that the aider and abettor knowingly and substantially assisted the conduct that constitutes the violation. n70 Generally, a person cannot escape aiding and abetting liability by claiming he was ignorant of the securities laws, n71 and the knowledge or awareness requirement can be satisfied by recklessness, which one court has described as "tantamount" to intent. n72 The SEC has taken the position that the substantial assistance requirement can be satisfied where a person's actions are a "proximate" or "substantial causal factor" in bringing about the primary violation. n73 The SEC also has taken the position that it need not show that the assistance rendered by the aider and abettor was "the sole cause or the principal cause; it need only be one of the causes." n74

To its credit, the SEC does not always accept the assertions of its Enforcement Staff on matters relating to aiding and abetting. For example, in one recent case, the SEC, upon *de novo* review, decided to dismiss all charges against a broker who, according to the Enforcement Staff, allegedly aided and abetted violations of the Investment Advisers Act in connection with an investment adviser's failure to disclose certain directed brokerage arrangements pursuant to which commissions generated from client transactions were used to compensate brokers for client referrals. n75

[ii] Causing Liability

The Investment Acts both empower the SEC to initiate cease-and-desist proceedings against persons who is, was, or would be a "cause" of a violation of any provision thereof. n76 In addition, the Investment Company Act authorizes the SEC to institute administrative proceedings and to impose civil money penalties against a person who willfully caused a materially false or misleading statement to be made in any registration, report, or other filing with the SEC or who omitted to include a material fact in such registration, report, or filing. n77 The Investment Company Act also prohibits a person from causing exchange offers to be made in violation of Section 11(a) thereof. n78 More generally, Section 48(a) of the Investment Company Act makes it "unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of this title or any rule, regulation, or order thereunder." n79

The SEC has taken the position that a finding that a person willfully aided and abetted violations of the securities laws necessarily makes that person a "cause" of those violations. n80

[5] Areas of Enforcement Focus

[a] Market Timing, Late Trading, and/or Selective Disclosure

Since the fall of 2003 the SEC has concentrated enormous resources on investigating and proceeding against individuals

and firms allegedly involved in "abusive market timing," "late trading" of mutual fund shares, and, in some case, selective disclosure of mutual fund portfolio holdings ("selective disclosure"). To date, the SEC's enforcement efforts have focused primarily on (1) hedge fund advisers that allegedly engaged in market timing and late trading, (2) broker-dealers that allegedly facilitated market timing and late trading transactions, (3) mutual fund advisers that allegedly entered into special market timing, late trading, and selective disclosure arrangements, and (4) various individuals associated with such hedge fund advisers, broker-dealers, and mutual fund advisers. In at least one recent case, alleged market timers and late traders have been criminally indicted. n81 In no case, however, has the SEC instituted proceedings against a mutual fund itself, or the board of directors of any fund, though it has proceeded against individual members of fund boards.

Over this same time period, the SEC has promulgated a blizzard of significant regulatory reforms designed to address concerns over the ever-widening market timing and late trading scandal and the public outcry over perceived lapses in regulation of the mutual fund industry. The SEC already has adopted reforms that will require, among other things, a greater number of independent directors on mutual fund boards, n82 greater disclosure of mutual fund policies on market timing and selective disclosure, n83 requiring the registration of hedge fund advisers, n84 and the adoption of a new code of ethics by investment advisers. n85 The SEC also has proposed reforms such as requiring mutual funds to abide by a "hard 4 p.m." deadline on receipt of orders, n86 and requiring the imposition of a mandatory redemption fee on short-term trades of mutual fund shares. n87 Many of these regulatory changes are only peripherally related, if at all, to the underlying cause of the "market timing" scandal; a mismatch between the quality of information available, the flexibility and the speed of the modern mutual fund marketplace and the once-a-day forward-pricing system put in place by the Investment Company Act of 1940. As a brief review of the nature and history of "market timing" regulation will show, the SEC is no closer now than it was in September, 2003 when the scandal broke to providing useful guidance as to what constitutes "inappropriate" frequent trading in mutual fund shares, or how to stop it. As always, the well-advised fund drafting prospectus disclosure on its efforts to discourage market timing will avoid promising too much.

[i] Nature of Market Timing

The "market timing" strategy relies upon predictable correlations between price movements in different asset classes, and seeks to take advantage of the difference between such predictable movements and a mutual funds' "once a day" NAV pricing. Much of the attention paid to market timing has focused on the predictable correlations between U.S. markets and subsequent price movements in international markets, and the opportunities for successful "time zone arbitrage" in international funds that result. n88 Such correlations exist, however, in many other asset classes, although not as well publicized. n89 As is perhaps demonstrated by the widespread opportunities for mutual fund arbitrage based on stale pricing for different asset classes, n90 the problem of arbitrage is to some extent endemic to the pricing scheme for open-end mutual funds. In a normal market, arbitrage is the cure for mispricing -- as traders leap to take advantage of the gap between the stale price and the "true" price (based on information currently available) the price would quickly rise, or fall, to the "true" price level. This cannot happen in the case of open-end mutual funds, because the price is fixed for that 24-hour period.

[ii] Historical Regulatory Treatment of Market Timing

Fund managers became concerned about the costs and risks of market timing to long-term shareholders as early as the 1980s. n91 Efforts to limit or stop trading by market timers were frequently met with lawsuits by the market-timing investors, alleging breach of contract and business torts. n92 As the disruption caused by market timing increased with the advance of technology that allowed instantaneous trading, some funds continued to seek to limit arbitrage opportunities, always at the risk of outcry from market-timing investors. This conflict was illustrated most starkly by the "Asian markets crisis" in October, 1997. When the U.S. markets rallied strongly after an earlier fourteen-percent decline in the Hong Kong market index on October 28, 1997, would-be arbitrageurs piled into international funds holding Hong Kong securities. Some funds, including Fidelity and T. Rowe Price, chose to invoke "fair value" pricing, and take the more recent U.S. market rally into account in pricing their securities. n93

Market timers complained to the SEC that they had been blindsided by this application of "fair value" pricing, and the SEC duly undertook an inquiry into whether fair value pricing had been appropriately applied. n94 The review showed that use of fair value pricing was well-disclosed in the funds' prospectuses, but that there was a lack of uniformity about use of fair value procedures even within the same complex. The review also found that a "striking" number of investors attempted to take advantage of the opportunity for time-zone arbitrage on October 28 and 29, 1997. n95 A "broader and more comprehensive analysis of fund pricing issues" promised in 1997 resulted in the publication of guidance letters from the Chief Counsel of the SEC's Division of Investment Management in 1999 and 2001. n96 The April, 2001 "fair value guidance" letter pointed out the risks of market timing for long-term shareholders in some detail, but provided little in the way of useful guidance to firms that might be inclined to try to discourage it.

There the matter rested, until September, 2003, when the Attorney General of the State of New York began filing fraud cases against some of the largest fund advisers in America for, among other things, violations of their prospectus disclosure regarding market timing and frequent trading. The SEC scrambled to follow suit.

[iii] Recent Cases

Within the past year, the SEC has brought well over a dozen administrative proceedings and cases involving market timing, late trading, and/or selective disclosure (collectively, "cases"). n97 Several of these cases have been settled with the defendants neither admitting nor denying any wrongdoing. Given the costs, uncertainty, and potentially negative public relations consequences of a protracted trial, it is not surprising that companies would elect to settle their cases with the SEC. However, one can reasonably expect that some of these cases will proceed to trial. To date, there has been no judicial decision on the merits of any of these cases.

The cases against investment advisers typically involve allegations by the SEC that the advisers, in violation of their fiduciary duties:

- provided "timing capacity" to market timers in violation of the policies and procedures and/or prospectus disclosure of one or more mutual funds they managed; n98
- entered into non-disclosed "sticky asset" arrangements with the market timers, whereby the advisers would permit market timing activity in exchange for the timers' placement of "sticky assets" with other hedge funds, mutual funds, or other investments managed by the adviser; n99 and/or
- selectively disclosed non-public information about a fund's portfolio holdings to market timers. n100

In some cases, portfolio managers were allegedly timing, for their own personal accounts, the mutual fund portfolios they managed. n101 Based on these findings, the SEC has obtained settlements imposing staggering civil monetary penalties. n102 The SEC also has required significant changes in mutual fund governance in some of these settlements. n103

The cases against broker-dealers typically involve allegations by the SEC that they deceived mutual funds and their shareholders by improperly helping clients to engage in market timing and late trading of mutual funds. For example, in *Mutuals.com*, the SEC alleged that the three individuals serving as CEO, president, and compliance officer for a registered broker-dealer and investment adviser engaged in a variety of schemes to thwart efforts by hundreds of mutual funds as well as two clearing firms to prevent them from engaging in market timing activities. According to the SEC, these schemes included:

- (1) forming and registering two affiliated broker-dealers through which they could engage in market

timing undetected;

- (2) changing account numbers for blocked customer accounts;
- (3) using alternative registered representative numbers for registered representatives who were blocked from trading by mutual funds;
- (4) using different branch identification numbers;
- (5) switching clearing firms; and
- (6) suggesting that their customers use third party tax identification numbers or social security numbers to disguise their identities, so that they could continue to trade in funds from which they had been banned. n104

The SEC also alleged that the broker-dealer permitted trades to be executed after 4 p.m. Eastern Standard Time ("EST") as if they had been received prior to that time, thereby enabling traders to profit from market events that occur after 4 p.m. EST but that are not reflected in that day's price. According to the SEC, Mutuals.com and its affiliates tried to conceal this late trading activity by omitting portions of the trading information they were required to provide to clearing agents. As a result of these activities, the SEC alleged that Mutuals.com and its affiliates violated Section 17(a) of the Securities Act, and violated and aided and abetted their clients' violations of Section 10(b) of the Exchange Act and *Rule 10b-5* thereunder. In addition, the SEC alleged that Mutuals.com and its affiliated broker-dealers violated Section 15(c)(1) of the Exchange Act, which violations its CEO, president, and compliance officer aided and abetted, as well as violated Rule 22c-1 of the Investment Company Act, which prohibits the purchase or sale of mutual fund shares except at the current net asset value ("NAV") for such shares next computed after receipt of a purchase or sale order.

In *Security Trust*, the SEC alleged that Security Trust Company ("STC"), a national banking association, and certain principals facilitated late trading by hedge funds ("Canary hedge funds") in nearly 400 mutual funds and concealed such market timing activity through the following means:

- *"Shotgun" method* -- STC employees opened accounts for the Canary hedge funds with numerous mutual funds to be traded through STC. The hedge funds then effected trades through these accounts to determine which funds would not detect or actively police timing.
- *"Omnibus" method* -- STC opened five omnibus accounts for the Canary hedge funds at STC through which the hedge funds' trades were rotated in an attempt to evade detection by the mutual funds.
- *"Taxpayer ID" method* -- STC opened mirror accounts for the five omnibus accounts using STC's taxpayer identification number. This approach sought to impede efforts by mutual fund companies to detect market timers by their tax ID numbers.
- *"Piggybacking" method* -- Devised by Seeger and implemented by McDermott, this method involved STC setting up a sub-account within the account of one of STC's TPA clients and attaching the Canary hedge funds' mutual fund trades to the trades of this client without its knowledge. The mutual funds that the hedge funds traded through piggybacking had previously rejected the hedge funds for market timing, and the hedge funds hoped they could continue to trade these funds under the name of another STC client. n105

In *Calugar*, the SEC also alleged that a registered broker-dealer and its president engaged in an extensive "sticky asset" arrangement with Alliance, pursuant to which he would make long-term investments in Alliance's hedge funds in exchange for Alliance permitting him to engage in market timing in its mutual funds.

The SEC has defined "market timing" as "short-term trading in mutual funds in order to exploit inefficiencies in mutual fund pricing," n106 and is quick to point out that market timing is not illegal *per se*. n107 However, in its complaints, the SEC typically recites the potential harm to long-term investors that can result from market timing. This potential harm includes (a) dilution of the value of mutual fund shares to the extent that a timer is permitted to buy, sell, or exchange shares rapidly and repeatedly to take advantage of arbitrage opportunities, and (b) an increase in transaction costs for mutual funds, such as taxes and trading costs, as the result of requiring the sale of securities to meet substantial redemptions at inopportune times. This potential harm, however, arguably would occur any time a shareholder makes a substantial redemption, which may help explain why the SEC has never stated exactly what amount of market timing would constitute an "excessive" or "abusive" practice. n108

[b] Sales of Mutual Fund Shares

[i] Breakpoint Cases

In February 2004, the SEC settled cases against seven brokerage firms ("firms") that allegedly failed to provide customers with reductions in front-end sales loads ("breakpoints") for eligible mutual fund transactions (the "breakpoint cases"). n109 The breakpoint cases resulted from an examination sweep that the SEC, NASD, and New York Stock Exchange ("NYSE") conducted in late 2002 and early 2003, to determine whether investors were receiving the benefit of available breakpoint discounts. n110 The examination sweep was prompted by concerns raised during prior routine NASD examinations. n111

The SEC's analytical point of departure in the breakpoint cases was that broker-dealers are responsible for: (a) disclosing breakpoint discount information to their customers, and (b) having procedures that are reasonably designed to ascertain information necessary to determine the availability and level of breakpoints. The failure to do so, according to the SEC, could deprive the customer of a benefit to which he or she is entitled, and could result in the broker-dealer and representative receiving increased commissions at the customer's expense. Although the SEC generally acknowledged the difficulty that many broker-dealers faced due to the many different breakpoint discounts offered and eligibility criteria imposed by mutual funds, the SEC nevertheless was of the view that the firms violated Section 17(a)(2) of the Securities Act n112 by failing to disclose to their customers that the prices they paid for their mutual fund shares did not reflect the breakpoint discounts to which they were entitled under the terms described in the prospectuses and statements of additional information of the relevant mutual funds. The SEC also was of the view that the firms violated Rule 10b-10 under the Exchange Act n113 because the confirmations sent to customers for mutual fund shares purchase did not disclose the remuneration received from front-end sales loads, and, where the firm failed to apply the applicable breakpoint discount, the prospectus disclosures concerning the availability of breakpoint discounts were insufficient, by themselves, to fully inform customers what they were paying for their shares. n114

In settling the breakpoint cases, the firms agreed, without admitting or denying the SEC's findings (other than as to jurisdiction and subject matter), to pay civil monetary penalties ranging from \$1.8 million to \$4.8 million, plus disgorgement and prejudgment interest to provide customer refunds, and to implement procedures to prevent and detect problems with breakpoint discounts.

From an historical perspective, it is worth noting that there is nothing new about the failure of broker-dealers to ensure that their customers receive breakpoint discounts. For example, in 1969, the SEC sanctioned Paine Webber for violations of Section 10(b) of the Exchange Act and *Rule 10b-5* thereunder in connection with various mutual fund transactions in certain of its offices and the failure to supervise such transactions, including mutual fund share purchases that were "close to" but nevertheless under an applicable breakpoint. n115 In imposing a five day suspension on the firm, and up to 30 day associational bars on certain representatives, the SEC noted that "[i]n selling the mutual fund shares in amounts close to but less than break points, and to customers known to have available for investment total amounts which exceeded the break points, it was incumbent on the salesmen to disclose to the customers prior to the

transactions the savings in sales charges obtainable through increasing the amount of the purchase or executing a letter of intent. In a situation such as this, a salesman has a responsibility, particularly where he makes a recommendation, to be sure the customer has had adequate opportunity to study and understand the alternatives." n116

[ii] B Share Cases

Over the past year, the SEC has proceeded against several broker-dealers and registered representatives for selling class B mutual fund shares ("B shares") to customers who may have been better off purchasing class A mutual fund shares ("A shares"). n117 The B share cases are analogous to the breakpoint cases, because the harm to the investor arises out of largely the same conduct, namely, the failure to inform an investor about, and ensure that he or she takes advantage of, a less expensive way to participate in a mutual fund.

Although A shares, unlike B shares, have front-end sales loads, B shares have higher asset-based charges (attributable to a higher Rule 12b-1 fee) as well as a significant back-end or contingent deferred sales charge. These higher asset-based charges, over time, can make B shares more expensive to own than A shares. In addition, there may be little or no advantage to owning B shares if the amount of A shares that could be purchased would entitle the investor to a breakpoint discount or possibly the elimination of the front-end sales load (as is often the case with large purchases, e.g., \$1 million or more). Notwithstanding the possible disadvantages of B shares, to the extent the compensation paid on a large purchase of B shares may be greater than that for A shares of the same amount, there can be a strong financial incentive to promote B shares over A shares.

In the B share cases, the SEC alleged that broker-dealers and/or registered representatives violated the law by:

- putting their own interests before those of their customers;
- failing to disclose (or concealing the fact) that an equivalent purchase of A shares in the same mutual fund could yield a higher return as a result of the availability of breakpoint discounts and reduced ongoing costs;
- failing to disclose the relative amount of commissions that the broker-dealer would receive for selling A versus B shares;
- failing to discuss with their customers the specific impact that a breakpoint discount and ongoing purchases could make;
- failing to compare the relative merits of A and B shares before recommending the purchase of B shares;
- failing to comply with or enforce applicable policies and procedures relating to the sale of B shares over a certain dollar amount; and/or
- failing to reasonably supervise personnel to ensure adequate disclosures were made.

The penalties in the B share cases have included censures, civil monetary penalties, limited suspensions from association in a supervisory capacity with any broker or dealer, and compliance with undertakings designed to achieve compliance with the legal requirements applicable to sales of B shares. However, in one case, the SEC, upon *de novo* review, dismissed all charges against registered representatives who had been found by an administrative law judge to have improperly sold B shares. n118

[iii] Switching Cases

Over 40 years ago, the SEC expressed concern over the deceptive practice of "switching," in which a broker-dealer would cause a customer to redeem from one mutual fund and purchase the shares of another fund in order to generate a sales commission. n119 These transactions are viewed as "unsuitable" because they generally do not result in any economic benefit to the customer, and often result in the imposition of another front-end sales load. It is generally not difficult to establish that the motivation for a switch was the generation of a sales commission where there is a pattern of multiple or excessive switches, with little documentation showing any economic benefit or other justification to support the switches. The SEC has brought switching cases in nearly every decade since its Special Study in 1963. n120

An interesting variation on these cases involves the SEC's recent actions involving allegedly improper switches of variable annuities. Variable annuities are insurance products that provide annuity and death benefit guarantees, as well as accumulation and income benefits based on the performance of the mutual funds in which they invest. Variable annuities are a significant source of investment funds for mutual funds. Variable annuities have sales load structures similar to mutual fund shares and, like mutual funds, variable annuity issuers compete fiercely for customers. In 2002, the SEC sanctioned Raymond A. Parkins, the president of a broker-dealer and investment adviser, for recommending fraudulent switches of variable annuities to his clients. n121 According to the SEC, at least two dozen times during the three year period ended December 1996, Parkins recommended to at least eight clients that they "switch" or terminate their variable annuities and use the proceeds to purchase variable annuities issued by another life insurance company. According to the SEC, Parkins induced his clients to switch variable annuities by providing them with "unfounded, false, and misleading justifications for the switches and by misrepresenting or omitting to inform them of the sales charges associated with the switches. As a result of Parkins' fraudulent conduct, his clients incurred unnecessary back-end surrender charges of more than \$168,000, and, in some cases, lost a portion of their investment principal. Parkins, on the other hand, received commissions of more than \$ 210,000." n122 The SEC ordered Parkins to cease and desist from violating Section 21C of the Exchange Act and Section 203(k) of the Investment Advisers Act, and from committing or causing any violation and any future violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and *Rule 10b-5* thereunder, and Sections 204, 206(1), and 206(2) of the Investment Advisers Act and Rule 204-2(a)(7) thereunder. The SEC also barred Parkins from associating with any broker-dealer or investment adviser, with the right to reapply after two years. The SEC waived disgorgement of \$214,656 plus prejudgment interest due to Parkins' demonstrated financial inability to pay.

In another recent case, the SEC sanctioned Donna Morehead, the former principal of a registered broker-dealer, for failing to reasonably supervise a registered representative who switched customers between variable annuities through a series of transactions that, according to the SEC, had no economical value to the customer and that was for the purpose of generating commissions. n123 The representative, according to the SEC, made materially misleading statements and omissions to induce customers to make the switches, which resulted in significant surrender charges to the customers, and generated hundreds of thousands of dollars in commissions.

The SEC found that Morehead was aware that certain switches raised "red flags," including the imposition of surrender charges as a result of the switches, the brevity of time between the purchase and redemption of a variable annuity, and the fact that the representative was continuing to recommend to some customers a variable annuity that he was switching other customers out of. Morehead discussed the basis for the switch recommendations with the representative and accepted his explanations without seeking objective information about the switches to verify whether the explanations were true. However, Morehead did not review account statements or customer correspondence, and did not contact any of the representative's customers. The SEC concluded that Morehead's supervision was deficient and that had she obtained other objective information concerning the customers' accounts, the representative's false explanations would have been exposed. The SEC imposed a \$10,000 fine and an bar from serving in a supervisory capacity at a broker-dealer with the right to reapply after one year.

[c] Directed Brokerage and Soft Dollar Cases

"Directed brokerage" refers to the practice of compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker-dealer. "Soft dollars" refers to an arrangement whereby an investment adviser directs client transactions to a broker-dealer and, in exchange for the commissions generated by these transactions, receives research, brokerage, or other products or services. Both types of arrangements recently have been the subject of SEC enforcement scrutiny. n124

For example, in *MFS II*, the SEC instituted proceedings against an investment adviser ("MFS") for directing the brokerage business of mutual funds managed by MFS ("MFS funds") to approximately 100 broker-dealers for "shelf space" or heightened visibility within their distribution systems. Under these "Strategic Alliances," MFS would direct brokerage (and in effect, "allocate" brokerage commissions") to broker-dealers based upon individually negotiated formulas relating to gross fund sales and the retention of fund assets. According to the SEC, MFS would allocate brokerage commissions for Strategic Alliances under three methods: (1) by forwarding portfolio transactions directly to a broker-dealer with whom it had a Strategic Alliance ("distributing broker"); n125 (2) through "step-out" arrangements; n126 and (3) through "introducing broker" arrangements. n127 MFS used the latter two methods in its effort to achieve best execution in circumstances in which the distributing broker had little or no execution capacity.

According to the SEC, these Strategic Alliances presented MFS with a potential conflict of interest due to the fact that MFS was using the brokerage business of the MFS funds, rather than its own assets, to satisfy the obligations under these arrangements. As a fiduciary, MFS was required, but, according to the SEC, failed to fully disclose this potential conflict to the boards of trustees of the MFS funds. n128 The SEC also found that MFS failed to disclose adequately the Strategic Alliance arrangements in the mutual funds' statements of additional information ("SAIs") in accordance with the requirements of Form N-1A. Item 16(c) of Form N-1A calls for SAI disclosure of "how the Fund will select brokers to effect securities transactions for the Fund" and requires that "if the Fund will consider the receipt of products or services other than brokerage or research services in selecting brokers, [the Fund should] specify those products or services." Although the MFS funds' SAIs disclosed that MFS may consider sales of shares of the funds as a factor in the selection of broker-dealers to execute the MFS funds' portfolio transactions, the SAIs did not, according to the SEC, adequately disclose to shareholders that MFS had entered into arrangements in which it agreed to allocate specific negotiated amounts of fund brokerage commissions to broker-dealers in exchange for "shelf space" or heightened visibility on their distribution systems, i.e., an arrangement that went beyond mere "consideration" of fund distribution as a factor in allocating brokerage. On the basis of these findings, the SEC alleged that MFS willfully violated Section 206(2) of the Investment Advisers Act n129 and Section 34(b) of the Investment Company Act. n130

MFS settled the matter without admitting or denying the SEC's findings (other than as to jurisdiction and subject matter). The SEC imposed a censure, a cease-and-desist order, a \$50 million civil monetary penalty, disgorgement in the amount of \$1, and compliance with certain remedial undertakings.

For another example, in *Morgan Stanley*, the SEC instituted proceedings against Morgan Stanley DW Inc. ("MSDW"), a registered broker-dealer, for violating Section 17(a)(2) of the Securities Act and Rule 10b-10 under the Exchange Act by failing to adequately disclose certain material facts to its customers in the offer and sale of mutual fund shares. At issue in this case were two disclosure failures by MSDW, the first of which related to the operation of certain preferential marketing programs ("preferred programs") that were designed to specially promote the sale of participating mutual funds by means of enhanced compensation to individual registered representatives, known as financial advisors ("FAs"), and branch managers as well as increased visibility in its extensive retail distribution network. The second disclosure failure related to MSDW's sale of B shares and involved many of the same types of allegations discussed above under "B Share Cases."

Under MSDW's "Asset Retention Program," participating mutual funds would pay to MSDW hard dollars and, in some cases, what MSDW referred to as "soft dollars" but which were in fact directed brokerage commissions, in exchange for a number of marketing benefits, such as: (a) inclusion on a "preferred list" that FAs would first look to in making

recommendations of mutual fund shares, (b) increased visibility within MSDW's distribution system, and (c) eligibility to participate in MSDW's 401(k) programs and to offer offshore products to MSDW's customers. In addition, MSDW would encourage asset retention by paying FAs to encourage their customers to make, and then retain their investments in participating mutual funds. Under MSDW's "Partners Program," which replaced the Asset Retention Program, MSDW provided participating mutual funds with greater access to its FAs and with greater prospects for sales through enhanced compensation incentives to its sales force on the sale of shares of participating funds. Although MSDW preferred cash payments, it accepted directed brokerage under both program, though the amounts paid for by brokerage commissions was generally a multiple of the hard dollar amount.

The SEC based its proceeding on the theory that MSDW failed to adequately disclose the foregoing arrangements to its customers. Although MSDW relied on disclosure contained in the prospectuses and SAIs of participating mutual funds, none, according to the SEC, adequately disclosed the preferred programs as such nor did "most provide sufficient facts about the preferred programs for investors to appreciate the dimension of the conflicts of interest inherent in them."

n131 The SEC noted that no fund prospectus specifically disclosed that MSDW received payments from the participating funds, or that the participating funds directed brokerage in exchange for preferential treatment. The SEC also found that MSDW, as a result of the foregoing arrangements, violated NASD Conduct Rule 2830(k), which prohibits member firms from favoring sales of mutual fund shares on the basis of directed brokerage received.

MSDW settled the matter, without admitting or denying the SEC's findings (other than as to jurisdiction and subject matter). The SEC imposed a censure, a \$25 million civil monetary penalty, disgorgement and prejudgment interest of \$25 million, and compliance with certain remedial undertakings.

Apart from directed brokerage arrangements, the SEC also has proceeded against mutual fund advisers for violations of the federal securities laws relating to soft dollar arrangements. According to the SEC, soft dollar arrangements present an inherent conflict of interest because the investment adviser stands to receive research services and other benefits from broker-dealers to whom they direct brokerage business, and disclosure of such arrangements and the proper use of soft dollar credits are important matters for a mutual fund's board of directors to consider.

In *Fundamental*, n132 for example, the SEC instituted proceedings against an investment adviser and its chief portfolio strategist ("Brofman") for, among other things, failing to disclose soft dollar arrangements to the boards of directors and trustees of certain mutual funds managed by the adviser. The SEC found that the investment adviser violated Sections 206(1) and (2) of the Investment Advisers Act by failing to disclose the existence of soft dollar arrangements, and that Brofman aided and abetted and caused such violations. The SEC imposed a cease-and-desist order, a civil monetary penalty of \$500,000 on the adviser, and a civil monetary penalty of \$250,000 on Brofman. The SEC also revoked the investment adviser's registration, and permanently barred Brofman from association with an investment adviser, broker-dealer, or investment company. Notably, the SEC had found that Brofman willfully concealed the existence of the soft dollar arrangements from the boards.

In *Parnassus*, n133 the SEC instituted a proceeding against a mutual fund investment adviser for improperly using the fund's soft dollar credits. The SEC found that the fund had earned approximately \$187,000 in soft dollar credits as the result of directing brokerage commissions to a wirehouse firm. The investment adviser used approximately \$105,000 of the soft dollar credits to purchase computers, half of which it used for brokerage or research-related functions, which were permissible uses, the other half of which it used for fund accounting and transfer agent functions, which were impermissible uses that the fund was separately paying the adviser to perform. The investment adviser also used approximately \$15,000 of the soft dollar credits to purchase accounting software. The investment adviser failed to disclose in its Form ADV that it was using soft dollar credits in this manner. For these and other violations, the SEC imposed a cease-and-desist order, but declined to impose a civil monetary penalty on the grounds that there was no fraud and no unjust enrichment.

FOOTNOTES:

(n1)Footnote 1. *E.g., Compliance Programs of Investment Companies and Investment Advisers, Adv. Act Rel. No. 2204, 2003 SEC LEXIS 2980* (Dec. 17, 2003) (imposing new requirement for registered investment advisers and investment companies to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the policies and procedures).

(n2)Footnote 2. Section 209(d) of the Investment Advisers Act, *15 U.S.C.S. § 80b-9(d)*; Section 42(d) of the Investment Company Act; *15 U.S.C.S., § 80a-41(d)*.

(n3)Footnote 3. Sections 209(a) and (b) of the Investment Advisers Act, *15 U.S.C.S. § 80b-9(a) and (b)*; Sections 42(a) and (b) of the Investment Company Act, *15 U.S.C.S. § 80a-41(a) and (b)*.

(n4)Footnote 4. Section 209(c) of the Investment Advisers Act, *15 U.S.C.S. § 80b-9(c)*; Section 42(c) of the Investment Company Act; *15 U.S.C.S. § 80a-41(c)*. Both Sections provide that any person who, without just cause, fails to obey an SEC subpoena is guilty of a misdemeanor punishable by a fine of not more than \$1,000, imprisonment for up to one year, or both.

(n5)Footnote 5. Section 209(e) of the Investment Advisers Act, *15 U.S.C.S. § 80b-9(e)*; Section 42(e) of the Investment Company Act; *15 U.S.C.S. § 80a-41(e)*.

(n6)Footnote 6. Section 203(e) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(e)*. Unlike the Investment Company Act, the Investment Advisers Act provides that the SEC "shall" take such action upon the requisite findings, whereas the Investment Company Act, at Section 9(b), provides that the SEC "may" take action. *Compare 15 U.S.C.S. § 80a-9(b)*, discussed in § 29.03[2][b][ii] below.

(n7)Footnote 7. Section 203(e)(1) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(e)(1)*.

(n8)Footnote 8. Section 203(e)(5) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(e)(5)*. This Section also permits the SEC to take action if it believes the person is unable to comply with such laws.

(n9)Footnote 9. Section 203(e)(6) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(e)(6)*.

(n10)Footnote 10. Section 203(e)(6) provides that "no person shall be deemed to have failed reasonably to supervise any person if: (A) [t]here have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (B) [s]uch person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with."

(n11)Footnote 11. Section 203(e)(3) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(e)(3)*.

(n12)Footnote 12. Section 203(e)(2)(A)-(D) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(e)(2)(A)-(D)*.

(n13)Footnote 13. Section 203(e)(4) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(e)(4)*.

(n14)Footnote 14. Section 203(e)(7) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(e)(7)*.

(n15)Footnote 15. Section 203(e)(9) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(e)(9)*.

(n16)Footnote 16. Section 203(f) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(f)*.

(n17)Footnote 17. Section 203(i) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(i)*.

(n18)Footnote 18. *15 U.S.C.S. § 80b-3(k)*.

(n19)Footnote 19. *7 U.S.C.S. § 1 et seq.*

(n20)Footnote 20. *15 U.S.C.S. § 80a-9(b)*.

(n21)Footnote 21. *15 U.S.C.S. § 80a-9(f)*.

(N22)Footnote 22. Section 202(a)(16) of the Investment Advisers Act, *15 U.S.C.S. § 80b-2(a)(16)*; Section 2(a)(28) of the Investment Company Act; *15 U.S.C.S. § 80a-2(a)(28)*.

(n23)Footnote 23. One federal court has observed that prior to 1970, the SEC "was without power to sanction persons, as opposed to companies, for violations of the [Investment Advisers Act] and the [Investment Company Act.]" *Steadman v. SEC*, *603 F.2d 1126, n.23 (5th Cir. 1979)* (citing to the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, *84 Stat. 1413 (1970)*).

(n24)Footnote 24. Section 202(a)(17) of the Investment Advisers Act defines "person associated with an investment adviser" to mean any partner, officer or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser" with an exception for ministerial or clerical employees in the case of the registration requirements of the Act. *15 U.S.C.S. § 80b-2(a)(17)*.

(n25)Footnote 25. See Section 2(a)(3)(D) of the Investment Company Act, which defines an "affiliated person" of an investment company to include, among other persons "any officer, director, partner, copartner, or employee." *15 U.S.C.S. § 80a-2(a)(2)(a)(3)(D)*.

(n26)Footnote 26. See Section 15 of the Securities Act; Section 20 of the Exchange Act.

(n27)Footnote 27. Section 208(d) of the Investment Advisers Act, *15 U.S.C.S. § 80b-8(d)*; Section 48(a) of the Investment Company Act, *15 U.S.C.S. § 80a-47(a)*.

(n28)Footnote 28. *In re John J. Kenny and Nicholson/Kenny Capital Management, Inc., Adv. Act Rel. No. 2128, 2003 SEC LEXIS 1170, n.54* (May 14, 2003) .

(n29)Footnote 29. See *SEC v. Berger*, *244 F. Supp. 2d 180 (S.D.N.Y. 2001)* (summary judgment granted against defendant Michael W. Berger in securities fraud action under the Investment Advisers Act where Berger effectively controlled the investment adviser and, therefore, was himself an investment adviser).

(n30)Footnote 30. See *In re Oxford Capital Management, Inc. and John G. Danz, Jr., Adv. Act Rel. No. 2061, 2002 SEC LEXIS 2392* (Sept. 23, 2002) (SEC alleged that president and majority shareholder caused violation by investment adviser and aided and abetted such violations). See § 29.03[4][d][i] for a discussion of aiding and abetting liability.

(n31)Footnote 31. Section 2(a)(3)(C) of the Investment Company Act, *15 U.S.C.S. § 80a-2(a)(3)(C)*.

(n32)Footnote 32. Section 2(a)(3)(A) of the Investment Company Act, *15 U.S.C.S. § 80a-2(a)(3)(A)*.

(n33)Footnote 33. E.g., *In re The Barr Financial Group, Inc. and Alfred E. Barr, Initial Decisions Rel. No. 206, 2002 SEC LEXIS 1594* (June 21, 2002) (advisory firm's president and chief executive officer had primary responsibility for firm's compliance with the federal securities laws).

(n34)Footnote 34. See § 29.03[4][c] below.

(n35)Footnote 35. See, e.g., *In re Michael Batterman and Randall B. Batterman III, Initial Decisions Rel. No. 246,*

2004 SEC LEXIS 300 (Feb. 12, 2004) , citing *In re Alexander Stein*, 52 S.E.C. 296 (June 8, 1995) ("Our authority to proceed under Section 203(f), however, does not rest on whether or not an entity or individual has registered with this Commission.").

(n36)Footnote 36. See, e.g., *SEC v. Gary A. Smith*, 1995 U.S. Dist. LEXIS 22352 (E.D. Mich. 1995) .

(n37)Footnote 37. See, e.g., *In re Samer M. El Bizri and Bizri Capital Partners, Inc.*, Adv. Act Rel. No. 2250, 2004 SEC LEXIS 1244 (June 16, 2004) (alleged hedge fund fraud by unregistered investment adviser); *In re Robert T. Littell and Wilfred Meckel*, Adv. Act Rel. No. 2203, 2003 SEC LEXIS 2958 (Dec. 15, 2003) (alleged hedge fund fraud by associated persons of unregistered investment adviser; failure to reasonably supervise).

(n38)Footnote 38. See Ropes & Gray, SEC Staff No-Action Letter, 1995 SEC No-Act. LEXIS 748 (Sept. 26, 1995).

(n39)Footnote 39. E.g., *In re Henry Weingarten*, Adv. Act Rel. No. 2019, 2002 SEC LEXIS 646 (Mar. 19, 2002) (New York registered investment adviser censured).

(n40)Footnote 40. See, e.g., *In re Main Street AC, Inc. and Chester Billingsley, Inv. Co.* Act Rel. No. 26069, 2003 SEC LEXIS 1363 (June 6, 2003) (failure to register as investment company); *SEC v. Nat'l Presto Indus., Inc.*, Lit. Rel. No. 17647, 2002 SEC LEXIS 1976 (Aug. 1, 2002) (announcing filing of action in federal district court against National Presto for illegally operating as an unregistered investment company since 1994); *In re Clarke Lanzen Skalla Investment Firm, Inc.*, Inv. Co. Act Rel. No. 21140, 1995 SEC LEXIS 1508 (June 16, 1995) (pool of investment company securities constituted a de facto unregistered "fund of funds" in violation of the Investment Company Act).

(n41)Footnote 41. See *Vocor Int'l Holding S.A.*, SEC Staff No-Action Letter, 1990 SEC No-Act. LEXIS 665 (Apr. 9, 1990) ("Unless excepted from registration, a foreign investment adviser that makes use of the mails or any means or instrumentality of interstate commerce ("U.S. jurisdictional means") to solicit clients in the United States must register under the [Investment Advisers Act]. In addition, a foreign parent company that offers investment advice in the United States through its registered subsidiary may be required to register, unless the subsidiary has an existence independent of its parent.") (citations omitted).

(n42)Footnote 42. Section 7(d) of the Investment Company Act, 15 U.S.C.S. § 80a-7(d). See *Cross-Border Tender Offers, Business Combinations and Rights Offerings*, Sec. Act Rel. No. 7611, n.126, 1998 SEC LEXIS 2480 (Nov. 13, 1998) . A foreign investment company may, however, make a private offer of its securities in the United States or to U.S. persons in reliance on one of the exclusions from the definition of "investment company" under the Investment Company Act, such as Section 3(c)(1) or 3(c)(7), 15 U.S.C.S. § 80a-3(c)(1) and 15 U.S.C.S. § 80a-3(c)(7). See *Statement of The Commission Regarding Use of Internet Web Sites To Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Sec. Act Rel. No. 7516, 1998 SEC LEXIS 488 (Mar. 23, 1998) at n.13 and accompanying text.

(n43)Footnote 43. See, e.g., *In re Dominion Capital Corp.*, Sec. Act Rel. No. 7683, 1999 SEC LEXIS 969 (May 13, 1999) ; *SEC v. Banner Fund Int'l, Inc.*, Litig. Rel. No. 15311, 1997 SEC LEXIS 705 (Apr. 1, 1997) (unregistered foreign investment company was illegally doing business in the U.S.). Section 205(b)(5) of the Investment Advisers Act, however, does except from the coverage of the Act's prohibition on performance fees persons who are not U.S. residents, which would include foreign investment companies. 15 U.S.C.S. § 80b-5(b)(5). See *Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*, Adv. Act Rel. No. 1731, n.9, 1998 SEC LEXIS 1446 (July 15, 1998) (adopting Rule 205-3).

(n44)Footnote 44. 15 U.S.C.S. § 80b-6.

(n45)Footnote 45. Rule 206(4)-1, 17 C.F.R. § 275.206(4)-1.

(n46)Footnote 46. Rule 206(4)-2, 17 C.F.R. § 275.206(4)-2.

(n47)Footnote 47. Rule 206(4)-3, *17 C.F.R. § 275.206(4)-3*.

(n48)Footnote 48. Rule 206(4)-4, *17 C.F.R. § 275.206(4)-4*.

(n49)Footnote 49. Rule 206(4)-6, *17 C.F.R. § 275.206(4)-6*.

(n50)Footnote 50. Rule 206(4)-7, *17 C.F.R. § 275.206(4)-7*.

(n51)Footnote 51. *15 U.S.C.S. § 80a-33(b)*.

(n52)Footnote 52. *17 C.F.R. § 270.34b-1*.

(n53)Footnote 53. *15 U.S.C.S. § 80a-34(a)(1)*. See also Section 35(b), which makes it unlawful for any person registered under the Investment Company Act to represent or imply that such person has been sponsored, recommended or approved, or that his abilities or qualifications have been passed upon by the U.S., or any agency or officer thereof. *15 U.S.C.S. § 80a-34(b)*.

(n54)Footnote 54. *15 U.S.C.S. § 80a-34(d)*.

(n55)Footnote 55. *17 C.F.R. § 270.35d-1*.

(n56)Footnote 56. *SEC v. Capital Gains Bureau, Inc., 375 U.S. 180, 191, 1963 U.S. LEXIS 2446 (1963)* ("The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested.").

(n57)Footnote 57. *Capital Gains Bureau, 375 U.S. at 194*.

(n58)Footnote 58. See, e.g., *SEC v. Gary L. Pilgrim, Harold J. Baxter and Pilgrim Baxter & Assoc., Ltd., Litig. Rel. No. 18474, 2003 SEC LEXIS 2764* (Nov. 20, 2003) (announcing filing of complaint against mutual fund adviser for, among other things, breach of fiduciary duties in violation of Sections 206(1) and (2) of the Investment Advisers Act in connection with market timing of mutual fund); *In re Renaissance Capital Advisors, Inc. and Richard N. Fine, Adv. Act Rel. No. 1688, 1997 SEC LEXIS 2643* (Dec. 22, 1997) (failure to disclose soft dollar arrangement constituted breach of adviser's fiduciary duty in violation of Sections 206(1) and (2) of the Investment Advisers Act).

(n59)Footnote 59. Section 36(a) of the Investment Company Act, *15 U.S.C.S. § 80a-35(a)*.

(n60)Footnote 60. *15 U.S.C.S. § 80a-35(b)*.

(n61)Footnote 61. See, e.g., *SEC v. Invesco Funds Group, Inc., and Raymond R. Cunningham, Lit. Rel. No. 18482, 2003 SEC LEXIS 2882* (Dec. 2, 2003) (announcing filing of complaint against mutual fund adviser and adviser's CEO for alleged, among other things, breach of Section 36(a) involving personal misconduct); *SEC v. Strategic Mgmt., Lit. Rel. No. 13701, 1993 SEC LEXIS 1799* (July 9, 1993) (announcing federal court injunction against associated person of investment adviser for breach of Section 36(a) involving personal misconduct).

(n62)Footnote 62. Section 205(a)(1) of the Investment Advisers Act, *15 U.S.C.S. § 80b-5(a)(1)*.

(n63)Footnote 63. Section 17(a) of the Investment Company Act, *15 U.S.C.S. § 80a-17(a)*.

(n64)Footnote 64. Rule 206(3)-2 under the Investment Advisers Act, *17 C.F.R. § 275.206(3)-2*.

(n65)Footnote 65. Rule 17d-1 under the Investment Company Act, *17 C.F.R. § 270.17d-1*.

(n66)Footnote 66. *See, e.g., In re Banc One Investment Advisors Corp. and Mark A. Beeson, Adv. Act Rel. No. 2254, 2004 SEC LEXIS 1353* (June 29, 2004) (SEC found that the adviser failed to disclose conflict of interest created by entering into a market-timing arrangement with a hedge-fund manager that was potentially harmful to shareholders, but would increase the adviser's fees and potentially attract additional business); *In re Alliance Capital Management, L.P., Adv. Act Rel. No. 2205, 2003 SEC LEXIS 2997* (Dec. 18, 2003) (SEC found that conflicts of interest led adviser to favor its own interests over that of its clients); *In re Jamison, Eaton & Wood, Inc., Adv. Act Rel. No. 2129, 2003 SEC LEXIS 1174* (May 15, 2003) (SEC found that the adviser violated Advisers Act by not disclosing to its referred clients that it faced a potential conflict of interest in receiving referrals from registered representatives of full service broker-dealers).

(n67)Footnote 67. *Investment Company Governance, Inv. Co. Act Rel. No. 26323, 2004 SEC LEXIS 89* (Jan. 15, 2004) (proposing changes to investment company corporate governance) at 6.

(n68)Footnote 68. *Prohibition on the Use of Brokerage Commissions to Finance Distribution, Inv. Co. Act Rel. No. 26356, 2004 SEC LEXIS 418* (Feb. 24, 2004) at 22 (emphasis added).

(n69)Footnote 69. *Investment Adviser Codes of Ethics, Adv. Act Rel. No. 2256, 2004 SEC LEXIS 1413* (July 2, 2004).

(n70)Footnote 70. *See, e.g., Investors Research Corp. v. SEC, 628 F.2d 168, 1980 U.S. App. LEXIS 18151 (D.C. Cir. 1980)*.

(n71)Footnote 71. *In re H.J. Meyers & Co., Inc., Initial Decision Rel. No. 211, 2002 SEC LEXIS 2075, *91* (Aug. 9, 2002). In this release, the SEC stated that "[w]illfulness is shown where a person intends to commit an act that constitutes a violation. *There is no requirement that the actor also be aware that he is violating any statutes or regulations.*" (citing *Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000)*; *Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976)* (emphasis added)).

(n72)Footnote 72. *Geman v. SEC, 334 F.3d 1183; 2003 U.S. App. LEXIS 13585, *39* (10th Cir. 2003). *See Vernazza v. SEC, 327 F.3d 851; 2003 U.S. App. LEXIS 7729* (9th Cir. 2003).

(n73)Footnote 73. *In re Performance Analytics, Inc., and Leslie I. Golembo, Adv. Act Rel. No. 2036, 2002 SEC LEXIS 1552, *14* (June 17, 2002) (citing *Russo Securities Inc. and Ferdinand Russo, Exch. Act Rel. No. 39181, 1997 SEC LEXIS 2075, *17-18* (Oct. 1, 1997) ("proximate cause") and *Rolf v. Blyth, Easton Dillon & Co., Inc., 570 F.2d 38, 48 (2d Cir. 1978)* ("substantial causal factor")).

(n74)Footnote 74. *Performance Analytics, Inc., Adv. Act Rel. No. 2036, 2002 SEC LEXIS 1552, *14* (June 17, 2002) (citing *Carole L. Haynes, Initial Decision Rel. No. 78, 1995 SEC LEXIS 3134, *80* (November 24, 1995)).

(n75)Footnote 75. *In re Clarke T. Blizzard and Rudolph Abel, Adv. Act Rel. No. 2253, 2004 SEC LEXIS 1298* (June 23, 2004). In this case, the SEC found that the broker did not have a role in preparing or review the investment adviser's disclosure, had openly disclosed to senior management of the adviser that brokerage would be directed based on client referrals, and had reason to believe that the question of disclosure was being handled appropriately by the adviser.

(n76)Footnote 76. Section 203(k) of the Investment Advisers Act, *15 U.S.C.S. § 80b-3(k)*; Section 9(f) of the Investment Company Act, *15 U.S.C.S. § 80a-9(f)*.

(n77)Footnote 77. Section 9(b)(1) of the Investment Company Act, *15 U.S.C.S. § 80a-9(b)(1)* (administrative proceedings); Section 9(d)(1)(C) of the Investment Company Act, *15 U.S.C.S. § 80a-9(d)(1)(C)* (civil money penalties).

(n78)Footnote 78. *15 U.S.C.S. § 80a-11(a)*.

(n79)Footnote 79. *15 U.S.C.S. § 80a-47(a)*.

(n80)Footnote 80. *Blizzard, 2004 SEC LEXIS 1298, *16 Abraham & Sons, 75 SEC Docket at 1492 & n.25 (citing ; Sharon M. Graham, 53 S.E.C. 1072, 1085 n.35 (1998) , aff'd, 222 F.3d 994 (D.C. Cir. 2000))* .

(n81)Footnote 81. *SEC Defendants Indicted for Market Timing and Late Trading of Mutual Fund Shares, Litig. Rel. No. 18767, 2004 SEC LEXIS 1342* (June 29, 2004) . The SEC filed a civil action against Geek Securities, Inc., Geek Advisors, Inc., Kautilya "Tony" Sharma, and Neal R. Wadhwa on June 4, 2004 and the U.S. Department of Justice filed a criminal action against the same defendants on June 24, 2004.

(n82)Footnote 82. The SEC adopted proposed investment company governance changes at an open meeting on June 24, 2004. Two of the five SEC Commissioners (Atkins and Glassman) voted against the proposed changes. The publication of the final adopting release had not occurred as of this writing and will include a dissent from Commissioners Atkins and Glassman. The proposed changes are described in *Investment Company Governance, Inv. Co. Act Rel. No. 26323, 2004 SEC LEXIS 89* (Jan. 15, 2004) *above*.

(n83)Footnote 83. *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Inv. Co. Act Rel. No. 26418, 2004 SEC LEXIS 843* (Apr. 16, 2004) .

(n84)Footnote 84. *Registration under the Advisers Act of Certain Hedge Fund Advisers, Adv. Act. Rel. No. 2266, 2004 SEC LEXIS 1537* (July 20, 2004) *above*.

(n85)Footnote 85. *Investment Adviser Codes of Ethics, Adv. Act Rel. No. 2256, 2004 SEC LEXIS 1413* (July 2, 2004) .

(n86)Footnote 86. *Amendments to Rules Governing Pricing of Mutual Fund Shares, Inv. Co. Act Rel. No. 26288, 2003 SEC LEXIS 2938* (Dec. 11, 2003) .

(n87)Footnote 87. *Mandatory Redemption Fees for Redeemable Fund Securities, Inv. Co. Act Rel. No. 26375A, 2004 SEC LEXIS 508* (Mar. 5, 2004) .

(n88)Footnote 88. *See C. Ciccotello, et al., Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in the Internet Age, 7 Va. J. L. & Tech. 6* (2002).

(n89)Footnote 89. *See E. Zitzewitz, Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J. L. Econ. Org. 245 (October, 2003) (based on regression analysis, "there are statistically and economically significant arbitrage opportunities in 44 of 48 Morningstar fund categories, the exceptions being the large-cap U.S. equity and specialty-utilities categories.")

(n90)Footnote 90. *See Zitzewitz, Who Cares About Shareholders?, above*.

(n91)Footnote 91. *See, e.g., Windsor Securities, Inc. v. Hartford Life Insurance Co., 986 F.2d 655, 658 (3rd Cir. 1993)* ("beginning in 1988, Hartford and its independent fund advisor, Wellington Management Company, began to observe a negative impact caused by market timing activity: increased trading and transaction costs, disruption of planned investment strategies, forced and unplanned portfolio turnover, lost opportunity costs, and large asset swings in a fund's asset base").

(n92)Footnote 92. *Windsor Securities, 986 F.2d at 658 ; see also First Lincoln Holdings, Inc. v. The Equitable Life Assurance Society, 164 F. Supp. 2d 383 (S.D.N.Y. 2001)* .

(n93)Footnote 93. E. Wyatt, *Mutual Funds; What's Fair In Setting Fund Value?*, The New York Times (November 9, 1997).

(n94)Footnote 94. B. Barbash, *Remembering the Past: Mutual Funds and the Lessons of the Wonder Years*, speech before the 1997 Investment Company Institute Securities Law Procedures Conference (December 4, 1997).

(n95)Footnote 95. B. Barbash, *Remembering the Past*, above.

(n96)Footnote 96. D. Scheidt, Letter to Craig Tyle, Investment Company Institute (Dec. 8, 1999); D.Scheidt, Letter to Craig Tyle, Investment Company Institute (April 30, 2001).

(n97)Footnote 97. *In re Alliance Capital Mgmt., L.P.*, Adv. Act No. 2205, 2003 SEC LEXIS 2997 (Dec. 18, 2003) ; *In re Banc One Inv. Advisors Corp. and Mark A. Beeson*, Adv. Act Rel. No. 2254, 2004 SEC LEXIS 1353 (June 29, 2004) ; *SEC v. Daniel Calugar and Security Brokerage, Inc.*, Litig. Rel. No. 18524, 2003 SEC LEXIS 3055 (Dec. 24, 2003) ; *SEC v. Columbia Mgmt. Advisors, Inc. and Columbia Funds Distrib., Inc.*, Litig. Rel. No. 18590, 2004 SEC LEXIS 413 (Feb. 24, 2004) ; *In re James Patrick Connelly Jr.*, Adv. Act Rel. No. 2183, 2003 SEC LEXIS 2438 (Oct. 16, 2003) ; *SEC v. Martin J. Druffner*, Litig. Rel. No. 18784, 2004 SEC LEXIS 1500 (July 15, 2004) (amended complaint against former Prudential Brokers in connection with market timing trades); *In re Paul A. Flynn*, Adv. Act Rel. No. 2212, 2004 SEC LEXIS 211 (Feb. 3, 2004) ; *SEC v. Geek Sec., Inc., Geek Advisors, Inc., Kautilya "Tony" Sharma, and Neal R. Wadhwa*, Litig. Rel. No. 18738, 2004 SEC LEXIS 1144 (June 4, 2004) ; *SEC v. Invesco Funds Group, Inc., and Raymond R. Cunningham*, Litig. Rel. No. 18482, 2003 SEC LEXIS 2882 (Dec. 2, 2003) ; *In re Steven B. Markovitz*, Adv. Act Rel. No. 2180, 2003 SEC LEXIS 2341 (Oct. 2, 2003) ; *In re Massachusetts Financial Services Co., John W. Ballen and Kevin R. Parke*, Adv. Act Rel. No. 2213, 2004 SEC LEXIS 248 (Feb. 5, 2004) ; *SEC v. Mutuals.Com, Inc., Connely Dowd Management, Inc., Mtt Fundcorp, Inc., Richard Sapio, Eric Mcdonald, and Michele Leftwich*, Litig. Rel. No.18489, 2003 SEC LEXIS 2862 (Dec. 4, 2003) ; *In re Pilgrim Baxter & Associates, Ltd.*, Adv. Act Rel. No. 2251, 2004 SEC LEXIS 1267 (June 21, 2004) ; *SEC v. PIMCO Advisors Fund Management LLC, PIMCO Advisors Fund Management LLC, Pea Capital LLC F/K/A/ PIMCO Equity Advisors LLC, PIMCO Advisors Distributors LLC, Stephen J. Treadway, and Kenneth W. Corba*, Litig. Rel. No. 18697, 2004 SEC LEXIS 940 (May 6, 2004) ; *In re Putnam Inv. Mgmt., LLC*, Adv. Act Rel. No. 2226, 2004 SEC LEXIS 803 (April 8, 2004) ; *SEC v. Security Trust Company, N.A., Grant D. Seeger, William A. Kenyon, and Nicole Mcdermott*, Litig. Rel. No. 18653, 2004 SEC LEXIS 768 (April 1, 2004) ; *In re Theodore Charles Sihpol*, Adv. Act Rel. No. 2172, 2003 SEC LEXIS 2198 (Sept. 16, 2003) ; *In re Strong Capital Mgmt., Inc., Strong Investor Servs., Inc., Strong Inv., Inc., Richard S. Strong, Thomas A. Hooker, Jr. and Anthony J. D'amato*, Adv. Act Rel. No. 2239, 2004 SEC LEXIS 1044 (May 20, 2004) .

(n98)Footnote 98. *E.g., Massachusetts Financial Services Co.*, Adv. Act Rel. No. 2213, 2004 SEC LEXIS 248 .

(n99)Footnote 99. *E.g., Columbia Mgmt. Advisors, Inc.*, Litig. Rel. No. 18590, 2004 SEC LEXIS 413 (Feb. 24, 2004) .

(n100)Footnote 100. *E.g., Alliance Capital Mgmt., L.P.*, Adv. Act No. 2205, 2003 SEC LEXIS 2997 .

(n101)Footnote 101. *E.g., Putnam Inv. Mgmt., LLC*, Adv. Act Rel. No. 2226, 2004 SEC LEXIS 803 (Apr. 8, 2004) .

(n102)Footnote 102. The investment adviser defendants in *Alliance* and *MFS*, for example, agreed to pay \$250 million and \$225 million, respectively, in disgorgement and penalties.

(n103)Footnote 103. *E.g., Bank One*, Adv. Act Rel. No. 2254, 2004 SEC LEXIS 1353 .

(n104)Footnote 104. *Mutuals.com*, Litig. Rel. No.18489, 2003 SEC LEXIS 2862, *4 (Dec. 4, 2003) .

(n105)Footnote 105. *Security Trust Company*, Litig. Rel. No. 18653, 2004 SEC LEXIS 768, *3-4 .

(n106)Footnote 106. *See, e.g.*, the SEC's complaint in *Druffner*, Litig. Rel. No. 18784, 2004 SEC LEXIS 1500 .

(n107)Footnote 107. The SEC is less equivocal about its view of late trading. In its complaints, the SEC has

asserted that late trading is the *illegal* practice of placing orders to buy or sell mutual fund shares after close of market at 4 p.m. EST, but at the mutual fund's NAV determined at the market close. The potential harm here is that late traders are given an opportunity to invest once the so-called "horse race" has already run.

(n108)Footnote 108. In its mandatory redemption fee proposal, *Inv. Co. Act Rel. No. 26375A, 2004 SEC LEXIS 508* (Mar. 5, 2004) *above*, the SEC would impose a 2% fee on any redemption made within five business days of purchase, with certain exceptions. While one might look to this five business day standard as an implicit proxy for what constitutes "excessive" market timing, the proposing release made no such statement.

(n109)Footnote 109. *In re American Express Fin. Advisors Inc., Sec. Act Rel. No. 8365, 2004 SEC LEXIS 320* (Feb. 12, 2004) ; *In re Legg Mason Wood Walker, Inc., Sec. Act Rel. No. 8368, 2004 SEC LEXIS 294* (Feb. 12, 2004) ; *In re Linsco/Private Ledger Corp., Sec. Act Rel. No. 8371, 2004 SEC LEXIS 315* (Feb. 12, 2004) ; *In re Raymond James Fin. Serv., Inc., Sec. Act Rel. No. 8374, 2004 SEC LEXIS 312* (Feb. 12, 2004) ; *In re UBS Fin. Serv., Inc., Sec. Act Rel. No. 8377, 2004 SEC LEXIS 307* (Feb. 12, 2004) ; *In re Wachovia Sec., LLC, Sec. Act Rel. No. 8380, 2004 SEC LEXIS 302* (Feb. 12, 2004) ; *In re H.D. Vest Inv. Sec., Inc., Sec. Act Rel. No. 8383, 2004 SEC LEXIS 306* (Feb. 12, 2004) .

(n110)Footnote 110. Mutual funds selling shares with front-end sales loads typically offer breakpoint discounts for investors who reach certain investment levels, i.e., breakpoints. An investor can reach a breakpoint level either by making a single large investment or by aggregating multiple investments pursuant to one or more investment programs typically offered by mutual funds. These investment programs include "letters of intent," pursuant to which an investor agrees to make a specified investment over time (generally 13 months), or through "rights of accumulation," which typically allows an investor to aggregate his or her purchases of a mutual fund's shares or class of shares with those of another fund within the same family. In addition, mutual funds typically allow investors to aggregate their holdings with those of family members for purposes of reaching a breakpoint.

(n111)Footnote 111. *See Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds* (March 2003). The results of the examination sweep showed that customers were, in many cases, not receiving the breakpoint reductions to which they were entitled.

(n112)Footnote 112. Section 17(a)(2) of the Securities Act makes it unlawful for any person, in connection with the offer or sale of a security and by use of jurisdictional means, to directly or indirectly "obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

(n113)Footnote 113. *17 C.F.R. § 240.10b-10(a)(2)(i)(B)*.

(n114)Footnote 114. The SEC did not find that Raymond James violated Rule 10b-10.

(n115)Footnote 115. *In re Paine, Webber, Jackson & Curtis, Exch. Act Rel. No. 8501, 1969 SEC LEXIS 225* (Jan. 22, 1969) .

(n116)Footnote 116. *Paine, Webber, Exch. Act Rel. No. 8501, 1969 SEC LEXIS 225, *4-5* .

(n117)Footnote 117. *See, e.g., In re IFG Network Sec., Inc., William Kissinger, Kissinger Advisory, Inc., Bert Miller, Glenn Wilkinson, and David Ledbetter, Exch. Act Rel. No. 50008, 2004 SEC LEXIS 1480* (July 13, 2004) ; *In re J. Michael Scarborough and Royal Alliance Associates, Inc., Sec. Act Rel. No. 8438, 2004 SEC LEXIS 1450* (July 8, 2004) ; *H.D. Vest, Sec. Act Rel. No. 8383, 2004 SEC LEXIS 306* (Feb. 12, 2004) , *above*; *In re Morgan Stanley DW Inc., Sec. Act Rel. No. 8339, 2003 SEC LEXIS 2732* (Nov. 17, 2003) ; *In re Michael Flanagan, Ronald Kindschi, and Spectrum Admin., Inc., Exch. Act Rel. No. 48255, 2003 SEC LEXIS 1803* (July 30, 2003) ; *In re Prudential Sec., Inc., Exch. Act Rel. No. 48149, 2003 SEC LEXIS 1614* (July 10, 2003) ; *In re the Application of Wendell D. Beldon, Exch. Act Rel. No. 47859, 2003 SEC LEXIS 1154* (May 14, 2003) .

(n118)Footnote 118. *See Flanagan, Exch. Act Rel. No. 48255, 2003 SEC LEXIS 1803 , above.*

(n119)Footnote 119. *Special Market Study (Chapter IX-Open-End Investment Companies), Rel. No. 36, 1963 SEC LEXIS 2368 at *9 (Aug. 8, 1963) .*

(n120)Footnote 120. *See, e.g., In re Russell L. Irish d/b/a Russell L. Irish Inv., Exch. Act Rel. No. 7687, 1965 SEC LEXIS 241 (Aug. 27, 1965) ; In re Application of Charles E. Marland & Co., Inc., and Charles E. Marland, Harold J. Monson, C. Clyde Allison, Exch. Act Rel. No. 11065, 1974 SEC LEXIS 2458 (Oct. 21, 1974) ; In re Application of Kenneth C. Krull, Exch. Act Rel. No. 41008, 1999 SEC LEXIS 210 (Feb. 1, 1999) ; In re Russell C. Turek, Exch. Act Rel. No. 45459, 2002 SEC LEXIS 396 (Feb 20, 2002) .*

(n121)Footnote 121. *In re Raymond A. Parkins, Jr., Adv. Act Rel. No. 2010, 2002 SEC LEXIS 146 (Jan. 18, 2002) .*

(n122)Footnote 122. *Raymond A. Parkins, Jr., Adv. Act Rel. No. 2010, 2002 SEC LEXIS 146, *3 .*

(n123)Footnote 123. *In re Donna N. Morehead, Exch. Act Rel. No. 46121, 2002 SEC LEXIS 1623 (June 26, 2002) .*

(n124)Footnote 124. *See, e.g., In re Massachusetts Fin'l Serv. Co., Adv. Act Rel. No. 2224, 2004 SEC LEXIS 734 (Mar. 31, 2004) ; Morgan Stanley, Sec. Act Rel. No. 8339, 2003 SEC LEXIS 2732 , above; In re Fundamental Portfolio Advisors, Inc., Lance M. Brofman, and Fundamental Service Corporation, Adv. Act Rel. No. 2146, 2003 SEC LEXIS 1654 (July 15, 2003) ; Blizzard, Adv. Act Rel. No. 2253, 2004 SEC LEXIS 1298 , above.*

(n125)Footnote 125. Under the distributing broker method, MFS would denote transactions that were intended to satisfy the Strategic Alliances for the executing brokers, who were also distributing brokers.

(n126)Footnote 126. Under the step out method, MFS would select a broker-dealer to execute the transaction and request the executing broker to "step out" a portion of the trade and, thus, a portion of the commission, to another broker with whom MFS had a Strategic Alliance.

(n127)Footnote 127. Under the introducing broker method, a broker-dealer would execute the transaction, and then forwarded the entire commission to an introducing broker with whom MFS had a Strategic Alliance. The introducing broker would pay the executing broker for its execution and clearing services.

(n128)Footnote 128. MFS did disclose to the MFS fund boards certain hard dollar payments that it made under the Strategic Alliances.

(n129)Footnote 129. *See 15 U.S.C.S. § 80b-6 and § 29.03[4][a].*

(n130)Footnote 130. *See 15 U.S.C.S. § 80a-33(b) and § 29.03[4][a].*

(n131)Footnote 131. *Morgan Stanley, Sec. Act Rel. No. 8339, 2003 SEC LEXIS 2732, *14-15 .*

(n132)Footnote 132. *See Fundamental Portfolio Advisors, Adv. Act Rel. No. 2146, 2003 SEC LEXIS 1654 , above.*

(n133)Footnote 133. *In re Parnassus Inv., Jerome L. Dodson, Marilyn Chou, and David L. Gibson, Initial Decisions Rel. No. 131, 1998 SEC LEXIS 1877 (Sept. 3, 1998) .*



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CHAPTER 30 PCAOB ENFORCEMENT

2-30 Securities Enforcement: Counseling and Defense 30.syn

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CHAPTER 30 PCAOB ENFORCEMENT

2-30 Securities Enforcement: Counseling and Defense § 30.01

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§ 30.01 Introduction

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is a private, non-profit corporation created by the Sarbanes-Oxley Act of 2002 in the wake of a series of corporate scandals involving accounting and auditing failures. n1 It was created as part of the attempt to restore public trust in the audits of public companies. The PCAOB's statutory purpose is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. To accomplish this purpose, the PCAOB is empowered to:

- register public accounting firms that prepare, or substantially contribute to the preparation of, audit reports for public companies;
- conduct inspections of registered public accounting firms in connection with their public company auditing practices;
- conduct investigations and disciplinary proceedings concerning, and to impose appropriate sanctions upon, registered public accounting firms and associated persons; and
- establish auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports on the financial statements of public companies. n2

The U.S. Securities and Exchange Commission ("SEC" or "Commission") has oversight authority of the PCAOB.

FOOTNOTES:

(n1)Footnote 1. Pub. Law 107-204, *116 Stat. 750, 15 U.S.C.S. § 7201, et seq.*, July 30, 2002.

(n2)Footnote 2. Sarbanes-Oxley Act, Section 101(c).



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CHAPTER 30 PCAOB ENFORCEMENT

2-30 Securities Enforcement: Counseling and Defense § 30.02

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§ 30.02 General Overview of the PCAOB Structure and Organization

The Board executes its authority through three major operating units: (1) Registration and Inspections, (2) Enforcement and Investigations, and (3) Professional Standards. Most of the PCAOB's staff is based in its Washington, D.C. headquarters. As of May 2005, it had offices in New York City, Atlanta, Chicago, Dallas, Denver, San Francisco and Orange County, California, to support its ongoing inspections process.

[1] Registration of Public Accounting Firms

Since October 22, 2003, it has been illegal for any U.S. public accounting firm to prepare, issue, or play a substantial role in the preparation or issuance of, an audit report on the financial statements of a U.S. public company unless it is registered with the Board. As of July 19, 2004, the same restriction applies to non-U.S. firms that prepare, issue, or play a substantial role in the preparation or issuance of, audit reports on the financial statements of U.S. public companies. The Division of Registration and Inspections is charged with building the registry of accounting firms and preparing for inspections of the firms.

Registration is not automatic. The Board considers each application and gives special attention to those firms that have received negative peer reviews, been subject to disciplinary proceedings (against the firm or its principals), or reported unusually high ratios of public company audit clients to accountants employed at the firm. To grant approval, the Board must determine that registering the applicant is consistent with the Board's responsibilities to protect investors and to further the public interest in the preparation of informative, accurate, and independent audit reports. As of April 26, 2005, the PCAOB had registered 1,493 U.S. and non-U.S. public accounting firms that audit or may wish to audit U.S. public companies.

The Board may also hold hearings on registration applications. Under the Board's registration rules, if the Board is unable to determine that a public accounting firm has met the approval standards, the Board may provide the firm with a notice of a hearing, which the firm may elect to treat as a written notice of disapproval for purposes of making an appeal to the Commission. If such a firm chooses instead to request a hearing, the Board may afford the firm a hearing pursuant to the rules. The proceedings are subject to the same hearing procedures as disciplinary proceedings, and the Division of Registration and Inspections takes on an adversarial role similar to that of the Division of Enforcement and

Investigations during the proceedings. n1

[2] Inspections of Registered Firms

Once a firm is registered, it is subject to Board inspections. The Sarbanes-Oxley Act and the Board's rules require annual inspections of firms that audit more than 100 public companies and triennial inspections of the remaining registered firms that have at least one U.S. public company client. n2 The Board also has the authority to conduct special inspections to address issues that come to the Board's attention. Inspections use the greatest portion of the Board's resources, largely because of the need for a sizable, well-trained staff. As of July 2004, the inspections staff included more than 80 auditors, and the PCAOB expects to have 130 to 160 by the end of 2004.

[3] Standards

The Sarbanes-Oxley Act requires that the Board establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms when preparing and issuing audit reports. The Sarbanes-Oxley Act and the Board's rules require registered public accounting firms to adhere to the Board's standards, as well as its independence rules. Any registered firm that fails to adhere to these standards is subject to Board discipline. The Office of the Chief Auditor and Professional Standards was created to advise the Board on standards-setting. In addition, in April 2004 the Board established a Standing Advisory Group to assist the Board in carrying out its standards-setting responsibilities. Among the issues that the Board, its staff, and the standing advisory group expect to examine are:

- Reviews of existing, interim standards;
- Revision to the hierarchy for generally accepted auditing standards to incorporate PCAOB auditing and related professional practice standards;
- Concurring or second partner review to ensure all public company audits include a review by a second partner, and
- Communications and relations with audit committees to incorporate Sarbanes-Oxley Act requirements into the audit and related professional practice standards.

In addition, the Board is considering projects related to the quality control and independence standards, which Congress specifically addresses in the Sarbanes-Oxley Act.

[4] Enforcement

It is expected that the PCAOB will address many of the auditing problems it identifies through a combination of standards-setting and supervision through the inspection process. However, when it finds potential violations of its standards or the securities laws by auditors under its jurisdiction, the PCAOB has stated that it will use the authority that the Sarbanes-Oxley gives it to investigate and, as appropriate, to seek disciplinary sanctions. The Division of Enforcement and Investigations was formed to perform investigations of possible violations of law or professional standards and to recommend to the Board any disciplinary action. Claudius Modesti was appointed in May 2004 as the Division's first Director. He was previously an Assistant United States Attorney and before that an SEC enforcement attorney.

FOOTNOTES:

(n1)Footnote 1. PCAOB Rules 5500-5501.

(n2)Footnote 2. Sarbanes-Oxley Act, § 104.



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CHAPTER 30 PCAOB ENFORCEMENT

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§ 30.03 PCAOB Inspection Process

PCAOB inspections take up the basic task that had been the province of the accounting profession's peer review system, but the PCAOB's inspections are designed to go much further than peer review. Under the peer review system, reviewers typically focused on technical compliance with professional accounting and auditing standards and, on the basis of that review, opined on overall quality control. The PCAOB begins by looking at the business context in which audits are performed. It focuses on the influences -- both good and bad -- on firm practices. These include firm culture and the relationships between a firm's audit practice and its other practices and between engagement personnel in field and affiliate offices and a firm's national office. By doing so, the PCAOB argues that it gains a much better appreciation for the practices and problems that led to the most serious financial reporting and auditing failures of the last few years.

[1] 2003 Limited Procedures

The PCAOB launched its inspection program in its 2003 start-up year with "limited procedures" inspections of the Big Four firms. The focus of those first-year inspections was to conduct a "baseline assessment" of the firms' internal systems of quality control over auditing. According to the PCAOB, a firm's quality control system provides assurance to investors and others that rely on auditors' opinions that a firm's auditors comply with professional auditing and accounting standards. Firm culture, including, for example, the "tone at the top" that management infuses into the organization, and the system by which partners and employees are compensated and promoted, is one of the most important elements of a quality-control system. The quality-control system also includes internal controls over decisionmaking relating to auditing issues and internal reviews of audit engagements. In addition, the PCAOB examined individual engagements to test whether the quality-control system was working.

The PCAOB issued its reports of these limited inspections on August 26, 2004. Certain deficiencies were identified at each firm, which, pursuant to Board rules were not made public. Each firm has 12 months in which to cure the identified deficiencies. If the firm fails to do so, the Board is entitled to make public the portions of the reports previously kept private.

In the inspections, the Board identified significant audit and accounting issues that were missed by the firms and identified concerns about significant aspects of each firm's quality controls systems. n1 In most cases, the problems

discovered were not serious enough to prompt a restatement of company earnings; however, for 20 companies, a problem involving classification of company debt did lead to restatements. In addition, one broad theme emerged from the findings: the need to improve documentation procedures. n2

[2] Report of Inspection

Under the Sarbanes-Oxley Act n3 and the PCAOB's rules, the PCAOB makes a draft of its report on an inspection available to the firm under review and the firm has 30 days to respond to the draft. The Board then finalizes the report and delivers it to the SEC. n4 The PCAOB may also make certain portions of each report public, although the Sarbanes-Oxley Act requires the PCAOB to keep any criticisms of, or potential defects in, a specific firm's quality control system confidential, so long as the firm corrects the problems within 12 months after the date of the report. n5

The inspections also provide valuable information about the need for enhanced standards. For example, although the limited number of engagements reviewed in 2003 prevented the Board from drawing conclusions about systemic deficiencies in audits, the PCAOB became concerned that auditors may place insufficient emphasis on the importance of thorough documentation of audit work. The Sarbanes-Oxley Act expressly requires the PCAOB to adopt an auditing standard on documentation, and it began work on such a standard while it was conducting the limited procedures inspections. The PCAOB used knowledge about existing documentation practices that it gained in the limited inspections to develop the new standard.

[3] Scope of Ongoing Inspections

In 2004, the PCAOB began its full inspections of the largest U.S. firms. These inspections focused on, among other things:

- efforts to detect fraud;
- control over compliance with independence requirements;
- the adequacy of documentation;
- efforts to identify, evaluate, and manage risk; and
- compliance with professional auditing and accounting standards.

The PCAOB planned to review approximately five percent of the Big Four firms' public company audits -- that is, more than 500 audits -- and 15 percent of the next four largest firms' public company audits -- or, about 150 audits for a total of more than 650 audits, in addition to the small-firm audits selected on a case-by-case basis.

[4] Referrals from Inspections

The PCAOB has stated that it generally expects that deficiencies discovered during the inspection process will be cured without referral to the Board's Enforcement Division. In the course of an inspection, the Board may identify acts, practices, or omissions to act that may constitute a violation of law, Board rules, Commission rules, or professional standards. The Sarbanes-Oxley Act provides that when the Board identifies such potential violations, the Board should, where appropriate, begin a formal investigation or disciplinary proceeding (including a hearing on the record) or report the matter to the Commission or the appropriate state regulatory authority. Accordingly, counsel should be brought in early in the inspection process to ensure both appropriate cooperation during the inspection process, to protect appropriate privileges and to monitor the inspection process to be aware as early as possible of issues that could lead the Staff to refer a matter to an investigating authority. In fact, the PCAOB's first enforcement proceedings arose out of a

firm's attempt to conceal certain information during the inspections process. This concealment led to the revocation of the firm's registration, a bar of one partner and a censure of two others. n6

Of course, introducing counsel into the inspection process also requires a delicate touch, as the firm does not want to create the appearance that it is attempting to hide anything or appear overly concerned about access to information. Use of outside counsel to communicate directly with the staff should therefore be avoided and instead used, if necessary, for advice and guidance by inside counsel. Inside Counsel, who depending on availability and practicability, should be utilized by the firm during the inspection process for any law-related communications that may be necessary.

FOOTNOTES:

(n1)Footnote 1. PCAOB, *Board Releases Reports on 2003 Limited Inspections of Big Four Accounting Firms*, August 26, 2004, found at www.pcaobus.org/pcaob_news_2004-08-26.asp.

(n2)Footnote 2. See Gordon, Marcy, *First Inspections of Big Four Firms Show Significant Problems but Not Broadly Negative, Official Says*, Associate Press, August 26, 2004, found at ap.tbo.com/ap/breaking/MGBCINBGDYD.html.

(n3)Footnote 3. Sarbanes-Oxley Act, § 104(f).

(n4)Footnote 4. The PCAOB may also provide the report "in appropriate detail" to state regulatory authorities.

(n5)Footnote 5. Sarbanes-Oxley Act, § 104(g)(2).

(n6)Footnote 6. *In re Goldstein and Morris, CPAs, PC and Edward B. Morris, CPA*, PCAOB Rel. No. 2005-010 (May 24, 2005), available at http://www.pcaobus.org/Enforcement/Discovery_Proceedings/2005/05-24_Goldstein_and_Morris.pdf; *In re Alan I. Goldberger, CPA and William A. Postelnik, CPA*, PCAOB Rel. No. 2005-011 (May 24, 2005), available at http://www.pcaobus.org/Enforcement/Disciplinary_Proceedings/2005/05-24_Goldberger_and_Postelnik.pdf.



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CHAPTER 30 PCAOB ENFORCEMENT

2-30 Securities Enforcement: Counseling and Defense § 30.04

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§ 30.04 PCAOB Investigations

A PCAOB investigation may arise from a number of different sources, including complaints or tips from auditing firm employees, issuers, or the public, issuer restatements, accounting disagreements between the auditor and its client, auditor resignations, findings arising out of inspections, new regulatory initiatives, press articles, arbitration panel referrals, and referrals from the SEC or other regulatory agencies. Indeed, the Board has established an online Center for Enforcement Tips, Complaints and other Information, that encourages members of the public to file complaints with the PCAOB or to provide information that may be relevant to a PCAOB inspection. The Board even offers an online form for providing information, which includes space for concerns about auditors and issuers. n1

The PCAOB's authority to investigate includes authority to seek relevant documents and testimony from auditors and others, including client personnel. Because audit failures typically have an impact on the reliability of the financial statements that the auditor is responsible for examining, PCAOB investigations will often be a component of a larger investigation of the financial reporting itself and management's role in that reporting. The PCAOB therefore expects to work closely with the SEC in such cases. It is not clear, however, exactly how the two entities will work together.

[1] Jurisdiction

Section 105 of the Sarbanes-Oxley Act grants the Board broad investigative and disciplinary authority over registered public accounting firms and persons associated with such firms. To implement this authority, Section 105(a) directs the Board to establish, by rule, fair procedures for the investigation and discipline of registered public accounting firms and associated persons of such firms. The PCAOB has adopted rules relating to investigations and adjudications similar to those promulgated by the SEC. The rules on investigations and adjudications consist of 64 rules (PCAOB Rules 5000 through 5501), plus certain definitions that appear in Rule 1001 and a rule on time computation in Rule 1002. n2

Under the rules, the PCAOB and its staff may conduct investigations concerning any acts or practices, or omissions to act, by registered public accounting firms and persons associated with such firms, or both, that may violate any provision of the Sarbanes-Oxley Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports, and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Sarbanes-Oxley Act, or professional standards.

[2] Commencement of a PCAOB Investigation

The PCAOB's investigation process is substantially similar to the process employed by the SEC and self-regulatory organizations ("SRO"). Indeed, the PCAOB adapted many of its Rules Relating to Investigations from the SEC's Rules Relating to Investigations and similar SRO rules. Like those investigations, PCAOB investigations are conducted on a confidential basis, subject to sharing the information with federal and state regulatory or criminal authorities. n3

Comment

When the PCAOB commences a formal investigation that involves a potential violation of the securities laws, it must send a copy of its formal order of investigation in the matter to the SEC and thereafter coordinate its work with that of the SEC's Enforcement Division. n4

The PCAOB has indicated that investigations may take one of two tracks: expedited investigations utilizing "emergency response teams" in cases of "serious financial reporting failures," and presumably more traditional investigations for matters that do not comprise "serious financial reporting failures." n5 According to the PCAOB, these response teams would be composed of staff from the inspections, chief auditor, and disciplinary functions, to investigate whether the auditor involved properly discharged required professional responsibilities. n6

[3] Informal Inquiry

Similar to the SEC's informal investigative process, the PCAOB staff may undertake an "informal inquiry" when it appears to the staff that an act or practice, or an omission to act, by a registered public accounting firm or an associated person may violate the Sarbanes-Oxley Act, the Board's rules, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Sarbanes-Oxley Act, or professional standards. n7 The staff may pursue an informal inquiry by requesting documents, information, or testimony from any person n8 in an informal inquiry; however, the staff, in an informal inquiry, lacks the power to compel such documents or testimony through an Accounting Board Demand. n9

Comment

The focus of the staff's inquiry may not be readily apparent from the staff's request for documents or other information. Retaining counsel at this point is wise, as counsel can contact the staff to seek clarification and information about the staff's inquiry. Individual auditors whose work is the subject of the information request should avoid contacting the staff if possible, as direct contact with the staff could provide the staff with the opportunity to conduct an informal interrogation about the matter being investigated.

In addition, although the PCAOB cannot compel production of documents or testimony during informal inquiries, failure to produce requested documents during the inquiry could be considered lack of cooperation. Moreover, any failure to produce would likely also cause the staff to seek a formal order of investigation to compel their production.

The PCAOB has stated that it expects its staff will not keep informal inquiries open beyond the time reasonably necessary to determine whether a formal investigation is warranted, and that it expects the staff to seek and review any documents relevant to making that determination. Characterization of a PCAOB investigation as an "informal inquiry" should not be taken to mean it is somehow less serious than a formal investigation. Any time an accounting firm or an associated person learns that their conduct is the subject of a PCAOB investigation, the matter should be taken seriously and consideration should be given to retaining outside counsel to assist in responding to the staff's requests.

[4] Formal Investigations

[a] Commencement and Termination

The Board may commence a formal investigation when it appears that an act or practice, or omission to act, by a registered public accounting firm or any person associated with such a firm may violate any provision of the Sarbanes-Oxley Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Sarbanes-Oxley Act, or professional standards. n10 The Board commences an investigation by issuing an order of formal investigation. n11 Like the SEC's Formal Order of Investigation, the Board may, in the formal order, designate Board staff members, or groups of staff members (such as a particular division or office) who are authorized to issue accounting board demands (similar to an investigative subpoena) and otherwise require or request the cooperation of any person in connection with the investigation. Rule 5101(b) provides that the Board may issue an order suspending a formal investigation for a specified period of time or terminating a formal investigation. However, no limitations have been placed on how long an investigation may remain open.

Moreover, there is no procedure for notifying persons involved in an investigation that the investigation has been closed. As with SEC investigations, those whose conduct was examined by the PCAOB during the investigation have no formal process for determining whether the PCAOB has closed an investigation without bringing proceedings against them. The PCAOB has indicated, however, that nothing in its rules prevents the development of a practice by which persons may request that the staff close an investigation, and the Board and its staff may consider such requests. n12 If counsel believes, after some time of inaction by the staff, that a case should be closed, counsel should consider requesting that the matter be closed. This step should only be taken if counsel is comfortable that the staff has completed the investigation and is not likely to bring charges.

[b] Initial Steps in Responding to an Investigation

When a firm first becomes aware of a PCAOB investigation, inside counsel, if any, and senior management should be immediately informed. Counsel should determine, to the extent possible, the scope and focus of the investigation, and what, if any, potential disciplinary exposure exists. The investigation's focus and potential violations may not be readily apparent from the staff's initial request for documents or other information. Counsel should consider engaging the staff in a dialogue early on to attempt to determine the focus of the staff's inquiry. Consideration should also be given to whether the issuer(s) should be notified of the investigation.

A decision should also be made regarding whether outside counsel should be retained. Obtaining counsel experienced in dealing with the PCAOB staff and the Board's rules is highly desirable. Retaining experienced outside counsel early on in the process will help prevent confusing, inadequate, and inadvertently misleading responses to the staff's requests that only lead to more time and labor intensive investigations.

Responding to a PCAOB investigation involves many of the same considerations as those that exist in SEC investigations, such as the following: alerting employees of the existence of the investigation, gathering information and conducting an internal investigation, representing individual associated persons, producing documents, preparing and representing witnesses in testimony before PCAOB staff and preparing pre-charging, Wells-like submissions to the staff. These matters are covered in detail in their respective chapters.

[5] Power to Require Production of Documents and Testimony

The Board's rules require registered public accounting firms and their associated persons n13 to cooperate with Board investigations, including producing documents and providing testimony. The Sarbanes-Oxley Act authorizes the Board to promulgate rules requiring the production of audit workpapers and any other document or information in the

possession of any registered public accounting firm or any associated person of such a firm, wherever domiciled, with respect to any matter that the Board considers relevant or material to an investigation. n14 The PCAOB has taken the position that the scope of its authority to demand documents--via an "accounting board demand"--goes well beyond documents that might be considered "audit workpapers," and includes any document that may be relevant or material to consideration of whether there have been violations of the Sarbanes-Oxley Act, its rules, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the SEC under the Sarbanes-Oxley Act, or professional standards. n15

Comment

As a practical matter, once on notice of a PCAOB investigation--either informal or formal-- firms and their associated persons should make every effort to preserve documents relevant to the investigation regardless of whether such documents are required to be preserved by law or firm policy. Destruction of documents during the course of an investigation will nearly certainly result in a noncooperation charge and likely a referral to the SEC or the United States Attorney's Office.

In addition, the rules permit the PCAOB to seek information from other persons, including clients of registered firms. However, the Board has no legal authority to compel the production of documents or testimony from persons or entities not covered by the Sarbanes-Oxley Act. But the Board does have the authority to request that the SEC issue a subpoena to compel such documents or testimony. Moreover, the PCAOB has indicated that it will not necessarily first seek the voluntary cooperation of such persons before requesting that the SEC issue a subpoena, but instead will make the decision as to when and under what circumstances to make the request on a case-by-case basis.

[6] Testimony

The PCAOB has the authority to compel the testimony of registered firms and their associated persons and to seek an SEC subpoena for other persons and entities. The PCAOB's rules require that testimony be sworn by oath or affirmation. Additionally, the examinations must be conducted before a reporter designated by the Board's staff. While there is no minimum period of notice for testimony, the PCAOB has suggested that it will not be unusual for the staff to provide two to three weeks' notice prior to the date of testimony. n16

Comment

It is likely that testimony will be scheduled at a mutually convenient time. Counsel should not hesitate to ask for additional time to prepare the witness and ensure the witness's availability. See Chapter 10 on preparing a witness for and representing a witness in testimony before the SEC staff.

Similar to SEC rules, there are certain restrictions on who may be present during the examination. Persons who may be present are limited to the witness, the witness's counsel, any member of the Board or the Board's staff, the reporter, and any other person whom the Board or the Staff determines is appropriate to be present. All of these provisions, however, are qualified by the restriction that in no event shall any person (other than the witness) who has been or is reasonably likely to be examined in the investigation be present. This last restriction is not limited to registered public accounting firms and associated persons of such firms, but also includes any other person from whom the Board or the staff could seek to require testimony pursuant to a Commission subpoena. n17

Several commenters to the proposed PCAOB rules suggested that the rules should allow a witness and counsel to be accompanied by a technical expert consultant during testimony as a matter of right, particularly given the highly technical nature of the accounting and auditing issues likely to be at issue. n18 Commenters stated that allowing accounting consultants helps to ensure that a witness's rights are fully protected and helps to produce a better investigative record. n19 The PCAOB adopted the rule as proposed, without modification, arguing that the rule

provided sufficient flexibility for the staff to permit a technical consultant to be present during investigative testimony, and that it expected the staff to allow that presence in appropriate circumstances and on appropriate terms, including, for example, that the consultant not be a partner or employee of the firm with which the witness is associated. The PCAOB noted that it expected the staff to be accommodating, but that it also expected the staff to be vigilant about not permitting a firm's internal personnel effectively to monitor an investigation by sitting in on testimony of all firm personnel. n20 Some firms have staff assigned to their law departments as technical experts for this very purpose in, for example, SEC investigations. It is not yet clear if the PCAOB will allow such firm-employed experts to attend testimony, whether or any other expert for that matter, or the PCAOB has stated that the protections provided by the Administrative Procedure Act are inapplicable to PCAOB proceedings. n21

[7] Privilege Issues

The PCAOB adapted Rule 6.2 of the local rules of the Southern District of New York regarding the provision of certain information, typically in the form of a privilege log, when a person subject to a demand for documents or testimony declines to provide the requested information on the basis of a claim of privilege. Significantly, the failure to supply the required privilege log information is itself a violation of the rule, and may subject a person to a disciplinary proceeding for violation of a Board rule or for noncooperation with an investigation. The PCAOB noted that it is not its intent to invade the province of any legitimately asserted privilege that would be treated as a valid basis for declining to provide documents or information in response to an SEC subpoena, including valid assertions of the privilege against self-incrimination under the *Fifth Amendment*. n22

Comment

The PCAOB has noted, however, that assertions of the *Fifth Amendment* privilege against self-incrimination may be used as evidence in PCAOB disciplinary proceedings and will be the basis for evidentiary inferences against the person asserting the privilege. Asserting the *Fifth Amendment* privilege in the context of a PCAOB investigation should be considered in the broader context of additional investigations by the SEC and criminal authorities and any adverse inferences that may be asserted in those contexts as well.

In addition, the PCAOB has indicated that it will not honor assertions of a state law accountant-client privilege, as they are, in the PCAOB's view, preempted by the Sarbanes-Oxley Act. A failure to comply with an accounting board demand on the basis of an asserted claim of accountant-client privilege will be grounds for a noncooperation sanction. The same is true of any perceived state law nondisclosure requirements. n23

[8] Wells Process

The PCAOB has established a mechanism similar to the SEC's Wells process that allows potential respondents the opportunity to submit written statements setting forth their interests and positions. The same considerations apply to the preparation of this type of submission as apply to the drafting of a Wells submission in an SEC action. n24 In addition, counsel should consider that the audience for the Wells submission might not only be the PCAOB staff and Board, but the SEC, state regulators, and federal prosecutors.

FOOTNOTES:

(n1)Footnote 1. See PCAOB Tips and Information Online Form, at www.pcaobus.org/tips/tips.aspx.

(n2)Footnote 2. These rules are available on the Internet at www.pcaobus.org/rules_of_the_board.asp.

(n3)Footnote 3. PCAOB Rule 5108(a).

(n4)Footnote 4. PCAOB Rule 5112(a).

(n5)Footnote 5. Ken Rankin, *PCAOB Moves Fast to Set up New Enforcement Policies*, Accounting Today, June 2003.

(n6)Footnote 6. Rankin, *PCAOB Moves Fast to Set up New Enforcement Policies*.

(n7)Footnote 7. PCAOB Rule 5100(a).

(n8)Footnote 8. PCAOB Rule 5100(b).

(n9)Footnote 9. An Accounting Board Demand is the PCAOB equivalent of a subpoena issued by the SEC staff pursuant to a Formal Order of Investigation.

(n10)Footnote 10. *See* PCAOB Rule 5101.

(n11)Footnote 11. PCAOB Rule 5101(a)(1).

(n12)Footnote 12. PCAOB Rel. No. 2003-015, Appendix 2 at p. A2-14, September 29, 2003.

(n13)Footnote 13. An "associated person" is defined as "any individual proprietor, partner, shareholder, principal, accountant, or other professional employee of a public accounting firm, or any other independent contractor or entity that, in connection with the preparation or issuance of any audit report (i) shares in the profits of, or receives compensation in any other form from, that firm; or (ii) participates as agent or otherwise on behalf of such accounting firm in any activity of that firm." Sarbanes-Oxley Act § 2(a)(9)(A).

(n14)Footnote 14. Sarbanes-Oxley Act § 105(b)(2)(B).

(n15)Footnote 15. PCAOB Rel. No. 2003-015, App. 2 at A2-23.

(n16)Footnote 16. PCAOB Rel. No. 2003-015, App. 2 at A2-16.

(n17)Footnote 17. PCAOB Rel. No. 2003-015, App. 2 at A2-17-18.

(n18)Footnote 18. *See, e.g.*, April 15, 2004 Comment Letter from Ernst & Young; April 15, 2004 Comment Letter from KPMG LLP; and April 15, 2004 Comment Letter from Deloitte & Touche LLP.

(n19)Footnote 19. Commenters also cited a district court opinion, *S.E.C. v. Whitman*, 613 F. Supp. 48 (D.D.C. 1985) (requiring the Commission to permit an expert consultant to assist counsel during investigative testimony) as authority for the proposition that the Board should allow for the presence of such consultants.

(n20)Footnote 20. PCAOB Rel. No. 2003-015, App. 2 at A2-18-19.

(n21)Footnote 21. PCAOB Rel. No. 2003-015, App. 2 at A2-19 n.1.

(n22)Footnote 22. PCAOB Rel. No. 2003-015, App. 2 at A2-33.

(n23)Footnote 23. PCAOB Rel. No. 2003-015, App. 2 at A2-33-34.

(n24)Footnote 24. *See* Chapter 16 for further guidance.



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CHAPTER 30 PCAOB ENFORCEMENT

2-30 Securities Enforcement: Counseling and Defense § 30.05

AUTHOR: Kenneth B. Winer

§ 30.05 Settlement Process

As of April 2005, the PCAOB had yet to settle any enforcement matter or commence any disciplinary proceeding. However, the PCAOB has established a settlement process adapted from Rule 240 of the SEC's Rules of Practice. n1

Comment

The PCAOB has indicated that it fully expects that the content of settlement negotiations will not be introduced as evidence in PCAOB proceedings. However, it also suggested that any such protections, including understandings with the staff concerning confidentiality, would be accomplished by letter agreements and other agreements specific to the matter and the negotiation. n2 Counsel should therefore take appropriate steps to ensure that the staff is on notice of and agrees to requests for confidentiality of settlement negotiations and that no admissions during negotiations may be introduced as evidence in any subsequent proceeding should negotiations not result in a settlement.

FOOTNOTES:

(n1)Footnote 1. PCAOB Rule 5205.

(n2)Footnote 2. PCAOB Rel. No. 2003-015, App. 2 at A2-73-74.



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CHAPTER 30 PCAOB ENFORCEMENT

2-30 Securities Enforcement: Counseling and Defense § 30.06

AUTHOR: Kenneth B. Winer

§ 30.06 Formal Disciplinary Proceedings

[1] Grounds for Commencement

The PCAOB has established procedural rules for the commencement and conduct of disciplinary proceedings. n1 The PCAOB identified in the Rules three grounds for commencing disciplinary proceedings to determine whether (1) a registered public accounting firm or associated person has violated the Sarbanes-Oxley Act, PCAOB rules, the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including SEC rules issued under the Sarbanes-Oxley Act, or professional standards; (2) the firm or its supervisory personnel failed to reasonably supervise an associated person; or (3) the firm or an associated person failed to comply with an accounting board demand, gave false testimony, or otherwise failed to cooperate in connection with an investigation.

Comment

The PCAOB has clarified that a single negligent act is sufficient grounds to institute a disciplinary proceeding, noting that the Sarbanes-Oxley Act provides that the PCAOB may impose the more severe sanctions authorized by the Sarbanes-Oxley Act in cases that involve intentional or knowing conduct (including reckless conduct) or repeated instances of negligent conduct. Thus, the PCAOB has asserted a provision that implicitly imposes lesser sanctions for a single instance of negligent conduct. n2

[2] Order Instituting Proceedings

PCAOB disciplinary proceedings are commenced similar to SEC administrative proceedings with the issuance by the Board of an order instituting proceedings ("OIP"). The pleading requirements concerning the alleged misconduct vary depending on whether the proceeding alleges violations of the Sarbanes-Oxley Act and the various rules, a failure to supervise, or noncooperation. n3 Although a party is not required to file an answer to the OIP unless ordered to do so in the OIP, a party may elect to file an answer. If a party chooses to file an answer, it must do so within 20 days after service of the OIP. n4

The PCAOB will utilize hearing officers to adjudicate disciplinary proceedings. Hearing officers may not be responsible

to or subject to the supervision or direction of an employee or agent who performs investigative or prosecuting functions for the PCAOB. The PCAOB has indicated that neither a Board member nor any staff of the interested division (Enforcement and Investigations in the case of violations and Registration and Inspections in the case of a denial of registration) will serve as a hearing officer. The PCAOB has stated that it intends to rely on a corps of qualified persons whose service to the Board is strictly limited to the role of hearing officer. It may rely on consultants for this purpose, or it may employ a staff of hearing officers, or a combination of the two. n5 In the interim, the PCAOB utilizes FINRA hearing officers.

Comment

The use of FINRA or lay hearing officers raises critical strategic litigation issues for counsel involved in these early disciplinary proceedings, as educating a hearing officer on the issues may be more akin to litigating before a judge or jury rather than before a technical expert.

[3] Discovery

The PCAOB provides respondents with certain discovery rights. n6 The staff's discovery obligations vary according to whether the proceeding is commenced for violations or failures to reasonably supervise, noncooperation, or disapproval of a registration application. For violations or failures to reasonably supervise, the Division of Enforcement and Investigations must make available for inspection and copying all documents prepared or obtained by the Division in connection with the investigation prior to the institution of proceedings. n7 In addition, the PCAOB adapted Rule 231 of the SEC's Rules of Practice relating to the production of witness statements so that the interested division is required to produce such statements as it would be required to do so pursuant to the Jencks Act if the PCAOB were a governmental agency. n8 However, the Division may decline to produce four categories of documents: (1) documents prepared by a Board member or the Board's staff that have not been disclosed to any person other than Board members, staff or persons retained by the Board or staff to provide services in connection with the investigation or proceeding; (2) any other document that is privileged, including those protected by the attorney work product doctrine; (3) any document that would disclose the identity of a confidential source; and (4) any other document that the staff identifies for the hearing officer's consideration as to whether it may be withheld as not relevant to the subject matter of the proceeding. n9

Comment

The staff may not, however, withhold documents identifying a confidential source if doing so would result in withholding material exculpatory evidence. This makes the PCAOB's rule more closely on track with the SEC's approach with respect to so-called *Brady* material.

The Division is required to produce a privilege log for documents withheld on the basis of privilege, although documents prepared by the Board or its staff and only disclosed to the board and staff are not required to be identified on the privilege log. Thus, only the second category of privileged documents must be identified on the privilege log. The PCAOB has indicated that this category would include documents that were privileged in the hands of the person who supplied them to the Board, but who supplied them pursuant to an understanding that doing so would not otherwise waive the privilege. n10

Comment

Although the rules are not clear, presumably counsel could challenge the assertion of privilege with respect to a particular document by motion to the hearing officer.

In noncooperation proceedings, discovery is substantially limited. The Division is only required to produce documents upon which it intends to rely in seeking a finding of noncooperation. n11 However, documents that contain material

exculpatory evidence on the issue of noncooperation must be produced, irrespective of whether the Division intends to rely on them. n12

For registration disapproval proceedings, the Division of Registration and Inspections must produce all documents obtained by the Division in connection with the registration application prior to the notice of hearing. n13

[4] Other Pre-Hearing Matters

The PCAOB has established additional pre-hearing rules similar to certain of the pre-hearing rules of the SEC Rules of Practice. These include motions for taking the deposition of a witness who will be unable to attend or testify at the hearing, n14 requests for accounting board demands n15 or requests that the Board seek an SEC subpoena to compel documents or testimony for the hearing, n16 and motions for summary disposition. n17

Comment

The SEC has serious concerns regarding the ability of a party during a disciplinary proceeding to seek a Commission subpoena through the Board under PCAOB Rule 5424(b), as any such process would likely be novel and potentially complex. As a result, the SEC and PCAOB must coordinate the development of additional rules and procedures to implement the rule. In late October 2004, the PCAOB issued a proposed rule on procedures relating to subpoena requests, which essentially permit the hearing officer to request that the Board request the issuance of a subpoena by the SEC. The Commission has yet to approve the rule as of April 2005. n18 These additional rules and procedures will address, among other things, the steps that the parties to PCAOB proceedings would need to follow prior to applying for Commission subpoenas, as well as the Commission's processes for handling such requests once they are received. The Commission has stated that it expects that Rule 5424(b) will not be available for use in PCAOB proceedings until these additional rules and procedures have been developed and implemented. n19 As a result, until this rule is clarified, parties to PCAOB hearings may be at a disadvantage in terms of their ability to compel nonregulated entities and persons to provide documents or testimony. Moreover, it is not clear how or who would be permitted to seek enforcement of any subpoena issues by the Commission should the requested party fail to comply.

[5] PCAOB Hearings

PCAOB hearings are not public unless otherwise ordered by the Board. n20 The PCAOB's hearing rules are otherwise similar to the SEC's Rules of Practice. They include provisions for recording the hearings, the admissibility of evidence, objections and offers of proof thereto, and the presentation of evidence at the hearing. The Federal Rules of Evidence do not apply in PCAOB hearings and the hearing officer has wide latitude to admit all relevant evidence. However, the Board expects evidentiary issues to be addressed in a manner similar to SEC administrative hearings and a hearing officer may refer to the principles found in the rules of evidence or other authoritative sources in exercising discretion to resolve evidentiary issues. n21

At the hearing, each party may present its case by oral or documentary evidence, submit rebuttal evidence, and conduct cross-examination. The scope and form of evidence, rebuttal evidence, and cross-examination will be determined by the Board or hearing officer in each proceeding. n22 The interested division bears the burden of proving its case by a preponderance of the evidence. n23 The PCAOB has also established procedures for filing post-hearing briefs. n24

The hearing officer must prepare an initial decision, which includes findings and conclusions, including sanctions, if appropriate, and the reasons therefore. For disciplinary hearings for violations or failures to reasonably supervise, the initial decision must be prepared within 60 days after the deadline for filing post-hearing briefs and other submissions. For noncooperation hearings, the deadline is 30 days, and for registration proceedings, the deadline is 45 days. n25

[6] Appeals

The PCAOB's process for reviewing hearing officer initial decisions is based in part on Rule 410 of the SEC's Rules of Practice. Any party may obtain Board review of an initial decision by filing a petition for review. To be timely, the petition must be filed within 30 days after service of the initial decision on the petitioner for all cases except those involving noncooperation, in which the petition must be filed within ten days of service to be timely. If one party submits a timely petition for review, any other party then has an additional ten days to submit its own petition for review, even if its petition raises different issues than those raised by the first party to submit a petition. According to the PCAOB, this latter ten-day provision is designed to:

avoid the unnecessary expenditure of Board resources in cases where no party would appeal if it knew that the other party would not appeal, but in which one or more parties nevertheless appeal because of a concern that failing to appeal will deprive it of the opportunity to raise issues in any appeal lodged by another party. Under Rule 5460(a), no party need guess about the other party's intentions, and no party sacrifices anything by waiting to see whether another party files a timely petition for review. n26

The PCAOB has established procedures for filing briefs with the Board as well as for oral argument, the submission of additional evidence, and reconsideration of a Board decision. A party may appeal a board decision to the SEC. The Sarbanes-Oxley Act provides that the procedures for Commission review of final disciplinary sanctions imposed by the Board (including sanctions for noncooperation) are the same as those for the SROs under Sections 19(d)(2) and 19(e)(1) of the Securities Exchange Act of 1934. n27

FOOTNOTES:

(n1)Footnote 1. *See* PCAOB Rules 5200-5206.

(n2)Footnote 2. PCAOB Rel. No. 2003-015, App. 2 at A2-58-59.

(n3)Footnote 3. PCAOB Rule 5201(b).

(n4)Footnote 4. PCAOB Rule 5421.

(n5)Footnote 5. PCAOB Rel. No. 2003-015, App. 2 at A2-5.

(n6)Footnote 6. PCAOB Rule 5422.

(n7)Footnote 7. PCAOB Rule 5422(a)(1).

(n8)Footnote 8. PCAOB Rule 5423(a).

(n9)Footnote 9. PCAOB Rule 5422(b)(1).

(n10)Footnote 10. PCAOB Rel. No. 2003-15, App. 2 at A2-101.

(n11)Footnote 11. PCAOB Rule 5422(a)(2).

(n12)Footnote 12. PCAOB Rule 5422(b)(2).

(n13)Footnote 13. PCAOB Rule 5422(a)(3).

(n14)Footnote 14. PCAOB Rule 5425.

(n15)Footnote 15. PCAOB Rule 5424 (a).

(n16)Footnote 16. PCAOB Rule 5424(b).

(n17)Footnote 17. PCAOB Rule 5427.

(n18)Footnote 18. PCAOB Rel. No. 2004-13, October 26, 2004.

(n19)Footnote 19. SEC Rel. No. 34-49704, May 14, 2004.

(n20)Footnote 20. PCAOB Rule 5203.

(n21)Footnote 21. PCAOB Rel. No. 2003-15, App. 2 at A2-113. See Chapter 19 for more information on SEC administrative proceedings.

(n22)Footnote 22. PCAOB Rule 5444.

(n23)Footnote 23. PCAOB Rule 5203(a).

(n24)Footnote 24. PCAOB Rule 5445.

(n25)Footnote 25. PCAOB Rule 5204(b).

(n26)Footnote 26. PCAOB Rel. No. 2003-015, App. 2 at 115-116.

(n27)Footnote 27. Sarbanes-Oxley Act, § 107(c)(2).



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CHAPTER 30 PCAOB ENFORCEMENT

2-30 Securities Enforcement: Counseling and Defense § 30.07

AUTHOR: Kenneth B. Winer

§ 30.07 Sanctions

The PCAOB has a vast array of sanctions under the Sarbanes-Oxley Act for violations and failures to reasonably supervise. These include:

- temporary suspension or permanent revocation of registration,
- temporary or permanent suspension or bar of a person from further association with any registered public accounting firm,
- limitations on the activities, functions or operations of such firms or persons,
- civil money penalties for each violation up to \$750,000 for individuals and \$15 million for entities,
- censure,
- additional professional education and training, requiring a party to engage an independent monitor, to engage counsel or other consultants to design policies to effectuate compliance with the Sarbanes-Oxley Act, to adopt or implement policies or undertake action to improve audit quality or to effectuate compliance with the Sarbanes-Oxley Act, or to obtain independent review and report on one or more engagements.

The most severe sanctions--suspensions, bars, and limitations on activities, as well as the highest level of money penalties--are reserved for conduct requiring scienter or repeated negligence. n1

In addition, a number of sanctions are available for noncooperation cases. These include revocations, bars, suspensions, civil money penalties, censures, limitations on activities, requiring a firm to engage a special master or independent monitor and report on the firm's compliance with accounting board demands, or authorizing the hearing officer to retain jurisdiction to monitor compliance with accounting board demands. n2

Suspensions and bars of individuals can have serious financial consequences, particularly for partners of firms because PCAOB rules require not only that the individual may not become or remain associated with a registered firm, work on audits of issuers, but also that the individual may not share in the profits of, or receive compensation in any other form, from a registered firm in connection with the preparation or issuance of any audit report. n3 A person is thus effectively prohibited from receiving any form of compensation relating to audit work concerning issuers.

FOOTNOTES:

(n1)Footnote 1. Sarbanes-Oxley Act, § 105(c)(5).

(n2)Footnote 2. Sarbanes-Oxley Act, § 105(b)(3)(A); PCAOB Rule 5300(b).

(n3)Footnote 3. PCAOB Rule 5301.



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APPENDIX A Forms, Reports and Memoranda

2-A Securities Enforcement: Counseling and Defense APPENDIX A.syn

§ A.syn Synopsis to Appendix A: Forms, Reports and Memoranda

SEC Testimony Questions

SEC Form 1662 Supplemental Information for Persons Requested to Supply Information Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena

Submissions and Settlements

Freedom of Information Act

Authority for Solicitation of Information

Effect of Not Supplying Information

Principal Uses of Information

Routine Uses of Information

[A.] Sample Consent

[B.] Sample Final Judgement

SEC Summary Financial Disclosure Statement Model Disclosure of Assets and Financial Information Form

[A.] Certification as to Completeness of Document Production

Release No. 44969 / October 23, 2001

U.S. Deputy Attorney General Memorandum

Charging a Corporation: General

Charging a Corporation: Factors to Be Considered

Charging a Corporation: Special Policy Concerns

Charging a Corporation: Pervasiveness of Wrongdoing Within the Corporation

Charging a Corporation: The Corporation's Past History

Charging a Corporation: Cooperation and Voluntary Disclosure

Charging a Corporation: Corporate Compliance Programs

Charging a Corporation: Restitution and Remediation

Charging a Corporation: Collateral Consequences

Charging a Corporation: Non-Criminal Alternatives

Charging a Corporation: Selecting Charges

Plea Agreements with Corporations

FORMAL OPINION 2004-02



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APPENDIX A Forms, Reports and Memoranda

2-A Securities Enforcement: Counseling and Defense Scope

SEC Testimony Questions

Q: Would you state and spell your name for the record?

Q: My name is _____. With me today is _____, _____, and _____.
Mr. _____ and I are attorneys. Mr. _____ and Mr. _____
are accountants. We're all members of the Division of Enforcement of the Securities and Exchange Commission, and we are all officers of the Commission for purposes of this investigation.

We will be asking you questions today. If you don't understand a question, please ask me for clarification. Your attorney will be permitted to object. Unless he objects on the grounds of privilege, you're required to answer the questions posed.

If at any time you need to take a break, please tell me so, and we'll try to accommodate you.

Are you under the influence of any alcohol or medication, or are you suffering from any other condition that would impair your ability to testify clearly and truthfully today?

Q: This is an investigation by the Securities and Exchange Commission in the matter of _____ to determine whether there have been violations of the federal securities laws. However, the facts developed in this investigation might constitute violations of other federal or state civil or criminal laws.

Prior to opening the record, your counsel was provided with a copy of the formal order of investigation in this matter, as supplemented, and it's available for your examination during the course of these proceedings. Have you had an adequate opportunity to review the formal order?

Q: In addition, prior to opening the record, you were provided with a copy of the Commission's supplemental information form, also known as form 1662. That form has been marked as Exhibit 1. Have you had an adequate opportunity to review Exhibit 1?

Q: Do you have any questions regarding Exhibit 1 or the formal order?

Q: Now, you're represented by counsel, in this investigation and at this testimony today, correct?

Q: Would counsel please identify himself, and would the others present on behalf of _____ identify themselves for the record? _____ - _____

Q: Just for clarification, Mr. _____ and Mr. _____ and Ms. _____, are each of you representing _____ in both his personal and professional capacity here today?

A: Yes. Ms. _____ and I are, and Mr. _____ is here assisting me as an expert. SEC: Will you mark this Exhibit 55 a copy of the subpoena that was served on _____ on behalf of _____?



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APPENDIX A Forms, Reports and Memoranda

2-A Securities Enforcement: Counseling and Defense Scope

SEC Form 1662

Supplemental Information for Persons Requested to Supply
Information Voluntarily or Directed to Supply Information
Pursuant to a Commission Subpoena

False Statements and Documents

Section 1001 of Title 18 of the United States Code provides as follows:

Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both.

Testimony

If your testimony is taken, you should be aware of the following:

1. *Record.* Your testimony will be transcribed by a reporter. If you desire to go off the record, please indicate this to the Commission employee taking your testimony, who will determine whether to grant your request. The reporter will not go off the record at your, or your counsel's, direction.
2. *Counsel.* You have the right to be accompanied, represented and advised by counsel of your choice. Your counsel may advise you before, during and after your testimony; question you briefly at the conclusion of your testimony to clarify any of the answers you give during testimony; and make summary notes during your testimony solely for your use. If you are accompanied by counsel, you may consult privately.

If you are not accompanied by counsel, please advise the Commission employee taking your testimony whenever during your testimony you desire to be accompanied, represented and advised by counsel. Your testimony will be adjourned to afford you the opportunity to arrange to do so.

2-A Securities Enforcement: Counseling and Defense Scope

You may be represented by counsel who also represents other persons involved in the Commission's investigation. This multiple representation, however, presents a potential conflict of interest if one client's interests are or may be adverse to another's. If you are represented by counsel who also represents other persons involved in the investigation, the Commission will assume that you and counsel have discussed and resolved all issues concerning possible conflicts of interest. The choice of counsel, and the responsibility for that choice, is yours.

3. *Transcript Availability.* Rule 6 of the Commission's Rules Relating to Investigations, *17 CFR 203.6*, states:

A person who has submitted documentary evidence or testimony in a formal investigative proceeding shall be entitled, upon written request, to procure a copy of his documentary evidence or a transcript of his testimony on payment of the appropriate fees: *Provided, however,* That in a nonpublic formal investigative proceeding the Commission may for good cause deny such request. In any event, any witness, upon proper identification, shall have the right to inspect the official transcript of the witness' own testimony.

If you wish to purchase a copy of the transcript of your testimony, the reporter will provide you with a copy of the appropriate form. Persons requested to supply information voluntarily will be allowed the rights provided by this rule.

4. *Perjury.* Section 1621 of Title 18 of the United States Code provides as follows:

Whoever ... having taken an oath before a competent tribunal, officer, or person, in any case in which a law of the United States authorizes an oath to be administered, that he will testify, declare, depose, or certify truly ... willfully and contrary to such oath states or subscribes any material matter which he does not believe to be true... is guilty of perjury and shall, except as otherwise expressly provided by law, be fined under this title or imprisoned not more than five years or both

5. *Fifth Amendment and Voluntary Testimony.* Information you give may be used against you in any federal, state, local or foreign administrative, civil or criminal proceeding brought by the Commission or any other agency.

You may refuse, in accordance with the rights guaranteed to you by the *Fifth Amendment to the Constitution of the United States*, to give any information that may tend to incriminate you or subject you to fine, penalty or forfeiture.

If your testimony is not pursuant to subpoena, your appearance to testify is voluntary, you need not answer any question, and you may leave whenever you wish. Your cooperation is, however, appreciated.

6. *Formal Order Availability.* If the Commission has issued a formal order of investigation, it will be shown to you during your testimony, at your request. If you desire a copy of the formal order, please make your request in writing.



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Submissions and Settlements

Rule 5(c) of the Commission's Rules on Informal and Other Procedures, *17 CFR 202.5(c)*, states:

Persons who become involved in ... investigations may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation. Upon request, the staff, in its discretion, may advise such persons of the general nature of the investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a staff recommendation to the Commission for the commencement of an administrative or injunction proceeding. Submissions by interested persons should be forwarded to the appropriate Division Director, Regional Director, or District Administrator with a copy to the staff members conducting the investigation and should be clearly referenced to the specific investigation to which they relate. In the event a recommendation for the commencement of an enforcement proceeding is presented by the staff, any submissions by interested persons will be forwarded to the Commission in conjunction with the staff memorandum.

The staff of the Commission routinely seeks to introduce submissions made pursuant to Rule 5(c) as evidence in Commission enforcement proceedings, when the staff deems appropriate.

Rule 5(f) of the Commission's Rules on Informal and Other Procedures, *17 CFR 202.5(f)*, states:

In the course of the Commission's investigations, civil lawsuits, and administrative proceedings, the staff, with appropriate authorization, may discuss with persons involved the disposition of such matters by consent, by settlement, or in some other manner. It is the policy of the Commission, however, that the disposition of any such matter may not, expressly or impliedly, extend to any criminal charges that have been, or may be, brought against any such person or any recommendation with respect thereto. Accordingly, any person involved in an enforcement matter before the Commission who consents, or agrees to consent, to any judgment or order does so solely for the purpose of resolving the claims against him in that investigative, civil, or administrative matter and not for the purpose of resolving any criminal charges that have been, or might be, brought against him. This policy reflects the fact that neither the Commission nor its staff has the authority or responsibility for instituting, conducting, settling, or

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otherwise disposing of criminal proceedings. That authority and responsibility are vested in the Attorney General and representatives of the Department of Justice.



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Freedom of Information Act

The Freedom of Information Act, 5 U.S.C. 552 (the "FOIA"), generally provides for disclosure of information to the public. Rule 83 of the Commission's Rules on Information and Requests, 17 CFR 200.83, provides a procedure by which a person can make a written request that information submitted to the Commission not be disclosed under the FOIA. That rule states that no determination as to the validity of such a request will be made until a request for disclosure of the information under the FOIA is received. Accordingly, no response to a request that information not be disclosed under the FOIA is necessary or will be given until a request for disclosure under the FOIA is received. If you desire an acknowledgment of receipt of your written request that information not be disclosed under the FOIA, please provide a duplicate request, together with a stamped, self-addressed envelope.



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Authority for Solicitation of Information

Persons Directed to Supply Information Pursuant to Subpoena. The authority for requiring production of information is set forth in the subpoena. Disclosure of the information to the Commission is mandatory, subject to the valid assertion of any legal right or privilege you might have.

Persons Requested to Supply Information Voluntarily. One or more of the following provisions authorizes the Commission to solicit the information requested: Sections 19 and/or 20 of the Securities Act of 1933; Section 21 of the Securities Exchange Act of 1934; Section 321 of the Trust Indenture Act of 1939; Section 42 of the Investment Company Act of 1940; Section 209 of the Investment Advisers Act of 1940; and *17 CFR 202.5*. Disclosure of the requested information to the Commission is voluntary on your part.



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Effect of Not Supplying Information

Persons Directed to Supply Information Pursuant to Subpoena. If you fail to comply with the subpoena, the Commission may seek a court order requiring you to do so. If such an order is obtained and you thereafter fail to supply the information, you may be subject to civil and/or criminal sanctions for contempt of court. In addition, if the subpoena was issued pursuant to the Securities Exchange Act of 1934, the Investment Company Act of 1940, and/or the Investment Advisers Act of 1940, and if you, without just cause, fail or refuse to attend and testify, or to answer any lawful inquiry, or to produce books, papers, correspondence, memoranda, and other records in compliance with the subpoena, you may be found guilty of a misdemeanor and fined not more than \$1,000 or imprisoned for a term of not more than one year, or both.

Persons Requested to Supply Information Voluntarily. There are no direct sanctions and thus no direct effects for failing to provide all or any part of the requested information.



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Principal Uses of Information

The Commission's principal purpose in soliciting the information is to gather facts in order to determine whether any person has violated, is violating, or is about to violate any provision of the federal securities laws or rules for which the Commission has enforcement authority, such as rules of securities exchanges and the rules of the Municipal Securities Rulemaking Board. Facts developed may, however, constitute violations of other laws or rules. Information provided may be used in Commission and other agency enforcement proceedings. Unless the Commission or its staff explicitly agrees to the contrary in writing, you should not assume that the Commission or its staff acquiesces in, accedes to, or concurs or agrees with, any position, condition, request, reservation of right, understanding, or any other statement that purports, or may be deemed, to be or to reflect a limitation upon the Commission's receipt, use, disposition, transfer, or retention, in accordance with applicable law, of information provided.



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Routine Uses of Information

The Commission often makes its files available to other governmental agencies, particularly United States Attorneys and state prosecutors. There is a likelihood that information supplied by you will be made available to such agencies where appropriate. Whether or not the Commission makes its files available to other governmental agencies is, in general, a confidential matter between the Commission and such other governmental agencies.

Set forth below is a list of the routine uses which may be made of the information furnished.

1. To coordinate law enforcement activities between the SEC and other federal, state, local or foreign law enforcement agencies, securities self-regulatory organizations, and foreign securities authorities.
2. By SEC personnel for purposes of investigating possible violations of, or to conduct investigations authorized by, the federal securities laws.
3. Where there is an indication of a violation or potential violation of law, whether civil, criminal or regulatory in nature, and whether arising by general statute or particular program statute, or by regulation, rule or order issued pursuant thereto, the relevant records in the system of records may be referred to the appropriate agency, whether federal, state, or local, a foreign governmental authority or foreign securities authority, or a securities self-regulatory organization charged with the responsibility of investigating or prosecuting such violation or charged with enforcing or implementing the statute or rule, regulation or order issued pursuant thereto.
4. In any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity.
5. To a federal, state, local or foreign governmental authority or foreign securities authority maintaining civil, criminal or other relevant enforcement information or other pertinent information, such as current licenses, if necessary to obtain information relevant to an agency decision concerning the hiring or retention of an employee, the issuance of a security clearance, the letting of a contract, or the issuance of a license, grant or other benefit.
6. To a federal, state, local or foreign governmental authority or foreign securities authority, in response to its request, in

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connection with the hiring or retention of an employee, the issuance of a security clearance, the reporting of an investigation of an employee, the letting of a contract, or the issuance of a license, grant or other benefit by the requesting agency, to the extent that the information is relevant and necessary to the requesting agency's decision on the matter.

7. In connection with proceedings by the Commission pursuant to Rule 102(e) of its Rules of Practice, *17 CFR 201.102(e)*.

8. When considered appropriate, records in this system may be disclosed to a bar association, the American Institute of Certified Public Accountants, a state accountancy board or other federal, state, local or foreign licensing or oversight authority, foreign securities authority, or professional association or self-regulatory authority performing similar functions, for possible disciplinary or other action.

9. In connection with investigations or disciplinary proceedings by a state securities regulatory authority, a foreign securities authority, or by a self-regulatory organization involving one or more of its members.

10. As a data source for management information for production of summary descriptive statistics and analytical studies in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies, and to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act or to locate specific individuals for personnel research or other personnel management functions.

11. In connection with their regulatory and enforcement responsibilities mandated by the federal securities laws (as defined in Section 3(a)(47) of the Securities Exchange Act of 1934, *15 U.S.C. 78c(a)(47)*), or state or foreign laws regulating securities or other related matters, records may be disclosed to national securities associations that are registered with the Commission, the Municipal Securities Rulemaking Board, the Securities Investor Protection Corporation, the federal banking authorities, including but not limited to, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, state securities regulatory or law enforcement agencies or organizations, or regulatory law enforcement agencies of a foreign government, or foreign securities authority.

12. To any trustee, receiver, master, special counsel, or other individual or entity that is appointed by a court of competent jurisdiction or as a result of an agreement between the parties in connection with litigation or administrative proceedings involving allegations of violations of the federal securities laws (as defined in Section 3(a)(47) of the Securities Exchange Act of 1934, *15 U.S.C. 78c(a)(47)*) or the Commission's Rules of Practice, *17 CFR 202.100 - 900*, or otherwise, where such trustee, receiver, master, special counsel or other individual or entity is specifically designated to perform particular functions with respect to, or as a result of, the pending action or proceeding or in connection with the administration and enforcement by the Commission of the federal securities laws or the Commission's Rules of Practice.

13. To any persons during the course of any inquiry or investigation conducted by the Commission's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.

14. To any person with whom the Commission contracts to reproduce, by typing, photocopy or other means, any record within this system for use by the Commission and its staff in connection with their official duties or to any person who is utilized by the Commission to perform clerical or stenographic functions relating to the official business of the Commission.

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15. Inclusion in reports published by the Commission pursuant to authority granted in the federal securities laws (as defined in Section 3(a)(47) of the Securities Exchange Act of 1934, *15 U.S.C. 78c(a)(47)*).
16. To members of advisory committees that are created by the Commission or by the Congress to render advice and recommendations to the Commission or to the Congress, to be used solely in connection with their official designated functions.
17. To any person who is or has agreed to be subject to the Commission's Rules of Conduct, *17 CFR 200.735-1 to 735-18*, and who assists in the investigation by the Commission of possible violations of federal securities laws (as defined in Section 3(a)(47) of the Securities Exchange Act of 1934, *15 U.S.C. 78c(a)(47)*), in the preparation or conduct of enforcement actions brought by the Commission for such violations, or otherwise in connection with the Commission's enforcement or regulatory functions under the federal securities laws.
18. Disclosure may be made to a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
19. To respond to inquiries from Members of Congress, the press and the public which relate to specific matters that the Commission has investigated and to matters under the Commission's jurisdiction.
20. To prepare and publish information relating to violations of the federal securities laws as provided in *15 U.S.C. 78c(a)(47)*, as amended.
21. To respond to subpoenas in any litigation or other proceeding.
22. To a trustee in bankruptcy.
23. To any governmental agency, governmental or private collection agent, consumer reporting agency or commercial reporting agency, governmental or private employer of a debtor, or any other person, for collection, including collection by administrative offset, federal salary offset, tax refund offset, or administrative wage garnishment, of amounts owed as a result of Commission civil or administrative proceedings.

Small Business Owners: The SEC always welcomes comments on how it can better assist small businesses. If you have comments about the SEC's enforcement of the securities laws, please contact the Office of Chief Counsel in the SEC's Division of Enforcement at 202-942 -4530 or the SEC's Small Business Ombudsman at 202-942 -2950. If you would prefer to comment to someone outside of the SEC, you can contact the Small Business Regulatory Enforcement Ombudsman toll free at 888- REG-FAIR. The Ombudsman's office receives comments from small businesses and annually evaluates federal agency enforcement activities for their responsiveness to the special needs of small business.



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Sample Consent

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Sample Final Judgement

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SEC Summary Financial Disclosure Statement
Model Disclosure of Assets and Financial Information Form

Instructions:

The Commission's Rules of Practice provide that under certain circumstances a respondent who asserts or intends to assert an inability to pay disgorgement, interest or penalties may be required to disclose certain financial information. *See* Rules 410 and 630. Unless otherwise ordered, this form may be used by individuals required to supply such information. Partnerships, corporations or other entities should submit a financial statement, including an income statement, balance sheet and federal tax returns for each year from the year of the earliest violation alleged against the entity in the order instituting proceedings to the present.

The respondent filing this form is required promptly to notify the Commission of any material change in the answer to any question on this form.

A respondent making financial information disclosures on this form or in another manner pursuant to the requirements of Rule 410 or Rule 630 may submit the form with a motion for a protective order pursuant to Rule 322 of the Commission's Rules of Practice. Any other person submitting this form may request that the Commission afford the information submitted confidential treatment under the Freedom of Information Act under the Commission's Freedom of Information Act ("FOIA") regulations, *see 17 CFR 200.83*. A request for confidential treatment allows the requester an opportunity to justify the need for confidentiality. A request for confidential treatment does not, however, guarantee confidentiality.

Notwithstanding any request for a protective order or for confidential treatment, copies of the financial disclosure statement shall be served on the interested division and will be included in the record of the proceeding. *See* Rule 630(d). If confidential treatment is sought, notice that a financial disclosure statement and request for confidential treatment have been filed shall be served on all other parties.

No party receiving information for which confidential treatment has been requested may transfer or convey the information to any person or entity not a party to the proceeding without the prior permission of the Commission or a hearing officer. SEC Summary Financial Disclosure Statement

United States of America
Before the
Securities and Exchange Commission

| | | | |
|------------------|--|---|---------------------|
| _____ | |) | |
| | |) | Administrative |
| In the Matter of | |) | Proceeding File No. |
| _____ | |) | 3-_____ |
| | |) | |
| _____ | |) | |

Part I: Summary Financial Disclosure Statement

Full Name: _____
Last First Middle

A. Net Worth

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3. Net _____
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B. Income and Payments Received

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**United States of America
Before the
Securities and Exchange Commission**

))
Administrative

2-A Securities Enforcement: Counseling and Defense Scope

In the Matter of _____) Proceeding File No.
 _____) 3-_____
 _____)

Part II: Detailed Financial Disclosure Information

Full Name: _____
 Last First Middle

If this form is filled out by a respondent requesting a protective order pursuant to Rule of Practice 322 (*17 CFR 201.322*), please check the box below.

PROTECTIVE ORDER REQUESTED. Disclosure of this document is prohibited unless specifically authorized below. This document should be placed in a nonpublic file.

For Use Only by the Secretary of the Commission:

By order of _____(date), the Commission authorized this form to be placed in a public file.

(Signature of Secretary) _____

A. Scope of Information Requested:

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B. Assets:

List all assets owned by you, directly or indirectly, and all assets that are subject to your enjoyment or control, regardless of whether legal title or ownership is held in your name.

C Liabilities:

List all your liabilities including, but not limited to, the items listed below.

2-A Securities Enforcement: Counseling and Defense Scope

| | | | |
|----|----------------|----|-------------|
| 1. | Cash _____ | 1. | Mor _____ |
| | — | | tgag _____ |
| | | | es _____ |
| | | | — |
| 2. | Listed _____ | 2. | Aut _____ |
| | Securit- _____ | | o _____ |
| | ies — | | Loa _____ |
| | | | ns — |
| 3. | Sur- _____ | 3. | Cred _____ |
| | render — | | it _____ |
| | Value _____ | | Card _____ |
| | of In- _____ | | Debt — |
| | surance — | | |
| 4. | Loans, _____ | 4. | Mar- _____ |
| | Notes, _____ | | gin _____ |
| | Ac- _____ | | Loa _____ |
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| | You _____ | | |
| 5. | Real _____ | 5. | In- _____ |
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| | | | Loa _____ |
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| 6. | Fur- _____ | 6. | In- _____ |
| | niture — | | stall _____ |
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| | | | Loa _____ |
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| 7. | Jew- _____ | 7. | Oth- _____ |
| | elry, _____ | | er _____ |
| | Art, _____ | | Loa _____ |
| | Rugs, _____ | | ns, — |
| | Silver _____ | | Note _____ |
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| | lect- _____ | | Ac- _____ |
| | ibles, _____ | | coun _____ |
| | Other _____ | | ts _____ |
| | Valu- _____ | | Pay- _____ |
| | ables — | | able _____ |
| 8. | Auto- _____ | 8. | Ac- _____ |
| | mobiles — | | crue _____ |
| | | | d _____ |

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 -

14. Total _____ **11.** **Tot** _____
Assets _ **al** _____
Li- _____
abil- _____
ities _____

D. Net Worth _____
 (Assets Less Liabilities) _____

E. Income/Payments Received

List all income or other payments received from any source in the last 12 months by you, or by any other person or entity if you have any right, power or authority to control or enjoy the use of the money or property received by such other person or entity. Identify the source, the recipient and the amount of payment, including but not limited to the items listed below.

| | Descrip- tion/ Purpose | Source | Amount |
|----|--|---------------|---------------|
| 1. | Sala ry/ Wag es | _____ | _____ |
| 2. | Com mis- sion s/ Ad- vanc es | _____ | _____ |
| 3. | Bo- nuse s | _____ | _____ |
| 4. | Di- vide nds | _____ | _____ |
| 5. | In- teres t | _____ | _____ |
| 6. | Dis- tri- | _____ | _____ |

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| | | | |
|-----|---|-------|-------|
| | bu- tions of Cap- ital | | |
| 7. | An- nu- ity, Pen- sion Pay- men ts | _____ | _____ |
| 8. | Rent s/ Roy al- ties (net) | _____ | _____ |
| 9. | Sale s of As- sets (net) | _____ | _____ |
| 10. | Re- pay- men t of Loa ns | _____ | _____ |
| 11. | Ali- mon y/ Chil d Sup- port | _____ | _____ |
| 12. | Gift s over \$1,0 00 | _____ | _____ |
| 13. | Pay- men ts by Oth- ers on | _____ | _____ |

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16. If you anticipate unusual income in the coming 12 months, please explain.

F. Ex-
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List all your expenditures for the past 12 months, including but not limited to the items listed below. Identify the purpose and the amount of each expenditure.

| | Description | Amount |
|----|------------------------|---------------|
| 1. | Mort- gage/ Rent | _____ |
| 2. | Food | _____ |
| 3. | Utilit- | _____ |

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- ies
- 4. Pay-
ments
on
Loans _____
- 5. Real
Estate
Taxes _____
- 6. Insur-
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ums _____
- 7. Medic-
al Ex-
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- 8. Auto-
mobile
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penses _____
- 9. Ali-
mony/
Child
Support _____
- 10. Income
Taxes
(federal
, state
and
local) _____
- 11. Other
Ex-
penses
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12. **Total** _____
Ex-
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Dis-
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13. If you anticipate unusual expenses in the coming 12 months, please describe them.

G. Asset Schedules

1. For each asset or class of assets included in Section II.B(5-13) with a fair market value greater than \$2,000, describe the asset(s), state the

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, appraisal, comparison, estimate, etc.).

2. List all securities or commodities brokerage accounts and accounts at banks or other financial institutions in your name, under your control, in which

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t, account number, balance and balance date. Please identify all accounts, regardless of their location.

3. List all 401(k) plans, pension plans, Keogh plans, individual retirement accounts, profi

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H. Liability Schedules

1. For each liability greater than \$2,000 listed in Section II.C., indicate the creditor,

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liabilities. Include any notes on which you are a co-maker, guarantor or endorser and all pending lawsuits in which you are named as a defendant.

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List any other names (including a maiden name) you have used.

If currently married, please state your spouse's name, age and social security number, whether or not he or she resides with you, and the date of your marriage.

If you have previously been married, please state the name of your former spouse(s) and the date of your marriage(s). If the date of a marriage was after the date of the first violation alleged against you, include your former spouse's social security number and last known address.

Identify all dependents. For each, please state his or her age, social security number, and whether or not he or she resides with you.

Identify any other members of your household. For each, please state his or her age and relationship to

you.

K. Attachments:

1. Attach any federal tax returns filed by you (including personal, trust, or business returns) for the year of the first violation alleged against you and all subsequent years.
2. Attach any federal gift tax returns filed by you for the year of the first violation alleged against you and all subsequent years.
3. Attach any financial statement that you prepared for any purpose (*e.g.*, a financial statement provided to a bank to secure a loan) in the year of the first violation alleged against you and all subsequent years.
4. If you are a trustee, executor or administrator, attach a copy of the instrument appointing you as such.
5. List of Attachments Submitted With This Form:
Please list all financial statements, tax returns and other materials

submitted with this form. Do not submit originals. Make sure all copies are legible. Illegible copies do not satisfy the requirements for filing your financial disclosure information.

L. Declarations and Signature

I, _____, hereby declare under penalty of perjury that I have examined the information given in this statement and attached hereto and, to the best of my knowledge and belief, it is true, correct, and complete. I further declare that I have no assets, owned either directly or indirectly, or income of any nature other than as shown in, or attached to, this statement. I understand that any material misstatements or omissions made by me herein, or in any attachments hereto, may constitute criminal violations, punishable under *18 U.S.C. 1001* or other statutes.

The Securities and Exchange Commission and any of its staff are authorized to obtain any such information from credit bureaus, financial institutions or any other source as may be needed to verify the statements made on this form.

The statements herein and attached hereto represent my financial condition as of _____ (date).

_____ (signature) _____ (date)

Sworn before me this _____ day of _____, 200_____.

[Seal]

_____ Notary Public

My commission expires on _____ (date)

FOOTNOTES:

(n1)Footnote *. If this amount, divided by 12, does not equal your current monthly income, please explain the discrepancy on an attached sheet.

(n2)Footnote *. If this amount, divided by 12, does not equal your current monthly expenses, please explain the discrepancy on an attached sheet.



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APPENDIX A Forms, Reports and Memoranda

2-A Securities Enforcement: Counseling and Defense [A.]

Certification as to Completeness of Document Production

[Certification form for individuals]

CERTIFICATION AS TO COMPLETENESS OF DOCUMENT PRODUCTION

_____ hereby certifies as follows:

1. I hereby acknowledge and agree that in settling enforcement action against me the Commission has relied upon the completeness of, among other things, my production of documents in response to all Commission subpoenas, document requests, and requests for voluntary production of documents to me in connection with this matter, subject to any modifications agreed to in writing by Commission staff ("the Commission's Document Demands").
2. I have made a diligent search of all files in my possession, custody, or control that are reasonable likely to contain documents responsive to the Commission's Document Demands, including but not limited to general file areas, off-site document files, e-mail and archive files, and all other original and back-up electronic and computer files and systems. I understand that documents and files in my possession, custody, or control include documents and files that I have a legal right to obtain from any other person or company, including but not limited to my present and former attorneys, accountants, and insurers.
3. To the best of my knowledge, all responsive documents in my possession, custody, or control have been produced to the Commission or identified in a privilege log submitted to the Commission. I have a good faith basis to believe that a bona fide privilege, recognized under applicable law, applies to each responsive document identified on a privilege log and not produced to the Commission.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on **[date]**.

[Name]

[Address]

2-A Securities Enforcement: Counseling and Defense [A.]

[Telephone number]

[Certification form for entities]

CERTIFICATION AS TO COMPLETENESS OF DOCUMENT PRODUCTION

_____ [name of signatory], the _____ [title] of _____ [name of entity] (the "Recipient"), hereby certifies as follows:

1. The Recipient hereby acknowledges and agrees that in settling enforcement action against the Recipient the Commission has relied upon the completeness of, among other things, the Recipient's production of documents in response to all Commission subpoenas, document requests, and requests for voluntary production of documents to the Recipient in connection with this matter, subject to any modifications agreed to in writing by Commission staff ("the Commission's Document Demands").

2. I have made diligent inquiry of and requested production from all of the Recipient's officers, directors, employees, and agents reasonably likely to have possession of documents responsive to the Commission's Document Demands. In addition, a diligent search has been made of all other files in Recipient's possession, custody, or control that are reasonable likely to contain responsive documents, including but not limited to general file areas, off-site document files, e-mail and archive files, and all other original and back-up electronic and computer files and systems. I understand that documents and files in Recipient's possession, custody, or control include documents and files that Recipient has a legal right to obtain from any other person or company, including but not limited to my present and former attorneys, accountants, and insurers.

3. To the best of my knowledge, all responsive documents in the possession, custody, or control of the Recipient and its officers, directors, employees, and agents have been produced to the Commission or identified in a privilege log submitted to the Commission. The Recipient has a good faith basis to believe that a bona fide privilege, recognized under applicable law, applies to each responsive document identified on a privilege log and not produced to the Commission.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on **[date]**.

[Name]

[Address]

[Telephone number]



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Release No. 44969 / October 23, 2001

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 1470 / October 23, 2001

Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions

Today, we commence and settle a cease-and-desist proceeding against Gisela de Leon-Meredith, former controller of a public company's subsidiary. n1 Our order finds that Meredith caused the parent company's books and records to be inaccurate and its periodic reports misstated, and then covered up those facts.

We are not taking action against the parent company, given the nature of the conduct and the company's responses. Within a week of learning about the apparent misconduct, the company's internal auditors had conducted a preliminary review and had advised company management who, in turn, advised the Board's audit committee, that Meredith had caused the company's books and records to be inaccurate and its financial reports to be misstated. The full Board was advised and authorized the company to hire an outside law firm to conduct a thorough inquiry. Four days later, Meredith was dismissed, as were two other employees who, in the company's view, had inadequately supervised Meredith; a day later, the company disclosed publicly and to us that its financial statements would be restated. The price of the company's shares did not decline after the announcement or after the restatement was published. The company pledged and gave complete cooperation to our staff. It provided the staff with all information relevant to the underlying violations. Among other things, the company produced the details of its internal investigation, including notes and transcripts of interviews of Meredith and others; and it did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation.

The company also strengthened its financial reporting processes to address Meredith's conduct -- developing a detailed closing process for the subsidiary's accounting personnel, consolidating subsidiary accounting functions under a parent company CPA, hiring three new CPAs for the accounting department responsible for preparing the subsidiary's financial statements, redesigning the subsidiary's minimum annual audit requirements, and requiring the parent company's controller to interview and approve all senior accounting personnel in its subsidiaries' reporting processes.

2-A Securities Enforcement: Counseling and Defense Scope

Our willingness to credit such behavior in deciding whether and how to take enforcement action benefits investors as well as our enforcement program. When businesses seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more promptly. n2 In setting forth the criteria listed below, we think a few caveats are in order:

First, the paramount issue in every enforcement judgment is, and must be, what best protects investors. There is no single, or constant, answer to that question. Self-policing, self-reporting, remediation and cooperation with law enforcement authorities, among other things, are unquestionably important in promoting investors' best interests. But, so too are vigorous enforcement and the imposition of appropriate sanctions where the law has been violated. Indeed, there may be circumstances where conduct is so egregious, and harm so great, that no amount of cooperation or other mitigating conduct can justify a decision not to bring any enforcement action at all. In the end, no set of criteria can, or should, be strictly applied in every situation to which they may be applicable.

Second, we are not adopting any rule or making any commitment or promise about any specific case; nor are we in any way limiting our broad discretion to evaluate every case individually, on its own particular facts and circumstances. Conversely, we are not conferring any "rights" on any person or entity. We seek only to convey an understanding of the factors that may influence our decisions.

Third, we do not limit ourselves to the criteria we discuss below. By definition, enforcement judgments are just that -- judgments. Our failure to mention a specific criterion in one context does not preclude us from relying on that criterion in another. Further, the fact that a company has satisfied all the criteria we list below will not foreclose us from bringing enforcement proceedings that we believe are necessary or appropriate, for the benefit of investors.

In brief form, we set forth below some of the criteria we will consider in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation -- from the extraordinary step of taking no enforcement action to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents we use to announce and resolve enforcement actions.

1. What is the nature of the misconduct involved? Did it result from inadvertence, honest mistake, simple negligence, reckless or deliberate indifference to indicia of wrongful conduct, willful misconduct or unadorned venality? Were the company's auditors misled?
2. How did the misconduct arise? Is it the result of pressure placed on employees to achieve specific results, or a tone of lawlessness set by those in control of the company? What compliance procedures were in place to prevent the misconduct now uncovered? Why did those procedures fail to stop or inhibit the wrongful conduct?
3. Where in the organization did the misconduct occur? How high up in the chain of command was knowledge of, or participation in, the misconduct? Did senior personnel participate in, or turn a blind eye toward, obvious indicia of misconduct? How systemic was the behavior? Is it symptomatic of the way the entity does business, or was it isolated?
4. How long did the misconduct last? Was it a one-quarter, or one-time, event, or did it last several years? In the case of a public company, did the misconduct occur before the company went public? Did it facilitate the company's ability to go public?
5. How much harm has the misconduct inflicted upon investors and other corporate constituencies? Did the share price of the company's stock drop significantly upon its discovery and disclosure?
6. How was the misconduct detected and who uncovered it?
7. How long after discovery of the misconduct did it take to implement an effective response?

2-A Securities Enforcement: Counseling and Defense Scope

8. What steps did the company take upon learning of the misconduct? Did the company immediately stop the misconduct? Are persons responsible for any misconduct still with the company? If so, are they still in the same positions? Did the company promptly, completely and effectively disclose the existence of the misconduct to the public, to regulators and to self-regulators? Did the company cooperate completely with appropriate regulatory and law enforcement bodies? Did the company identify what additional related misconduct is likely to have occurred? Did the company take steps to identify the extent of damage to investors and other corporate constituencies? Did the company appropriately recompense those adversely affected by the conduct?

9. What processes did the company follow to resolve many of these issues and ferret out necessary information? Were the Audit Committee and the Board of Directors fully informed? If so, when?

10. Did the company commit to learn the truth, fully and expeditiously? Did it do a thorough review of the nature, extent, origins and consequences of the conduct and related behavior? Did management, the Board or committees consisting solely of outside directors oversee the review? Did company employees or outside persons perform the review? If outside persons, had they done other work for the company? Where the review was conducted by outside counsel, had management previously engaged such counsel? Were scope limitations placed on the review? If so, what were they?

11. Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation? Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law? Did the company produce a thorough and probing written report detailing the findings of its review? Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered? Did the company ask its employees to cooperate with our staff and make all reasonable efforts to secure such cooperation? n3

12. What assurances are there that the conduct is unlikely to recur? Did the company adopt and ensure enforcement of new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct? Did the company provide our staff with sufficient information for it to evaluate the company's measures to correct the situation and ensure that the conduct does not recur?

13. Is the company the same company in which the misconduct occurred, or has it changed through a merger or bankruptcy reorganization?

We hope that this Report of Investigation and Commission Statement will further encourage self-policing efforts and will promote more self-reporting, remediation and cooperation with the Commission staff. We welcome the constructive input of all interested persons. We urge those who have contributions to make to direct them to our Division of Enforcement. The public can be confident that all such communications will be fairly evaluated not only by our staff, but also by us. We continue to reassess our enforcement approaches with the aim of maximizing the benefits of our program to investors and the marketplace.

By the Commission (Chairman Pitt, Commissioner Hunt, Commissioner Unger).

FOOTNOTES:

(n3)Footnote 1. *In the Matter of Gisela de Leon-Meredith*, Exchange Act Release No. 44970 (October 23, 2001).

(n4)Footnote 2. We note that the federal securities laws and other legal requirements and guidance also promote and even require a certain measure of self-policing, self-reporting and remediation. *See, e.g.*, Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1 (requiring issuers and auditors to report certain illegal conduct to the Commission); *In the Matter of W.R. Grace & Co.*, Exchange Act Release No. 39157 (Sept. 30, 1997) (emphasizing

the affirmative responsibilities of corporate officers and directors to ensure that shareholders receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the federal securities laws); *In the Matter of Cooper Companies, Inc.*, Exchange Act Release No. 35082 (Dec. 12, 1994) (emphasizing responsibility of corporate directors in safeguarding the integrity of a company's public statements and the interests of investors when evidence of fraudulent conduct by corporate management comes to their attention); *In the Matter of John Gutfreund*, Exchange Act Release No. 31554 (Dec. 3, 1992) (sanctions imposed against supervisors at broker-dealer for failing promptly to bring misconduct to attention of the government). *See also Federal Sentencing Guidelines § 8C2.5(f) & (g)* (organization's "culpability score" decreases if organization has an effective program to prevent and detect violations of law or if organization reports offense to governmental authorities prior to imminent threat of disclosure or government investigation and within reasonably prompt time after becoming aware of the offense); *New York Stock Exchange Rules 342.21 & 351(e)* (members and member organizations required to review certain trades for compliance with rules against insider trading and manipulation, to conduct prompt internal investigations of any potentially violative trades, and to report the status and/or results of such internal investigations).

(n5)Footnote 3. In some cases, the desire to provide information to the Commission staff may cause companies to consider choosing not to assert the attorney-client privilege, the work product protection and other privileges, protections and exemptions with respect to the Commission. The Commission recognizes that these privileges, protections and exemptions serve important social interests. In this regard, the Commission does not view a company's waiver of a privilege as an end in itself, but only as a means (where necessary) to provide relevant and sometimes critical information to the Commission staff. Thus, the Commission recently filed an *amicus* brief arguing that the provision of privileged information to the Commission staff pursuant to a confidentiality agreement did not necessarily waive the privilege as to third parties. *Brief of SEC as Amicus Curiae, McKesson HBOC, Inc.*, No. 99-C-7980-3 (Ga. Ct. App. Filed May 13, 2001). Moreover, in certain circumstances, the Commission staff has agreed that a witness' production of privileged information would not constitute a subject matter waiver that would entitle the staff to receive further privileged information.



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U.S. Deputy Attorney General Memorandum

U.S. Department of Justice

Office of the Deputy Attorney General

The Deputy Attorney General

Washington, D.C. 20530

January 20, 2003

MEMORANDUM

TO: Heads of Department Components
United States Attorneys

FROM: Larry D. Thompson
Deputy Attorney General

SUBJECT: Principles of Federal Prosecution of Business Organizations

As the Corporate Fraud Task Force has advanced in its mission, we have confronted certain issues in the principles for the federal prosecution of business organizations that require revision in order to enhance our efforts against corporate fraud. While it will be a minority of cases in which a corporation or partnership is itself subjected to criminal charges, prosecutors and investigators in every matter involving business crimes must assess the merits of seeking the conviction of the business entity itself.

Attached to this memorandum are a revised set of principles to guide Department prosecutors as they make the decision whether to seek charges against a business organization. These revisions draw heavily on the combined efforts of the Corporate Fraud Task Force and the Attorney General's Advisory Committee to put the results of more than three years of experience with the principles into practice.

The main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation. Too often business organizations, while purporting to cooperate with a Department investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation. The revisions make

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clear that such conduct should weigh in favor of a corporate prosecution. The revisions also address the efficacy of the corporate governance mechanisms in place within a corporation, to ensure that these measures are truly effective rather than mere paper programs.

Further experience with these principles may lead to additional adjustments. I look forward to hearing comments about their operation in practice. Please forward any comments to Christopher Wray, the Principal Associate Deputy Attorney General, or to Andrew Hruska, my Senior Counsel.



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Charging a Corporation: General

A. General Principle: Corporations should not be treated leniently because of their artificial nature nor should they be subject to harsher treatment. Vigorous enforcement of the criminal laws against corporate wrongdoers, where appropriate results in great benefits for law enforcement and the public, particularly in the area of white collar crime. Indicting corporations for wrongdoing enables the government to address and be a force for positive change of corporate culture, alter corporate behavior, and prevent, discover, and punish white collar crime.

B. Comment: In all cases involving corporate wrongdoing, prosecutors should consider the factors discussed herein. First and foremost, prosecutors should be aware of the important public benefits that may flow from indicting a corporation in appropriate cases. For instance, corporations are likely to take immediate remedial steps when one is indicted for criminal conduct that is pervasive throughout a particular industry, and thus an indictment often provides a unique opportunity for deterrence on a massive scale. In addition, a corporate indictment may result in specific deterrence by changing the culture of the indicted corporation and the behavior of its employees. Finally, certain crimes that carry with them a substantial risk of great public harm, e.g., environmental crimes or financial frauds, are by their nature most likely to be committed by businesses, and there may, therefore, be a substantial federal interest in indicting the corporation.

Charging a corporation, however, does not mean that individual directors, officers, employees, or shareholders should not also be charged. Prosecution of a corporation is not a substitute for the prosecution of criminally culpable individuals within or without the corporation. Because a corporation can act only through individuals, imposition of individual criminal liability may provide the strongest deterrent against future corporate wrongdoing. Only rarely should provable individual culpability not be pursued, even in the face of offers of corporate guilty pleas.

Corporations are "legal persons," capable of suing and being sued, and capable of committing crimes. Under the doctrine of *respondeat superior*, a corporation may be held criminally liable for the illegal acts of its directors, officers, employees, and agents. To hold a corporation liable for these actions, the government must establish that the corporate agent's actions (i) were within the scope of his duties and (ii) were intended, at least in part, to benefit the corporation. In all cases involving wrongdoing by corporate agents, prosecutors should consider the corporation, as well as the responsible individuals, as potential criminal targets.

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Agents, however, may act for mixed reasons -- both for self-aggrandizement (both direct and indirect) and for the benefit of the corporation, and a corporation may be held liable as long as one motivation of its agent is to benefit the corporation. In *United States v. Automated Medical Laboratories*, 770 F.2d 399 (4th Cir. 1985), the court affirmed the corporation's conviction for the actions of a subsidiary's employee despite its claim that the employee was acting for his own benefit, namely his "ambitious nature and his desire to ascend the corporate ladder." The court stated, "*Partucci* was clearly acting in part to benefit AML since his advancement within the corporation depended on AML's well-being and its lack of difficulties with the FDA." Similarly, in *United States v. Cincotta*, 689 F.2d 238, 241-42 (1st Cir. 1982), the court held, "criminal liability may be imposed on the corporation only where the agent is acting within the scope of his employment. That, in turn, requires that the agent be performing acts of the kind which he is authorized to perform, and those acts must be motivated -- at least in part -- by an intent to benefit the corporation." Applying this test, the court upheld the corporation's conviction, notwithstanding the substantial personal benefit reaped by its miscreant agents, because the fraudulent scheme required money to pass through the corporation's treasury and the fraudulently obtained goods were resold to the corporation's customers in the corporation's name. As the court concluded, "Mystic--not the individual defendants--was making money by selling oil that it had not paid for."

Moreover, the corporation need not even necessarily profit from its agent's actions for it to be held liable. In *Automated Medical Laboratories*, the Fourth Circuit stated:

[B]enefit is not a "touchstone of criminal corporate liability; benefit at best is an evidential, not an operative, fact." Thus, whether the agent's actions ultimately redounded to the benefit of the corporation is less significant than whether the agent acted with the intent to benefit the corporation. The basic purpose of requiring that an agent have acted with the intent to benefit the corporation, however, is to insulate the corporation from criminal liability for actions of its agents which be inimical to the interests of the corporation or which may have been undertaken solely to advance the interests of that agent or of a party other than the corporation.

770 F.2d at 407 (emphasis added; quoting *Old Monastery Co. v. United States*, 147 F.2d 905, 908 (4th Cir.), cert. denied, 326 U.S. 734 (1945)).



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Charging a Corporation: Factors to Be Considered

A. General Principle: Generally, prosecutors should apply the same factors in determining whether to charge a corporation as they do with respect to individuals. *See* USAM § 9-27.220, *et seq.* Thus, the prosecutor should weigh all of the factors normally considered in the sound exercise of prosecutorial judgment: the sufficiency of the evidence; the likelihood of success at trial; the probable deterrent, rehabilitative, and other consequences of conviction; and the adequacy of noncriminal approaches. *See id.* However, due to the nature of the corporate "person," some additional factors are present. In conducting an investigation, determining whether to bring charges, and negotiating plea agreements, prosecutors should consider the following factors in reaching a decision as to the proper treatment of a corporate target:

1. the nature and seriousness of the offense, including the risk of harm to the public, and applicable policies and priorities, if any, governing the prosecution of corporations for particular categories of crime (*see* section III, *infra*);
2. the pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management (*see* section IV, *infra*);
3. the corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it (*see* section V, *infra*);
4. the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection (*see* section VI, *infra*);
5. the existence and adequacy of the corporation's compliance program (*see* section VII, *infra*);
6. the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies (*see* section VIII, *infra*);
7. collateral consequences, including disproportionate harm to shareholders, pension holders and employees not proven

personally culpable and impact on the public arising from the prosecution (*see* section IX, *infra*); and

8. the adequacy of the prosecution of individuals responsible for the corporation's malfeasance;
9. the adequacy of remedies such as civil or regulatory enforcement actions (*see section X, infra*).

B. Comment: As with the factors relevant to charging natural persons, the foregoing factors are intended to provide guidance rather than to mandate a particular result. The factors listed in this section are intended to be illustrative of those that should be considered and not a complete or exhaustive list. Some or all of these factors may or may not apply to specific cases, and in some cases one factor may override all others. The nature and seriousness of the offense may be such as to warrant prosecution regardless of the other factors. Further, national law enforcement policies in various enforcement areas may require that more or less weight be given to certain of these factors than to others.

In making a decision to charge a corporation, the prosecutor generally has wide latitude in determining when, whom, how, and even whether to prosecute for violations of Federal criminal law. In exercising that discretion, prosecutors should consider the following general statements of principles that summarize appropriate considerations to be weighed and desirable practices to be followed in discharging their prosecutorial responsibilities. In doing so, prosecutors should ensure that the general purposes of the criminal law -- assurance of warranted punishment, deterrence of further criminal conduct, protection of the public from dangerous and fraudulent conduct, rehabilitation of offenders, and restitution for victims and affected communities -- are adequately met, taking into account the special nature of the corporate "person."



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Charging a Corporation: Special Policy Concerns

A. General Principle: The nature and seriousness of the crime, including the risk of harm to the public from the criminal conduct, are obviously primary factors in determining whether to charge a corporation. In addition, corporate conduct, particularly that of national and multi-national corporations, necessarily intersects with federal economic, taxation, and criminal law enforcement policies. In applying these principles, prosecutors must consider the practices and policies of the appropriate Division of the Department, and must comply with those policies to the extent required.

B. Comment: In determining whether to charge a corporation, prosecutors should take into account federal law enforcement priorities as discussed above. *See* USAM § 9-27-230. In addition, however, prosecutors must be aware of the specific policy goals and incentive programs established by the respective Divisions and regulatory agencies. Thus, whereas natural persons may be given incremental degrees of credit (ranging from immunity to lesser charges to sentencing considerations) for turning themselves in, making statements against their penal interest, and cooperating in the government's investigation of their own and others' wrongdoing, the same approach may not be appropriate in all circumstances with respect to corporations. As an example, it is entirely proper in many investigations for a prosecutor to consider the corporation's pre-indictment conduct, *e.g.*, voluntary disclosure, cooperation, remediation or restitution, in determining whether to seek an indictment. However, this would not necessarily be appropriate in an antitrust investigation, in which antitrust violations, by definition, go to the heart of the corporation's business and for which the Antitrust Division has therefore established a firm policy, understood in the business community, that credit should not be given at the charging stage for a compliance program and that amnesty is available only to the first corporation to make full disclosure to the government. As another example, the Tax Division has a strong preference for prosecuting responsible individuals, rather than entities, for corporate tax offenses. Thus, in determining whether or not to charge a corporation, prosecutors should consult with the Criminal, Antitrust, Tax, and Environmental and Natural Resources Divisions, if appropriate or required.



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Charging a Corporation: Pervasiveness of Wrongdoing Within the Corporation

A. General Principle: A corporation can only act through natural persons, and it is therefore held responsible for the acts of such persons fairly attributable to it. Charging a corporation for even minor misconduct may be appropriate where the wrongdoing was pervasive and was undertaken by a large number of employees or by all the employees in a particular role within the corporation, *e.g.*, salesmen or procurement officers, or was condoned by upper management. On the other hand, in certain limited circumstances, it may not be appropriate to impose liability upon a corporation, particularly one with a compliance program in place, under a strict *respondeat superior* theory for the single isolated act of a rogue employee. There is, of course, a wide spectrum between these two extremes, and a prosecutor should exercise sound discretion in evaluating the pervasiveness of wrongdoing within a corporation.

B. Comment: Of these factors, the most important is the role of management. Although acts of even low-level employees may result in criminal liability, a corporation is directed by its management and management is responsible for a corporate culture in which criminal conduct is either discouraged or tacitly encouraged. As stated in commentary to the Sentencing Guidelines:

Pervasiveness [is] case specific and [will] depend on the number, and degree of responsibility, of individuals [with] substantial authority ... who participated in, condoned, or were willfully ignorant of the offense. Fewer individuals need to be involved for a finding of pervasiveness if those individuals exercised a relatively high degree of authority. Pervasiveness can occur either within an organization as a whole or within a unit of an organization.

USSG § 8C2.5, comment. (n. 4).



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Charging a Corporation: The Corporation's Past History

A. General Principle: Prosecutors may consider a corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it, in determining whether to bring criminal charges.

B. Comment: A corporation, like a natural person, is expected to learn from its mistakes. A history of similar conduct may be probative of a corporate culture that encouraged, or at least condoned, such conduct, regardless of any compliance programs. Criminal prosecution of a corporation may be particularly appropriate where the corporation previously had been subject to non-criminal guidance, warnings, or sanctions, or previous criminal charges, and yet it either had not taken adequate action to prevent future unlawful conduct or had continued to engage in the conduct in spite of the warnings or enforcement actions taken against it. In making this determination, the corporate structure itself, *e.g.*, subsidiaries or operating divisions, should be ignored, and enforcement actions taken against the corporation or any of its divisions, subsidiaries, and affiliates should be considered. *See USSG § 8C2.5(c) & comment. (n. 6).*



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Charging a Corporation: Cooperation and Voluntary Disclosure

A. General Principle: In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection.

B. Comment: In investigating wrongdoing by or within a corporation, a prosecutor is likely to encounter several obstacles resulting from the nature of the corporation itself. It will often be difficult to determine which individual took which action on behalf of the corporation. Lines of authority and responsibility may be shared among operating divisions or departments, and records and personnel may be spread throughout the United States or even among several countries. Where the criminal conduct continued over an extended period of time, the culpable or knowledgeable personnel may have been promoted, transferred, or fired, or they may have quit or retired. Accordingly, a corporation's cooperation may be critical in identifying the culprits and locating relevant evidence.

In some circumstances, therefore, granting a corporation immunity or amnesty or pretrial diversion may be considered in the course of the government's investigation. In such circumstances, prosecutors should refer to the principles governing non-prosecution agreements generally. *See* USAM § 9-27.600-650. These principles permit a non prosecution agreement in exchange for cooperation when a corporation's "timely cooperation appears to be necessary to the public interest and other means of obtaining the desired cooperation are unavailable or would not be effective." Prosecutors should note that in the case of national or multi-national corporations, multi-district or global agreements may be necessary. Such agreements may only be entered into with the approval of each affected district or the appropriate Department official. *See* USAM § 9-27.641.

In addition, the Department, in conjunction with regulatory agencies and other executive branch departments, encourages corporations, as part of their compliance programs, to conduct internal investigations and to disclose their findings to the appropriate authorities. Some agencies, such as the SEC and the EPA, as well as the Department's Environmental and Natural Resources Division, have formal voluntary disclosure programs in which self-reporting, coupled with remediation and additional criteria, may qualify the corporation for amnesty or reduced sanctions. n2 Even in the absence of a formal program, prosecutors may consider a corporation's timely and voluntary disclosure in

evaluating the adequacy of the corporation's compliance program and its management's commitment to the compliance program. However, prosecution and economic policies specific to the industry or statute may require prosecution notwithstanding a corporation's willingness to cooperate. For example, the Antitrust Division offers amnesty only to the first corporation to agree to cooperate. This creates a strong incentive for corporations participating in anti-competitive conduct to be the first to cooperate. In addition, amnesty, immunity, or reduced sanctions may not be appropriate where the corporation's business is permeated with fraud or other crimes.

One factor the prosecutor may weigh in assessing the adequacy of a corporation's cooperation is the completeness of its disclosure including, if necessary, a waiver of the attorney-client and work product protections, both with respect to its internal investigation and with respect to communications between specific officers, directors and employees and counsel. Such waivers permit the government to obtain statements of possible witnesses, subjects, and targets, without having to negotiate individual cooperation or immunity agreements. In addition, they are often critical in enabling the government to evaluate the completeness of a corporation's voluntary disclosure and cooperation. Prosecutors may, therefore, request a waiver in appropriate circumstances. ⁿ³ The Department does not, however, consider waiver of a corporation's attorney-client and work product protection an absolute requirement, and prosecutors should consider the willingness of a corporation to waive such protection when necessary to provide timely and complete information as one factor in evaluating the corporation's cooperation.

Another factor to be weighed by the prosecutor is whether the corporation appears to be protecting its culpable employees and agents. Thus, while cases will differ depending on the circumstances, a corporation's promise of support to culpable employees and agents, either through the advancing of attorneys fees, ⁿ⁴ through retaining the employees without sanction for their misconduct, or through providing information to the employees about the government's investigation pursuant to a joint defense agreement, may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation. By the same token, the prosecutor should be wary of attempts to shield corporate officers and employees from liability by a willingness of the corporation to plead guilty.

Another factor to be weighed by the prosecutor is whether the corporation, while purporting to cooperate, has engaged in conduct that impedes the investigation (whether or not rising to the level of criminal obstruction). Examples of such conduct include: overly broad assertions of corporate representation of employees or former employees; inappropriate directions to employees or their counsel, such as directions not to cooperate openly and fully with the investigation including, for example, the direction to decline to be interviewed; making presentations or submissions that contain misleading assertions or omissions; incomplete or delayed production of records; and failure to promptly disclose illegal conduct known to the corporation.

Finally, a corporation's offer of cooperation does not automatically entitle it to immunity from prosecution. A corporation should not be able to escape liability merely by offering up its directors, officers, employees, or agents as in lieu of its own prosecution. Thus, a corporation's willingness to cooperate is merely one relevant factor, that needs to be considered in conjunction with the other factors, particularly those relating to the corporation's past history and the role of management in the wrongdoing.

FOOTNOTES:

(n6)Footnote 2. In addition, the Sentencing Guidelines reward voluntary disclosure and cooperation with a reduction in the corporation's offense level. *See USSG § 8C2.5(g)*.

(n7)Footnote 3. This waiver should ordinarily be limited to the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue. Except in unusual circumstances, prosecutors should not seek a waiver with respect to communications and work product related to advice concerning the government's criminal investigation.

(n8)Footnote 4. Some states require corporations to pay the legal fees of officers under investigation prior to a

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formal determination of their guilt. Obviously, a corporation's compliance with governing law should not be considered a failure to cooperate.



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Charging a Corporation: Corporate Compliance Programs

A. General Principle: Compliance programs are established by corporate management to prevent and to detect misconduct and to ensure that corporate activities are conducted in accordance with all applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own. However, the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal conduct undertaken by its officers, directors, employees, or agents. Indeed, the commission of such crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program. In addition, the nature of some crimes, *e.g.*, antitrust violations, may be such that national law enforcement policies mandate prosecutions of corporations notwithstanding the existence of a compliance program.

B. Comment: A corporate compliance program, even one specifically prohibiting the very conduct in question, does not absolve the corporation from criminal liability under the doctrine of *respondeat superior*. See *United States v. Basic Construction Co.*, 711 F.2d 570 (4th Cir. 1983) ("a corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation, even if... such acts were against corporate policy or express instructions."). In *United States v. Hilton Hotels Corp.*, 467 F.2d 1000 (9th Cir. 1972), *cert. denied*, 409 U.S. 1125 (1973), the Ninth Circuit affirmed antitrust liability based upon a purchasing agent for a single hotel threatening a single supplier with a boycott unless it paid dues to a local marketing association, even though the agent's actions were contrary to corporate policy and directly against express instructions from his superiors. The court reasoned that Congress, in enacting the Sherman Antitrust Act, "intended to impose liability upon business entities for the acts of those to whom they choose to delegate the conduct of their affairs, thus stimulating a maximum effort by owners and managers to assure adherence by such agents to the requirements of the Act." n5 It concluded that "general policy statements" and even direct instructions from the agent's superiors were not sufficient; "Appellant could not gain exculpation by issuing general instructions without undertaking to enforce those instructions by means commensurate with the obvious risks." See also *United States v. Beusch*, 596 F.2d 871, 878 (9th Cir. 1979) ("[A] corporation may be liable for the acts of its employees done contrary to express instructions and policies, but ... the existence of such instructions and policies may be considered in determining whether the employee in fact acted to benefit the corporation."); *United States v. American Radiator & Standard Sanitary Corp.*, 433 F.2d 174 (3rd Cir. 1970) (affirming conviction of corporation based upon its officer's participation in price-fixing scheme, despite corporation's defense that officer's conduct violated its "rigid

anti-fraternization policy" against any socialization (and exchange of price information) with its competitors; "When the act of the agent is within the scope of his employment or his apparent authority, the corporation is held legally responsible for it, although what he did may be contrary to his actual instructions and may be unlawful.").

While the Department recognizes that no compliance program can ever prevent all criminal activity by a corporation's employees, the critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives. The Department has no formal guidelines for corporate compliance programs. The fundamental questions any prosecutor should ask are: "Is the corporation's compliance program well designed?" and "Does the corporation's compliance program work?" In answering these questions, the prosecutor should consider the comprehensiveness of the compliance program; the extent and pervasiveness of the criminal conduct; the number and level of the corporate employees involved; the seriousness, duration, and frequency of the misconduct; and any remedial actions taken by the corporation, including restitution, disciplinary action, and revisions to corporate compliance programs. ⁿ⁶ Prosecutors should also consider the promptness of any disclosure of wrongdoing to the government and the corporation's cooperation in the government's investigation. In evaluating compliance programs, prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct. For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations; are the directors provided with information sufficient to enable the exercise of independent judgment, are internal audit functions conducted at a level sufficient to ensure their independence and accuracy and have the directors established an information and reporting system in the organization reasonable designed to provide management and the board of directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law. *In re: Caremark*, 698 A.2d 959 (Del. Ct. Chan. 1996) .

Prosecutors should therefore attempt to determine whether a corporation's compliance program is merely a "paper program" or whether it was designed and implemented in an effective manner. In addition, prosecutors should determine whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation's compliance efforts. In addition, prosecutors should determine whether the corporation's employees are adequately informed about the compliance program and are convinced of the corporation's commitment to it. This will enable the prosecutor to make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that, when consistent with other federal law enforcement policies, may result in a decision to charge only the corporation's employees and agents.

Compliance programs should be designed to detect the particular types of misconduct most likely to occur in a particular corporation's line of business. Many corporations operate in complex regulatory environments outside the normal experience of criminal prosecutors. Accordingly, prosecutors should consult with relevant federal and state agencies with the expertise to evaluate the adequacy of a program's design and implementation. For instance, state and federal banking, insurance, and medical boards, the Department of Defense, the Department of Health and Human Services, the Environmental Protection Agency, and the Securities and Exchange Commission have considerable experience with compliance programs and can be very helpful to a prosecutor in evaluating such programs. In addition, the Fraud Section of the Criminal Division, the Commercial Litigation Branch of the Civil Division, and the Environmental Crimes Section of the Environment and Natural Resources Division can assist U.S. Attorneys' Offices in finding the appropriate agency office and in providing copies of compliance programs that were developed in previous cases.

FOOTNOTES:

(n9)Footnote 5. Although this case and *Basic Construction* are both antitrust cases, their reasoning applies to other criminal violations. In the Hilton case, for instance, the Ninth Circuit noted that Sherman Act violations are commercial offenses "usually motivated by a desire to enhance profits," thus, bringing the case within the normal rule that a

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"purpose to benefit the corporation is necessary to bring the agent's acts within the scope of his employment." *467 F.2d at 1006 & n4*. In addition, in *United States v. Automated Medical Laboratories*, *770 F.2d 399, 406 n.5 (4th Cir. 1985)*, the Fourth Circuit stated "that Basic Construction states a generally applicable rule on corporate criminal liability despite the fact that it addresses violations of the antitrust laws."

(n10)Footnote 6. For a detailed review of these and other factors concerning corporate compliance programs, see United States Sentencing Commission, GUIDELINES MANUAL, § 8A1.2, comment. (n.3(k)) (Nov. 1997). See also *USSG § 8C2.5(f)*



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Charging a Corporation: Restitution and Remediation

A. General Principle: Although neither a corporation nor an individual target may avoid prosecution merely by paying a sum of money, a prosecutor may consider the corporation's willingness to make restitution and steps already taken to do so. A prosecutor may also consider other remedial actions, such as implementing an effective corporate compliance program, improving an existing compliance program, and disciplining wrongdoers, in determining whether to charge the corporation.

B. Comment: In determining whether or not a corporation should be prosecuted, a prosecutor may consider whether meaningful remedial measures have been taken, including employee discipline and full restitution. ⁿ⁷ A corporation's response to misconduct says much about its willingness to ensure that such misconduct does not recur. Thus, corporations that fully recognize the seriousness of their misconduct and accept responsibility for it should be taking steps to implement the personnel, operational, and organizational changes necessary to establish an awareness among employees that criminal conduct will not be tolerated. Among the factors prosecutors should consider and weigh are whether the corporation appropriately disciplined the wrongdoers and disclosed information concerning their illegal conduct to the government.

Employee discipline is a difficult task for many corporations because of the human element involved and sometimes because of the seniority of the employees concerned. While corporations need to be fair to their employees, they must also be unequivocally committed, at all levels of the corporation, to the highest standards of legal and ethical behavior. Effective internal discipline can be a powerful deterrent against improper behavior by a corporation's employees. In evaluating a corporation's response to wrongdoing, prosecutors may evaluate the willingness of the corporation to discipline culpable employees of all ranks and the adequacy of the discipline imposed. The prosecutor should be satisfied that the corporation's focus is on the integrity and credibility of its remedial and disciplinary measures rather than on the protection of the wrongdoers.

In addition to employee discipline, two other factors used in evaluating a corporation's remedial efforts are restitution and reform. As with natural persons, the decision whether or not to prosecute should not depend upon the target's ability to pay restitution. A corporation's efforts to pay restitution even in advance of any court order is, however, evidence of its "acceptance of responsibility" and, consistent with the practices and policies of the appropriate Division of the Department entrusted with enforcing specific criminal laws, may be considered in determining whether to bring

criminal charges. Similarly, although the inadequacy of a corporate compliance program is a factor to consider when deciding whether to charge a corporation, that corporation's quick recognition of the flaws in the program and its efforts to improve the program are also factors to consider.

FOOTNOTES:

(n11)Footnote 7. For example, the Antitrust Division's amnesty policy requires that "[w]here possible, the corporation [make] restitution to injured parties... ."



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Charging a Corporation: Collateral Consequences

A. General Principle: Prosecutors may consider the collateral consequences of a corporate criminal conviction in determining whether to charge the corporation with a criminal offense.

B. Comment: One of the factors in determining whether to charge a natural person or a corporation is whether the likely punishment is appropriate given the nature and seriousness of the crime. In the corporate context, prosecutors may take into account the possibly substantial consequences to a corporation's officers, directors, employees, and shareholders, many of whom may, depending on the size and nature (e.g., publicly vs. closely held) of the corporation and their role in its operations, have played no role in the criminal conduct, have been completely unaware of it, or have been wholly unable to prevent it. Prosecutors should also be aware of non-penal sanctions that may accompany a criminal charge, such as potential suspension or debarment from eligibility for government contracts or federal funded programs such as health care. Whether or not such non-penal sanctions are appropriate or required in a particular case is the responsibility of the relevant agency, a decision that will be made based on the applicable statutes, regulations, and policies.

Virtually every conviction of a corporation, like virtually every conviction of an individual, will have an impact on innocent third parties, and the mere existence of such an effect is not sufficient to preclude prosecution of the corporation. Therefore, in evaluating the severity of collateral consequences, various factors already discussed, such as the pervasiveness of the criminal conduct and the adequacy of the corporation's compliance programs, should be considered in determining the weight to be given to this factor. For instance, the balance may tip in favor of prosecuting corporations in situations where the scope of the misconduct in a case is widespread and sustained within a corporate division (or spread throughout pockets of the corporate organization). In such cases, the possible unfairness of visiting punishment for the corporation's crimes upon shareholders may be of much less concern where those shareholders have substantially profited, even unknowingly, from widespread or pervasive criminal activity. Similarly, where the top layers of the corporation's management or the shareholders of a closely-held corporation were engaged in or aware of the wrongdoing and the conduct at issue was accepted as a way of doing business for an extended period, debarment may be deemed not collateral, but a direct and entirely appropriate consequence of the corporation's wrongdoing.

The appropriateness of considering such collateral consequences and the weight to be given them may depend on the special policy concerns discussed in section III, *supra*.



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Charging a Corporation: Non-Criminal Alternatives

A. General Principle: Although non-criminal alternatives to prosecution often exist, prosecutors may consider whether such sanctions would adequately deter, punish, and rehabilitate a corporation that has engaged in wrongful conduct. In evaluating the adequacy of non-criminal alternatives to prosecution, *e.g.*, civil or regulatory enforcement actions, the prosecutor may consider all relevant factors, including:

1. the sanctions available under the alternative means of disposition;
2. the likelihood that an effective sanction will be imposed; and
3. the effect of non-criminal disposition on Federal law enforcement interests.

B. Comment: The primary goals of criminal law are deterrence, punishment, and rehabilitation. Non-criminal sanctions may not be an appropriate response to an egregious violation, a pattern of wrongdoing, or a history of non-criminal sanctions without proper remediation. In other cases, however, these goals may be satisfied without the necessity of instituting criminal proceedings. In determining whether federal criminal charges are appropriate, the prosecutor should consider the same factors (modified appropriately for the regulatory context) considered when determining whether to leave prosecution of a natural person to another jurisdiction or to seek non-criminal alternatives to prosecution. These factors include: the strength of the regulatory authority's interest; the regulatory authority's ability and willingness to take effective enforcement action; the probable sanction if the regulatory authority's enforcement action is upheld; and the effect of a non-criminal disposition on Federal law enforcement interests. *See* USAM §§ 9-27.240, 9-27.250.



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Charging a Corporation: Selecting Charges

A. General Principle: Once a prosecutor has decided to charge a corporation, the prosecutor should charge, or should recommend that the grand jury charge, the most serious offense that is consistent with the nature of the defendant's conduct and that is likely to result in a sustainable conviction.

B. Comment: Once the decision to charge is made, the same rules as govern charging natural persons apply. These rules require "a faithful and honest application of the Sentencing Guidelines" and an "individualized assessment of the extent to which particular charges fit the specific circumstances of the case, are consistent with the purposes of the Federal criminal code, and maximize the impact of Federal resources on crime." *See* USAM § 9-27.300. In making this determination, "it is appropriate that the attorney for the government consider, *inter alia*, such factors as the sentencing guideline range yielded by the charge, whether the penalty yielded by such sentencing range ... is proportional to the seriousness of the defendant's conduct, and whether the charge achieves such purposes of the criminal law as punishment, protection of the public, specific and general deterrence, and rehabilitation." *See* Attorney General's Memorandum, dated October 12, 1993.



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Plea Agreements with Corporations

A. General Principle: In negotiating plea agreements with corporations, prosecutors should seek a plea to the most serious, readily provable offense charged. In addition, the terms of the plea agreement should contain appropriate provisions to ensure punishment, deterrence, rehabilitation, and compliance with the plea agreement in the corporate context. Although special circumstances may mandate a different conclusion, prosecutors generally should not agree to accept a corporate guilty plea in exchange for non-prosecution or dismissal of charges against individual officers and employees.

B. Comment: Prosecutors may enter into plea agreements with corporations for the same reasons and under the same constraints as apply to plea agreements with natural persons. *See* USAM §§ 9-27.400-500. This means, *inter alia*, that the corporation should be required to plead guilty to the most serious, readily provable offense charged. As is the case with individuals, the attorney making this determination should do so "on the basis of an individualized assessment of the extent to which particular charges fit the specific circumstances of the case, are consistent with the purposes of the federal criminal code, and maximize the impact of federal resources on crime. In making this determination, the attorney for the government considers, *inter alia*, such factors as the sentencing guideline range yielded by the charge, whether the penalty yielded by such sentencing range ... is proportional to the seriousness of the defendant's conduct, and whether the charge achieves such purposes of the criminal law as punishment, protection of the public, specific and general deterrence, and rehabilitation." *See* Attorney General's Memorandum, dated October 12, 1993. In addition, any negotiated departures from the Sentencing Guidelines must be justifiable under the Guidelines and must be disclosed to the sentencing court. A corporation should be made to realize that pleading guilty to criminal charges constitutes an admission of guilt and not merely a resolution of an inconvenient distraction from its business. As with natural persons, pleas should be structured so that the corporation may not later "proclaim lack of culpability or even complete innocence." *See* USAM §§ 9-27.420(b)(4), 9-27.440, 9-27.500. Thus, for instance, there should be placed upon the record a sufficient factual basis for the plea to prevent later corporate assertions of innocence.

A corporate plea agreement should also contain provisions that recognize the nature of the corporate "person" and ensure that the principles of punishment, deterrence, and rehabilitation are met. In the corporate context, punishment and deterrence are generally accomplished by substantial fines, mandatory restitution, and institution of appropriate compliance measures, including, if necessary, continued judicial oversight or the use of special masters. *See USSG §§ 8B1.1, 8C2.1, et seq.* In addition, where the corporation is a government contractor, permanent or temporary debarment

may be appropriate. Where the corporation was engaged in government contracting fraud, a prosecutor may not negotiate away an agency's right to debar or to list the corporate defendant.

In negotiating a plea agreement, prosecutors should also consider the deterrent value of prosecutions of individuals within the corporation. Therefore, one factor that a prosecutor may consider in determining whether to enter into a plea agreement is whether the corporation is seeking immunity for its employees and officers or whether the corporation is willing to cooperate in the investigation of culpable individuals. Prosecutors should rarely negotiate away individual criminal liability in a corporate plea.

Rehabilitation, of course, requires that the corporation undertake to be law-abiding in the future. It is, therefore, appropriate to require the corporation, as a condition of probation, to implement a compliance program or to reform an existing one. As discussed above, prosecutors may consult with the appropriate state and federal agencies and components of the Justice Department to ensure that a proposed compliance program is adequate and meets industry standards and best practices. *See* section VII, *supra*.

In plea agreements in which the corporation agrees to cooperate, the prosecutor should ensure that the cooperation is complete and truthful. To do so, the prosecutor may request that the corporation waive attorney-client and work product protection, make employees and agents available for debriefing, disclose the results of its internal investigation, file appropriate certified financial statements, agree to governmental or third-party audits, and take whatever other steps are necessary to ensure that the full scope of the corporate wrongdoing is disclosed and that the responsible culprits are identified and, if appropriate, prosecuted. *See* generally section VIII, *supra*.



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FORMAL OPINION 2004-02

FORMAL OPINION 2004-02

REPRESENTING CORPORATIONS AND THEIR CONSTITUENTS IN THE CONTEXT OF GOVERNMENTAL INVESTIGATIONS

Topic: Multiple Representations; Corporations and Corporate Constituents

Digest: Multiple representations of a corporation and one or more of its constituents are ethically complex, and are particularly so in the context of governmental investigations. If the interests of the corporation and its constituent actually or potentially differ, counsel for a corporation will be ethically permitted to undertake such a multiple representation, provided the representation satisfies the requirements of DR 5-105(C) of the New York Code of Professional Responsibility: (i) corporate counsel concludes that in the view of a disinterested lawyer, the representation would serve the interests of both the corporation and the constituent; and (ii) both clients give knowledgeable and informed consent, after full disclosure of the potential conflicts that might arise. In determining whether these requirements are satisfied, counsel for the corporation must ensure that he or she has sufficient information to apply DR 5-105(C)'s disinterested lawyer test in light of the particular facts and circumstances at hand, and that in obtaining the information necessary to do so, he or she does not prejudice the interests of the current client, the corporation. Even if the lawyer concludes that the requirements of DR 5-105(C) are met at the outset of a multiple representation, the lawyer must be mindful of any changes in circumstances over the course of the representation to ensure that the disinterested lawyer test continues to be met at all times. Finally, the lawyer should consider structuring his or her relationships with both clients by adopting measures to minimize the adverse effects of an actual conflict, should one develop. These may include prospective waivers that would permit the attorney to continue representing the corporation in the event that the attorney must withdraw from the multiple representation, contractual limitations on the scope of the representation, explicit agreements as to the scope of the attorney-client privilege and the permissible use of any privileged information obtained in the course of the representations, and/or the use of co-counsel or shadow counsel to assist in the representation of the constituent client.

Code: DR 2-110; DR 4-101; DR 5-105; DR 5-107; DR 5-108; DR 5-109; DR 7-104

Question

Under what circumstances may a lawyer simultaneously represent a corporation and one or more of its officers, directors, employees or other constituents in the context of a governmental investigation? What disclosures must the lawyer make to her current and prospective clients and what consents must she obtain prior to undertaking such a representation? How may the lawyer structure her relationship with her clients so as to minimize adverse consequences if conflicts between their interests arise?

Opinion

In an era in which each day's edition of The Wall Street Journal brings fresh reports of companies under investigation, it has become increasingly common for lawyers to be asked to undertake simultaneous representation of a corporation and one or more of its officers, directors, employees or other constituents (sometimes collectively referred to as "constituents") in the context of a governmental investigation. In addition, in an era in which corporations are under increasing pressure to demonstrate that they are "good corporate citizens" by cooperating fully with governmental investigations, it has become increasingly likely that simultaneous representation of a corporation and its constituents may involve the representation of differing interests.

At the same time, there is relatively little guidance available to attorneys on the ethical issues implicated by a request for simultaneous representation of a corporation and an officer or employee of that corporation in the context of a governmental investigation. We have found no ethics opinions addressing the topic. n1 In addition, reported case law on multiple representation -- which tends to be limited to issues such as when conflicts will require the disqualification of counsel or the reversal of a conviction -- is of only limited assistance. n2

As a result, we believe it would be helpful and timely to outline the ethical issues implicated by multiple representation of a corporate client and one or more officers, directors, employees or other constituents in the context of a governmental investigation. In particular, this Opinion focuses on: (1) the circumstances under which a lawyer for the corporation may ethically undertake simultaneous representation of one or more employees of the corporation; (2) the disclosures that must be made and the consents that must be obtained in order to render such multiple representation ethically permissible; and (3) the steps that can or should be considered to minimize potential harm to the corporate and employee clients if conflicts between their interests arise. n3 Although this Opinion deals specifically with multiple representations in the context of governmental investigations, we believe that most, if not all, of the concepts discussed in this opinion would apply to any multiple representation of a corporation and one or more of its constituents.

While there is no per se bar to simultaneous representation of corporate and employee clients in the context of governmental investigations, the Code of Professional Responsibility imposes three important restrictions on the permissibility of such representations. First, the lawyer must be able to conclude that a disinterested lawyer would, given the facts at hand, regard multiple representation as in the interest of both the corporate client and the employee client. Second, the lawyer must obtain the consent of both clients after full disclosure of the advantages and risks involved in multiple representation. Third, the lawyer must be alert to changes in circumstances that would render continuation of multiple representation impermissible.

In addition, the lawyer contemplating multiple representation should consider whether steps might be taken to structure his relationship with each client so as to minimize adverse consequences in the event that a conflict between them arises. For example, it may be appropriate or even necessary for the lawyer to seek a prospective waiver from his clients permitting him to continue his representation of the corporate client in the event that a conflict arises between the corporate client and the employee client. Additionally, or alternatively, the lawyer may conclude that the disinterested lawyer test is more clearly satisfied if he jointly represents one or both clients with co-counsel or shadow counsel.

The Standard Articulated in DR 5-105

DR 5-105 articulates the ethical standard governing the permissibility of representing multiple clients in a matter. Subject only to the exception contained in DR 5-105(C), the provisions of DR 5-105(A) and (B) prohibit undertaking or continuing in multiple representation "if the exercise of independent professional judgment in behalf of a client will be or is likely to be adversely affected" or "if it would be likely to involve the lawyer in representing differing interests."

As defined by the Code, differing interests "include every interest that will adversely affect either the judgment or the loyalty of a lawyer to a client, whether it be conflicting, inconsistent, diverse, or other interest." 22 N.Y.C.R.R. § 1200.1(a); see also NYSBA Comm. on Prof'l Ethics Op. 674 (n.d.). Accordingly, a finding of "adverse" or "differing" interests does not require "actual detriment" or any actual conflict; rather, a broad prophylactic rule is appropriate because it "not only preserves the client's expectation of loyalty but also promotes public confidence in the integrity of the bar." *Tekni-Plex, Inc. v. Meyner & Landis*, 89 N.Y.2d 123, 131, 674 N.E.2d 663, 667 (1996) (discussing, on motion to disqualify, similar standard under DR 5-108 regarding conflicts with former clients).

Under DR 5-105, a lawyer may undertake or continue multiple representation of clients with potentially differing interests only if:

a disinterested lawyer would believe that the lawyer can competently represent the interests of each [client] and if each consents to the representation after full disclosure of the implications of the simultaneous representation and the advantages and risks involved.

DR 5-105(C).

The Disinterested Lawyer Test

Thus, under DR 5-105, the first determination that must be made before undertaking simultaneous representation of a corporate client and an employee client is that a disinterested lawyer would believe that a single lawyer could competently represent the interests of each client. In addition, since DR 5-105 also speaks to continuing a multiple representation, it requires the attorney to remain alert to potential conflicts and to reassess, as circumstances change, whether the disinterested lawyer test is still satisfied.

A "disinterested lawyer" is an objective, hypothetical lawyer "whose only aim would be to give the client the best advice possible about whether the client should consent to a conflict" or potential conflict. Simon's New York Code of Prof'l Responsibility Ann. 554-55 (2003). If the lawyer believes that such a disinterested lawyer "would conclude that any of the affected clients should not agree to the representation under the circumstances, the lawyer involved should not ask for" consent to multiple representation. EC 5-16.

In some instances, it will be obvious that the disinterested lawyer test cannot be satisfied with respect to the simultaneous representation of a corporate client and an employee client. For example, if the government is investigating securities law violations relating to the filing of false or misleading financial statements, a disinterested lawyer could not reasonably conclude that a single lawyer could competently represent both the corporation and an employee who has admitted wrongdoing in connection with the financial statements under investigation.

In such a scenario, the corporation would have a strong interest in avoiding or limiting criminal or civil liability by, among other things, cooperating fully with the government and providing any information sought by the government regarding the preparation of the financial statements.⁴ The individual employee would, by contrast, have to consider a variety of factors before deciding whether it was in his interest to cooperate with the government, and he would need

counsel able and willing to negotiate the best possible resolution of the matter for him.

In other scenarios, it would be clear that the disinterested lawyer test is easily satisfied. For example, in our same hypothetical investigation of securities law violations, an employee in the corporation's maintenance department who merely overheard comments regarding the need to alter the corporation's financial statements would have no reason for concern about personal liability. Such an employee would have no need for counsel to negotiate independently with the government on his behalf, and a disinterested lawyer would easily conclude that a single lawyer could competently represent the interests of both the corporation and the maintenance worker.

Many situations, however, are likely to be far less clear than the two scenarios described above. What if, for example, instead of working in the corporation's maintenance department, the employee was the head of one of the corporation's accounting divisions, albeit not the one involved in the financial statements under investigation? What if the employee worked in the accounting division under investigation, and had some, but not full, discretion to decide how to account for the transactions giving rise to the investigation? What if the employee had no decision-making authority, but nonetheless participated in booking the transactions? What if the employee is the corporation's CEO, who is not an accountant but who certified the accuracy of the corporation's financial statements?

In all such scenarios, the question of whether multiple representation would pass the disinterested lawyer test is much closer and likely would turn on the specific knowledge possessed by the employee, the specific laws or regulations implicated by the conduct, and the perceived scope of the government's investigation. As a result, in all such scenarios, the lawyer must take particular care to ensure that he has a sufficiently detailed grasp of the relevant facts to be able to make the assessment required by DR 5-105(C).

Obtaining the Facts Needed to Apply the Disinterested Lawyer Test

The need for facts sufficient to apply the disinterested lawyer test raises the issue of what, if any, precautions a lawyer must take in his fact-gathering to avoid potential harm to his existing or prospective clients. In the typical case, an attorney's first encounter with a corporate employee will occur in the context of an interview in which the attorney is representing only the corporation and is engaged in fact-gathering on behalf of the corporation. In such interviews, it is typical for the attorney to advise the employee that: (1) the attorney represents the corporation, not the employee; (2) any information imparted to the attorney is privileged, but the privilege is held by the corporation, not the employee; and (3) it will be up to the corporation to decide whether to waive the privilege and share any information imparted by the employee with third parties.

In all cases where the interests of the constituent and the interests of the corporation may differ, attorneys are affirmatively required to give at least part of the advice described above. The Code requires an attorney to advise a corporation's employees that she is "the lawyer for the organization and not for any of the constituents" in any situation in which "it appears that the organization's interests may differ from those of the constituents." DR 5-109(A). Given the ease with which the "differing interests" test is satisfied, we believe an attorney should usually advise a corporate employee that she represents the corporation rather than the employee. Furthermore, given the increased solicitude that courts and other authorities have shown for the reasonable expectations of a party in determining whether an attorney-client relationship has been formed, n5 an attorney also acts at the peril of his corporate client if the attorney fails to make clear whom she does and does not represent.

If, in an initial interview, a corporate employee asks the corporation's attorney whether he should consult with counsel, it is typical for the attorney to reiterate that he represents the corporation and therefore cannot advise the employee. Here, too, the Committee regards that practice as a prudent precaution. While DR 7-104(a)(2) allows an attorney to advise an unrepresented party to secure counsel, n6 the attorney also must bear in mind that as corporate counsel, "he owes allegiance to the entity and not to a shareholder, director, officer, employee, representative, or other person

connected with the entity." EC 5-18. Because affirmatively advising a corporate employee to secure counsel may work against the interests of the corporation, we believe it is appropriate for corporate counsel to be reluctant to render that advice -- at least in the absence of the consent of his client to do so. n7

If a constituent requests, prior to an initial interview by corporate counsel, to be represented by corporate counsel, it is typical for corporate counsel to decline at that point to undertake multiple representation. The Committee regards that practice as a prudent precaution. While it is, in theory, possible that corporate counsel will already have facts sufficient to enable her to apply the disinterested lawyer test prior to an initial interview with the employee, it seems likely that in most instances she will not have sufficient facts. Thus, we regard it as likely to be an exceptional case in which corporate counsel could properly agree to represent one of the corporation's employees prior to an initial interview of that employee.

If an employee who has already been interviewed subsequently requests representation by corporate counsel -- a request that typically is triggered by a request from the government to interview or take testimony from the employee -- the corporate attorney will then need to determine whether he has sufficient facts to enable him to apply the disinterested lawyer test. If he does not, he must then determine how best to obtain those additional facts.

In this regard, the corporate attorney should take care to avoid proceeding in a manner that could work against the interests of his existing client, the corporation. Thus, for example, if the corporate attorney were simply to agree to meet again with the corporate employee for the purpose of determining whether he could represent the employee, without first discussing whether the attorney may not be free to share with the corporation any additional information that was imparted, then the attorney may not in fact be able to share that information with the corporation, see, e.g., *United States v. Dennis*, 843 F.2d 652, 656-57 (2d Cir. 1988) (statements made by prospective client are privileged even if attorney ultimately declines the engagement), and might even in some cases be unable to continue to represent the corporation. See Restatement (Third) of the Law Governing Lawyers § 15 (2000) (addressing a lawyer's duty to protect information relating to the representation of a prospective client and how to protect against adverse consequences to an existing client). As a consequence, to protect the interests of the existing client, the corporation, it is important that the lawyer make clear to the employee that information shared in the interview will be disclosed to the corporation and that the corporation will control the decision as to whether to disclose such information further.

Consent After Full Disclosure

If the attorney concludes that the disinterested lawyer test has been satisfied, the lawyer may undertake multiple representation only with the consent of each client after "full disclosure of the implications of the simultaneous representation and the advantages and risks involved." DR 5-105(C).

"Full disclosure" means the provision of "information reasonably sufficient, giving due regard to the sophistication of the client, to permit the client to appreciate the significance of the potential conflict" EC 5-16; cf. *People v. Gomberg*, 38 N.Y.2d 307, 314, 342 N.E.2d 550, 554 (1975) ("Attorneys are under an ethical obligation to disclose to their clients, at the earliest possible time, any conflicting interests that might cloud their representation.").

Full disclosure also includes "disclosure of any and all defenses and arguments that a client will forgo because of the joint representation, together with the lawyer's fair and reasoned evaluation of such defenses and arguments, and the possible consequences to the client of failing to raise them." NYCLA Ethics Op. 707 (1995).

This Opinion cannot, and does not attempt to, catalogue all possible advantages and risks attendant to simultaneous representation of a corporation and one or more of its employees. Instead, the Opinion attempts to provide general guidance in this area by noting some of the more common advantages and risks, with the caveat that in each case in which multiple representation is contemplated, the attorney must give careful, fact-specific consideration to the

potential risks and advantages of the representation so that there can be full disclosure to the clients within the meaning of DR 5-105(C).

Risks and Advantages from the Corporate Client's Perspective

In the case of a corporate client, the most common (and most readily apparent) advantage to multiple representation is avoiding the expense of separate counsel. Other common advantages include providing employees with the benefit of counsel who has a detailed and broad knowledge of the relevant facts and avoiding the suggestion that there is any division of interest between the corporation and its employees. n8

With respect to the risks posed to a corporate client from multiple representation, the most serious potential risk will tend to be the possibility that a conflict will arise that will disable corporate counsel from continuing as corporate counsel. If a matter is time sensitive, or if corporate counsel has invested considerable time in the representation, the prejudice to the corporation from such a development could be quite significant.

In this regard, corporate counsel should ensure that the corporation understands that if the interests of the corporation and the employee become materially adverse, corporate counsel will not be able to continue in the matter on behalf of the corporation unless the employee consents to counsel doing so. See DR 5-108(A) (prohibiting, absent consent after full disclosure, representation that is materially adverse to a former client in the same or a substantially related matter). In addition, if there is any reasonable possibility of a divergence of interests, we believe that corporate counsel should seriously consider advising the corporation to obtain a prospective waiver sufficient to satisfy DR 5-108(A) as a condition of consenting to multiple representation. Indeed, in some cases, the absence of such a waiver might well cause the multiple representation to fail the disinterested lawyer test.

Other common disadvantages, from the corporation's perspective, to multiple representation include potential loss of credibility with the investigating agency, complication of corporate counsel's ability to report facts to the corporation, and complication of the corporation's ability to report facts to the government.

With respect to the first of those possible disadvantages, it may well be the case that a government attorney will regard with greater suspicion the testimony of a corporate employee that is favorable to the corporation if the employee is represented by counsel for the corporation. Indeed, a government attorney may even affirmatively object to the multiple representation. In such cases, it is not uncommon for the corporation or its counsel to decide against multiple representation even if it is believed to be permissible.

Multiple representation may also complicate corporate counsel's ability to report to the corporation because, absent consent, she may not be able to pass on the confidences or secrets of his employee client. See DR 4-101(B)(3); DR 4-101(C)(1) (confidences and secrets of a client cannot be disclosed or used for the advantage of a third party without consent of the client after full disclosure); *Greene v. Greene*, 47 N.Y.2d 447, 453, 391 N.E.2d 1355, 1358 (1979) (prohibition against disclosure of client confidences covers any confidential communication made by the client in the course of the lawyer's representation and continues even after the dissolution of the attorney-client relationship). n9 While such a factor is likely to be less significant in cases in which the prospective employee client has already been extensively debriefed, it nonetheless remains a potential complicating factor that ordinarily should be disclosed prior to seeking consent for multiple representation.

Similarly, corporate counsel should ordinarily consider and discuss with the corporation the possibility that multiple representation could complicate the corporation's ability to cooperate with, and report facts to, the government. As noted above, the current state of the law, and the current state of mind of law enforcement officials, operate to place considerable pressure on corporations to be willing to self-report, to waive the attorney-client privilege and effectively to serve as an investigative arm of the government with respect to the conduct of their employees. Allowing corporate

counsel to simultaneously represent a corporate employee may put the corporation or its counsel in the undesirable position of having information that is of interest to the government but that cannot be shared with the government because the employee client has declined to waive his attorney-client privilege. n10

Risks and Advantages from the Employee's Perspective

From the employee's perspective, many of the common advantages of multiple representation tend to be similar to the advantages that exist from a corporate client's perspective. Those advantages typically include obtaining counsel who has a detailed and broad knowledge of the relevant facts and avoiding the suggestion that there is any division of interest between the corporation and the employee. n11

The principal risks posed to the employee client from multiple representation typically tend to be that corporate counsel's larger constituency may render it difficult for him (despite his best intentions) to be as vigilant in his protection of the individual client's interests, or that a divergence of interests will require the attorney to withdraw from representation of the employee client. Any such risks should be discussed with the prospective employee client prior to obtaining his consent to multiple representation. In addition, where the need to withdraw would be likely to work a significant disadvantage to the employee client (because, for example, the matter is time sensitive or especially complex), consideration should be given to the advisability of having co-counsel or shadow counsel. n12

Structuring the Representation to Minimize Potential Adverse Consequences

As the foregoing discussion indicates, an attorney contemplating multiple representation can, and often should, consider whether the attorney-client relationship can be structured to minimize potential drawbacks to multiple representation. Such structuring may include obtaining prospective waivers of conflict, contractually limiting representation to minimize the possibility of conflicts, having a written understanding with regard to confidential information learned during the representations, and providing for co-counsel or shadow counsel.

Prospective Waivers

There is, as a general matter, no ethical bar to seeking a waiver of future conflicts. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 372 (1993); NYCLA Ethics Op. 724 (1998). In order to best ensure the likelihood that such waivers will be effective, however, it is advisable to put them in writing, see ABA Formal Op. 372, and they should otherwise meet all the requirements for contemporaneous waivers. See *id.*; NYCLA Ethics Op. 724; see also, e.g., *Woolley v. Sweeney*, No. 3:01-CV-1331-BF, 2003 U.S. Dist. LEXIS 8110, at *22 (N.D. Tex. May 13, 2003) (rejecting client's prospective waiver of conflicts where client "has never had the benefit of full disclosure"). The nature of these requirements depends on the specific conflicts to be waived, which, in turn, depend on the interests of the various clients. NYCLA Ethics Op. 724 (stating that "adequacy of disclosure and consent will depend ... upon the circumstances of each individual case") (citation omitted).

In seeking to obtain a prospective waiver from clients, it frequently will be difficult for an attorney to make "full disclosure" to the same extent as in connection with a concurrent waiver. This is because it may not be clear to the attorney at the outset of the representation just what conflicts might later arise. To satisfy his obligation of full disclosure, then, the lawyer seeking a prospective waiver should at least advise the client "of the types of possible future adverse representations that the lawyer envisions, as well as the types of matters that may present such conflicts. The lawyer also should disclose the measures that will be taken to protect the client or prospective client should a conflict arise." NYCLA Ethics Op. 724. "[I]t would be unlikely that a prospective waiver which did not identify either the potential opposing party or at least a class of potentially conflicted clients would survive scrutiny." ABA Formal Op.

372 . In other words, the more specific the lawyer can be, the more likely the waiver is to be upheld. *Id.*

In the context of governmental investigations, prospective waivers may be useful in dealing with a number of the potential conflicts discussed above. Most commonly, prospective waivers may be sought in such cases from an employee client regarding the ability of corporate counsel to continue representing the corporate client in the event an actual or potential conflict develops. In addition, if there is any realistic likelihood that the governmental investigation might lead to litigation, consideration should be given to obtaining a waiver of the employee client's right to object to being cross-examined by his former attorney. Such a waiver will satisfy the specificity requirement for advance waivers because the constituent client will understand the nature of the future representation in which the lawyer would cease to represent the individual and continue to represent the entity. n13

It bears noting that even if the prospective waivers do comport with the requirements for contemporaneous waivers as of the time they are made, the lawyer must still revisit the issues at the time the actual or potential conflicts arise. ABA Formal Op. 372 (stating that securing "'second' waiver" from client at time that actual conflict develops "in many cases ... will be ethically required"); NYCLA Ethics Op. 724 (stating that "[n]otwithstanding" prospective waiver, "the lawyer must reassess the propriety of the adverse concurrent representation ... when the conflict actually arises"). If the actual or potential conflicts turn out to be "materially different" from those the clients waived, the lawyer will not be permitted to rely on the prospective waivers, and will have to obtain new, contemporaneous waivers. NYCLA Ethics Op. 724. Likewise, courts will not necessarily accept the validity of prospective waivers, and may have to satisfy themselves that such waivers continue to be appropriate in light of the circumstances that actually develop. Cf. *United States v. Alex*, 788 F. Supp. 359, 363 (N.D. Ill. 1992) (rejecting waiver of conflicts by former clients as "by no means binding on this court," and recognizing "obligation to independently review the former clients' consents to waive their former counsel's conflict of interest"). Thus, in seeking such prospective waivers, the lawyer should be as specific as possible, in order to ensure that the lawyer has adequately disclosed the risks, and to maximize the likelihood that a reviewing court will conclude that the waiver was knowledgeably made. n14

Contractual Limits on Representation

A lawyer may likewise ethically limit by contract his representation of a client, provided that the representation still comports with the requirements of the N.Y. Code of Professional Responsibility. NYSBA Comm. on Prof'l Ethics Op. 604 (1989). In effect, this means that the representation may not be so limited as to be inadequate. Ass'n of the Bar of the City on New York Comm. on Prof'l & Judicial Ethics [hereinafter "ABCNY"] Formal Op. 2001-3 (2001). Stated otherwise, the representation "must be sufficient ... to render practical service to the client," and must not "materially impair the client's rights." NYSBA Ethics Op. 604. Such a limitation on representation is, however, subject to many of the same requirements as valid waivers: there must be full disclosure of the terms of the engagement and the client must consent. ABCNY Formal Op. 2001-3. In addition, such a representation should not be proposed if "a client could not reasonably conclude that the proposed arrangement serves its interests." *Id.* Finally, any such representation "must cover a discreet matter or a discreet stage of a matter and not terminate before the completion of that stage." NYSBA Ethics Op. 604.

Accordingly, it may be possible for a lawyer to limit his representation of an employee of the corporation to a discreet stage of an investigation in which a conflict with the corporation is unlikely to arise. For example, the lawyer may attempt to limit his representation of the employee to the investigatory stage of the case, thereby eliminating any risk that he would still represent the employee at the time of trial, should he then need to cross-examine the employee. Alternatively, depending on the facts of the particular case, the lawyer may be able to limit the scope of his representation of the employee even more narrowly, perhaps to just a single interview or a handful of interviews with the government about a narrowly circumscribed topic.

Understandings with Respect to Privileged and Confidential Information

Once it is decided that the lawyer will represent the corporation and the constituent, it is important to have a clear understanding with both clients as to (1) whether and what kind of confidential information will be shared; (2) who will control the privilege with respect to such information; (3) how the attorney-client privilege will operate in the event a dispute arises between the clients concerning the matter; and (4) whether the lawyer will continue to represent the corporation even if a conflict develops between the corporation and the constituent. While the New York Code does not require that such understandings be in writing, we strongly recommend that they be in writing.

Co-Counsel or Shadow Counsel

Another potential middle ground that may be appropriate in some cases is the use of co-counsel or shadow counsel -- that is, separate counsel who serves as additional counsel for the corporate employee and thus is available to offer independent advice to the employee and, if necessary, to take over as sole counsel for the employee. While the use of such counsel diminishes one of the advantages of multiple representation -- namely, cost-savings -- it can also significantly diminish the potential risks of multiple representation. If the co-counsel's existence is disclosed to the government (as it is in some cases), it can allay any concern on the part of the government that the corporate employee is not receiving independent legal advice. In addition, if the matter is a complex or time-sensitive one, having co-counsel who is kept reasonably well apprised of facts and developments could help prevent prejudice to the employee if it is subsequently determined that corporate counsel cannot continue to represent the employee.

Conclusion

Multiple representations are ethically complex, and the high-stakes nature of a typical governmental investigation only adds to the complexities. Before undertaking simultaneous representation of a corporation and one or more of its employees in the context of a governmental investigation, an attorney must carefully consider whether a disinterested lawyer would conclude that he can competently represent the interests of each client. The attorney must also take care to ensure that she has sufficient information to apply the disinterested lawyer test, and must give careful, fact-specific consideration to the risks and advantages to multiple representation and discuss those factors fully with each client before seeking their consent to multiple representation. In addition, throughout the representation, the attorney must remain alert to changing circumstances that may render continuation of multiple representation impermissible or inadvisable, and the attorney must discuss any such circumstances with his clients. Finally, the attorney should give consideration to whether there are ways in which the multiple representation can be structured so as to minimize adverse consequences to her clients should a conflict between them arise.

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FOOTNOTES:

(n12)Footnote 1. Although we have found one ethics opinion in New York relating to multiple representation in a corporate context, that opinion is limited to the relatively narrow issue of an attorney's duties when perjury is committed by a corporate officer and the attorney represents both the officer and the corporation. NYSBA Comm. On Prof'l Ethics, Op. 674 (1995).

(n13)Footnote 2. The issues that might arise at trial are distinct from those implicated at the investigative stage of a matter. In addition, whether counsel should be disqualified and whether counsel should have accepted or continued in multiple representation are separate questions. Thus, while decisions rendered in the context of litigated actions provide some assistance, they do not define the universe of issues relevant to deciding whether it is ethically permissible to undertake multiple representation of a corporate client and one or more employee clients in the context of a government

investigation.

(n14)Footnote 3. The guidelines established in this Opinion apply to situations where a lawyer represents or may represent an organization and also one of its constituents, regardless of whether the constituent is an officer, director, or employee, and we use those terms interchangeably throughout the Opinion. However, as with all circumstances in which disclosure and consent is or may be required, the degree of sophistication of the constituent will play a role in how detailed the discussions of those issues need to be.

(n15)Footnote 4. In recent years, both the Department of Justice and the Securities and Exchange Commission, among other law enforcement agencies, have repeatedly cited the willingness of a corporation to cooperate with governmental investigations (which cooperation is sometimes requested to include waiver of the attorney-client privilege) as an important factor in determining whether to hold a corporation civilly or criminally liable for the actions of its officers or employees. See, e.g., United States Attorneys Manual, Criminal Resource Manual 161 (January 20, 2003 memorandum of Deputy Attorney General Larry D. Thompson announcing a revised set of principles governing federal prosecution of business organizations) ("The main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation."); *SEC Release No. 34-44969, 2001 WL 1301408* (October 23, 2001) (Report on the Relationship of Cooperation to Agency Enforcement Decisions) (describing the nature and extent of a company's cooperation with the SEC as important factors to be taken into account in determining whether an enforcement action will be brought against the company).

(n16)Footnote 5. See, e.g., Restatement (Third) of the Law Governing Lawyers § 14 & cmts. e-f (conditioning attorney-client relationship on client's intent and lawyer's failure to "manifest lack of consent," and stating that failure of corporate counsel to clarify whom he represents "in circumstances calling for such a result might lead a lawyer to have entered into client-lawyer representations not intended by the lawyer"); Nancy J. Moore, Conflicts of Interest for In-House Counsel: Issues Emerging from the Expanding Role of the Attorney-Employee, *39 S. Tex. L. Rev.* 497, 506 (1998) (noting the inability of many corporate employees to understand the distinction between the lawyer's role as corporate counsel and his role as counsel for the employee in his individual capacity); see also *Rosman v. Shapiro*, 653 F. Supp. 1441, 1445 (S.D.N.Y. 1987) (implying attorney-client relationship between corporate counsel and corporate officer where attorney represented close corporation and officer "reasonably believed that [attorney] was representing him"). But see *Talvy v. Am. Red Cross*, 205 A.D.2d 143, 149-50, 618 N.Y.S.2d 25, 29-30 (1st Dep't 1994) ("Unless parties have expressly agreed otherwise in the circumstances of a particular matter, a lawyer for a corporation represents the corporation, not its employees."), *aff'd mem.*, 87 N.Y.2d 826, 661 N.E.2d 159 (1995) .

(n17)Footnote 6. DR 7-104(a)(2) states that "[d]uring the course of the representation of a client a lawyer shall not give advice to a party who is not represented by a lawyer, other than the advice to secure counsel, if the interests of such party are or have a reasonable possibility of being in conflict with the interests of the lawyer's client." However, since the employee will not typically be named in any related action actually being litigated before a tribunal while the governmental investigation is still pending, the employee, properly speaking, may not be a "party" within the meaning of this provision.

(n18)Footnote 7. As noted above, DR 5-109(A) prescribes what corporate counsel must instruct a corporate constituent in cases where the interests of the corporation and the constituent "differ." Where the interests of the entity and the interests of the constituent are actually adverse, however, the New York Code provides no additional guidance and requires nothing more. It nevertheless may be advisable to consider that in situations of actually adverse interests, the ABA Model Rules provide specific guidance not also provided by the New York Code. Comment 10 to ABA M.R. 1.13 states: "There are times when the organization's interest may be or become adverse to those of [the constituent]. In such circumstances the lawyer should advise any constituent ... that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for the constituent individual, and that discussion between the lawyer for the organization and the individual may not be privileged." Of course, there are many situations in which the entity's and the constituent's

interests will or might "differ" within the meaning of the New York Code yet such warnings and separate representation will not be necessary.

(n19)Footnote 8. Less sophisticated corporate clients might also mistakenly believe that multiple representation carries the benefit of ensuring that their employees are represented by attorneys whose first loyalty is to the corporation. In such cases, it is incumbent upon corporate counsel to make clear to the corporation that he will owe a full and equal duty of loyalty to the employee clients, and that, if she is unable to discharge that duty, she will not be able to continue representing the employee clients.

(n20)Footnote 9. Although there is an exception to the obligations of DR 4-101 "where an attorney acts for two or more clients jointly," the scope of this exception is not entirely clear. Some authorities suggest that it is limited "only to the evidentiary privilege and applies only in subsequent litigation between the clients." NYSBA Comm. on Prof'l Ethics Op. 555 (1984). These sources stress that before confidences may be shared between jointly represented clients, "the circumstances must clearly demonstrate that it is fair to conclude that the clients have knowingly consented to the limited non-confidentiality." *Id.* Courts, however, have appeared more willing to infer such consent from the nature of the relationships in a multiple representation. See *Tekni-Plex*, 89 N.Y.2d at 137, 674 N.E.2d at 670 ("Generally, where the same lawyer jointly represents two clients with respect to the same matter, the clients have no expectation that their confidences concerning the joint matter will remain secret from each other ... "); accord *Talvy*, 205 A.D.2d at 149-50, 618 N.Y.S.2d at 29-30 . Given these differing approaches, the Committee believes that it will always be advisable, prior to sharing the confidences of one client with another, for the lawyer to obtain the client's consent, after full disclosure. See DR 4-101(C)(1). This can be done in an engagement letter that sets out the understandings and agreements between the corporate client and the employee client with regard to the sharing and control of confidential information.

(n21)Footnote 10. For an example of one such potential complication, see *infra* note 13.

(n22)Footnote 11. Cost savings will not ordinarily be among the potential advantages to the employee client because the cost of separate counsel would in many, if not most, cases be borne by the corporation. Payment of such costs by the corporation is plainly allowed so long as there is full disclosure and the client consents. See DR 5-107.

(n23)Footnote 12. To determine whether to withdraw from employment in the context of a multiple representation, a lawyer should refer to, *inter alia*, DR 2-110 and EC 5-15.

(n24)Footnote 13. In seeking the prospective waivers and advance permission to reveal confidential information (see discussion *infra* at 13), counsel should also bear in mind any specific reporting requirements to which the corporate client may be subject. For example, certain corporations, such as banks and broker-dealer firms, are subject to federal laws that require them to report suspicious financial transactions by filing suspicious activity reports ("SARs"). See, e.g., 12 C.F.R. pt. 21. If counsel for such a corporation undertakes the simultaneous representation of a corporate employee, counsel may obtain, in the course of representing that employee, otherwise privileged information regarding suspicious transactions that, as an agent of the corporation, counsel may be obligated to disclose to the corporation and that the corporation, in turn, may be obligated to report to the government. As such, counsel for corporations with reporting requirements should consider seeking prospective waivers and advance permission to disclose information from any potential employee client that would permit the filings of such reports. While DR 4-101(C)(2) permits an attorney to reveal client "[c]onfidences or secrets when ... required by law ...," the precise scope of this provision is unclear. It is thus uncertain whether the attorney, absent consent from the employee client, could report to the government information acquired in the course of representing that employee. Moreover, given that some of the reporting laws prohibit the filer of a SAR from informing any party that is involved in the underlying transaction, see, e.g., 31 U.S.C. 5318(g)(2)(A)(i), a prospective waiver prior to undertaking the representation may be the only opportunity for counsel to obtain the employee client's consent.

(n25)Footnote 14. In evaluating the validity of prospective waivers, reviewing courts try to ascertain whether the client was reasonably informed about the future matter. See Restatement (Third) of the Law Governing Lawyers § 122

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(2000) (defining "informed consent" to a prospective (as well as current) waiver as "requiring that the client or former client have reasonably adequate information about the material risks of such representation"). ABA Formal Op. 372 ("the particular future conflict of interest as to which the waiver is invoked [must have been] reasonably contemplated at the time the waiver was given"); NYCLA Ethics Op. 724 (an advance waiver is valid if "the subsequent conflicts should have been reasonably anticipated by the original client based on the disclosures made and the scope of the consent sought"). Where the attorney specifically identifies the party or parties with whom the client's interests potentially could differ and explains how that divergence could occur, courts have tended to uphold prospective waivers. See *Unified Sewerage Agency v. Jelco Inc.*, 646 F.2d 1339, 1345 (9th Cir. 1981) (quoting *In re Boivin*, 533 P.2d 171, 174 (Or. 1975) ; accord *Fisons Corp. v. Atochem N.A., Inc.*, No. 90 Civ. 1080 (JMC), 1990 U.S. Dist. LEXIS 15284, at *15 (S.D.N.Y. Nov. 14, 1990) ; see also *Interstate Props. v. Pyramid Co.*, 547 F. Supp. 178, 181-82 (S.D.N.Y. 1982) . In the scenarios being considered in this opinion, the party with whom the client's interests might differ normally will be reasonably clear. Cf. *W.R. Grace & Co. v. Goodyear Tire & Rubber Co.*, No. 1:99-CV-305, 1999 U.S. Dist. LEXIS 22554, at *12-*16 (W.D. Mich. 1999) (upholding prospective waiver executed by members of defense group that prohibited members from objecting "to the continued representation by Common Counsel of all or any of the other members [of the group] in connection with any legal services arising out of" the subject of the agreement). Moreover, even in litigation, courts have upheld prospective waivers involving representation of a corporation and its constituents. See *In re Rite Aid Corp. Sec. Litig.*, 139 F.Supp.2d 649 (E.D. Pa. 2001) (permitting a lawyer who represented the corporation and several of its executives to withdraw from representing one of the executives and continue to represent the corporation after a conflict developed, based upon a written engagement letter containing an advance waiver); see also *Zador Corp. v. Kwan*, 37 Cal. Rptr. 2d 754 (Cal. Ct. App. 6th Dist. 1995) (upholding an advance waiver permitting a lawyer who represented a corporation and an individual to continue representing the corporation after a conflict developed between the corporation and individual).



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APPENDIX B Litigation Papers

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APPENDIX C Selected SEC Releases

2-C Securities Enforcement: Counseling and Defense APPENDIX C.syn

§ C.syn Synopsis to Appendix C: Selected SEC Releases

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APPENDIX C Selected SEC Releases

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Improper Influence on Conduct of Audits

Summary: As directed by section 303 of the Sarbanes-Oxley Act of 2002, we are adopting rules to prohibit officers and directors of an issuer, and persons acting under the direction of an officer or director, from taking any action to coerce, manipulate, mislead, or fraudulently influence the auditor of the issuer's financial statements if that person knew or should have known that such action, if successful, could result in rendering the financial statements materially misleading.

Effective Date: June 26, 2003.

For Further Information Contact: Michael J. Kigin, Associate Chief Accountant, or Robert E. Burns, Chief Counsel, at (202) 942-4400, Office of the Chief Accountant, or David M. Estabrook, Associate Chief Accountant, at (202) 942-4510, Division of Enforcement, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

Supplementary Information: We are redesignating rule 13b2-2 of Regulation 13B-2 n1 as rule 13b2-2(a) and adding new rules 13b2-2(b) and (c).

§ I. Executive Summary

On July 30, 2002, the Sarbanes-Oxley Act of 2002 (the "Act") n2 was enacted. Section 303(a) of the Act states:

It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

As mandated by the Act, the Commission is adopting rules to implement section 303(a). n3 The rules, in combination with the existing rules under Regulation 13B-2, are designed to ensure that management makes open and full disclosures to, and has honest discussions with, the auditor of the issuer's financial statements. These rules prohibit officers or directors of an issuer, or persons acting under their direction, from subverting the auditor's responsibilities to

investors to conduct a diligent audit of the financial statements and to provide a true report of the auditor's findings.

§ II. Discussion of Final Rules

A. Introduction

The new rules supplement the rules currently in Regulation 13B-2, which address the falsification of books, records and accountsⁿ⁴ and false or misleading statements, or omissions to make certain statements, to accountants.ⁿ⁵ New rule 13b2-2(b)(1) specifically prohibits officers and directors, and persons acting under their direction, from coercing, manipulating, misleading, or fraudulently influencing (collectively referred to herein as "improperly influencing") the auditor of the issuer's financial statements when the officer, director or other person knew or should have known that the action, if successful, could result in rendering the issuer's financial statements materially misleading.ⁿ⁶ New rule 13b2-2(b)(2) provides examples of actions that improperly influence an auditor that could result in "rendering the issuer's financial statements materially misleading." This paragraph also clarifies that such actions should not occur at any time that the auditor is called upon to exercise professional judgment related to the issuer's financial statements. New rule 13b2-2(c) applies similar provisions to audits of investment companies' financial statements.

B. Discussion

Definition of "issuer." In the proposing release, we noted that the definition of the term "issuer" in section 3 of the Securities Exchange Act of 1934 ("Exchange Act") would apply to the term as used in the rule. This definition includes, with certain exceptions, any person who issues or proposes to issue securities.ⁿ⁷ One commenter noted that this definition would include all private issuers of securities and suggested that we use the definition of "issuer" in the Sarbanes-Oxley Act.ⁿ⁸ The definition in that Act generally would limit application of the rule to issuers whose securities are registered with the Commission under section 12 of the Exchange Act, that are required to file reports with the Commission under section 15(d) of the Exchange Act, or that have filed registration statements with the Commission that have not yet become effective and have not been withdrawn.ⁿ⁹ We continue to believe that the definition of the term "issuer" in section 3 of the Exchange Act applies to the use of the term in the new rules.ⁿ¹⁰ The term "issuer," as defined in the Exchange Act, has been used in Rule 13b2-2 since it was adopted in 1979,ⁿ¹¹ and we believe that the amendments do not require a change in the meaning of the term. In addition, because the new rule specifically applies to improperly influencing auditors of issuers' financial statements "that are required to be filed with the Commission," the commenter's concern that this definition would extend the scope of the rule to all private issuers of securities has been addressed. Accordingly, the term "issuer" in the new rule should be defined as stated in section 3 of the Exchange Act.

Definition of "officer." New rule 13b2-2(b)(1) addresses activities by an officer or director of an issuer, or any other person acting under the direction of an officer or director.ⁿ¹² The Commission has defined the term "officer" to include the company's "president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated."ⁿ¹³ The term "executive officer" includes an issuer's chief executive officer and other officers who perform policy-making functions for the issuer.ⁿ¹⁴

Some commenters suggested that the term "officer" should include all those responsible for corporate governance mattersⁿ¹⁵ or who influence the preparation of an issuer's financial statements.ⁿ¹⁶ Commenters also suggested that the definition include an issuer's general counsel or chief legal officer.ⁿ¹⁷ We do not believe at this time that it is necessary to amend the existing definition of "officer" or "executive officer," or to write a new definition specifically for Regulation 13B-2. The existing definitions cover, among others, those who set corporate governance policies and

legal policies for an issuer. Should we note that members of management not encompassed by the existing definitions of "officer" and "executive officer" are engaging in the conduct addressed in the rule, we may revisit this issue.

Definition of "under the direction." As noted above, new rule 13b2-2(b)(1) covers the activities of not only officers and directors of the issuer who engage in an attempt to misstate financial statements but also "any other person acting under the direction thereof." Activities by such "other persons" currently may constitute violations of the anti-fraud or other provisions of the securities laws n18 or aiding or abetting n19 or causing n20 an issuer's violations of the securities laws. Section 303(a) and the new rule provide the Commission n21 with an additional means of addressing efforts by persons acting under the direction of an officer or director to improperly influence the audit process and the accuracy of the issuer's financial statements.

As noted in the proposing release, we interpret Congress' use of the term "direction" to encompass a broader category of behavior than "supervision." n22 In other words, someone may be "acting under the direction" of an officer or director even if they are not under the supervision or control of that officer or director. Such persons might include not only the issuer's employees but also, for example, customers, vendors or creditors who, under the direction of an officer or director, provide false or misleading confirmations or other false or misleading information to auditors, or who enter into "side agreements" that enable the issuer to mislead the auditor. n23 In appropriate circumstances, persons acting under the direction of officers and directors also may include not only lower level employees of the issuer n24 but also other partners or employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer) and attorneys, securities professionals, or other advisers who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such a report would be unwarranted, n25 to not object to an inappropriate accounting treatment, or not to withdraw an issued audit report on the issuer's financial statements. In the case of a registered investment company, persons acting under the direction of officers and directors of the investment company may include, among others, officers, directors, and employees of the investment company's investment adviser, sponsor, depositor, administrator, principal underwriter, custodian, transfer agent, or other service providers. n26

Commenters on this discussion in the proposing release were divided. Some believe that some form of specific instruction or direction from an officer or director should be required before the rule should apply to "other persons." n27 Others expressed the opposite view that no specific direction should be required, n28 that the conduct should be considered illegal whether or not the person was acting under the direction of an officer or director, n29 and that the rule should apply to anyone who lies to or misleads the auditor n30 and to all those who have responsibilities or activities relevant to the financial statements. n31 Still others suggested that we neither define the term "under the direction" nor provide examples. n32 As noted above, we continue to believe that "direction" encompasses a broader category of behavior than supervision, and may include the activities of third parties who participate in an effort to improperly influence the auditor when those third parties knew or should have known that the effect of their conduct would be to render an issuer's financial statements materially misleading.

Some commenters were concerned that including customers, vendors and creditors in the discussion of those persons who, in appropriate circumstances, might be considered to be acting under the direction of an officer or director would have a chilling effect on communications between those persons and the auditors. n33 Other commenters noted that this chilling effect would be enhanced by the Commission's position in the proposing release that negligently misleading the auditor was sufficient conduct to trigger application of the rule. n34 In particular, some commenters noted that a misleading legal analysis should violate the rule only if accompanied by fraudulent or "bad" intent on the part of the attorney providing the analysis. n35 These comments would appear to be based on the premise that in the past the Commission has not addressed the negligent communication of misleading information to auditors and that the new rule, therefore, would chill communications during the audit process and thereby lower the quality of the audit process. To the contrary, for many years we have initiated enforcement actions against those who, by negligently providing misleading confirmations to auditors, cause n36 an issuer to violate the financial reporting or books and records provisions of the Securities Exchange Act of 1934. n37 The new rule, by providing an additional means of addressing such conduct, should provide more credibility and integrity to the audit process. We believe that third parties

providing information or analyses to an auditor should exercise reasonable attention and care in those communications. n38 A primary purpose for enactment of the Sarbanes-Oxley Act is the restoration of investor confidence in the integrity of financial reports, which will require the cooperation of all parties involved in the audit process. We do not intend to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues. We do believe, however, that those third parties who, under the direction of an issuer's officers or directors, mislead or otherwise improperly influence auditors when they know or should know that their conduct could result in investors being provided with misleading financial statements or a misleading audit report, should be subject to sanction by the Commission. n39

"Fraudulently influence." New rules 13b2-2(b)(1) and (c)(2) address certain actions "to coerce, manipulate, mislead, or fraudulently influence" the auditor of the issuer's financial statements. Much of the conduct addressed by the rules, particularly efforts to "manipulate or mislead" the auditor, generally would be subject to other provisions of the securities laws and the Commission's regulations, including the existing rules in Regulation 13B-2. n40 The new rules, however, would provide an additional means to address conduct to coerce, manipulate, mislead, or fraudulently influence an auditor during his or her examination or review of the issuer's financial statements, including conduct that did not succeed in affecting the audit or review. n41

In the proposing release, we noted that in the rule the word "fraudulently" modifies influence but not coerce, manipulate or mislead. Several commenters suggested that the Commission should amend this interpretation and state that "fraudulently" modifies all four types of conduct. n42 Some commenters indicated that intent to materially mislead the auditor should be required n43 and others stated any attempt to purposely skew the issuer's disclosure should violate the rule. n44 One commenter noted that fraudulent intent should not be required for officers, directors or employees, but should be required for third parties such as vendors and customers. n45

We have decided not to amend our view that the word "fraudulently" modifies only "influence." To emphasize this point, we have reordered the words to place "fraudulently influence" at the end of the list instead of at the beginning. n46 The new rule, therefore, reads that no officer or director or person acting under his or her direction "shall directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence" any accountant engaged in the performance of an audit or review of an issuer's financial statements.

In the context of the new rule, the words "coerce" and "manipulate" imply compelling the auditor to act in a certain way through pressure, threats, trickery, intimidation or some other form of purposeful action, n47 and further modifiers are not necessary. Regarding the term "mislead," pre-existing rule 13b2-2 for many years has prohibited officers and directors from directly or indirectly making or causing to be made materially misleading statements to auditors. Causing n48 misleading statements to be made to auditors has included, and will continue to include, an officer or director entering into an arrangement with a third party to send a misleading confirmation or to provide other misleading information or data to the auditor of the issuer's financial statements. n49 The new rule does not alter this approach. As noted above, a primary purpose for enactment of the Sarbanes-Oxley Act is the restoration of investor confidence in the integrity of financial reports. Such a purpose would not be served by imposing what would amount to a new scienter requirement on the pre-existing provision prohibiting officers and directors from causing misleading statements or omissions to be made to auditors.

Types of Conduct. As stated in the proposing release, types of conduct that the Commission believes could constitute improper influence (if the person engaged in that conduct knows or should know that the conduct, if successful, could result in rendering the issuer's financial statements materially misleading) include, but are not limited to, directly or indirectly:

- Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services,
- Providing an auditor with an inaccurate or misleading legal analysis,

- Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting,
- Seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting,
- Blackmailing, and
- Making physical threats.

The facts and circumstances of each case would be relevant to determining whether the conduct would violate the new rule.

Commenters had varied reactions to the illustrative list of the types of conduct that could be covered by the rule. Some commenters suggested that providing inaccurate or misleading information to internal auditors, as well as to independent auditors, should be deemed a violation of the rule. n50 While we believe that an officer or director, or person acting under the direction of an officer or director, providing misleading information to an internal auditor would be relevant to the status of the issuer's internal accounting controls or disclosure controls, it would not appear to be related to the purpose of section 303 of the Act and the new rule, which is to protect and enhance the independent audit function. n51

Other commenters suggested that, due to other safeguards in the Act, we should delete from the illustrative list the actions of offering future employment with the issuer n52 and threatening to cancel audit or non-audit contracts for services. n53 These commenters indicated that section 206 of the Act, which requires a one-year "cooling off" period from the time certain officers of the issuer last participated as a partner or employee of the accounting firm in an audit of the issuer's financial statements to the commencement of the audit, n54 provides sufficient protection against offering employment as a means of improperly influencing the auditor. Similarly, commenters indicated that the provisions in sections 201 and 202 requiring audit committee pre-approval of audit and non-audit services should be an adequate safeguard against the use of such services to improperly influence auditors. n55 Sections 201, 202 and 206, as well as the remainder of Title II of the Act, are designed to enhance the independence of auditors. We believe, however, services and employment opportunities that would not impair an auditor's independence nonetheless could provide financial incentives used to improperly influence or otherwise deter auditors from performing an appropriate audit. Accordingly, such actions continue to be possible mechanisms, assuming the other criteria in the rule are met, for violating the new rule.

Some commenters suggested qualifying other examples in the list. For example, commenters indicated that canceling or threatening to cancel an audit or non-audit engagement should be within the purview of the rule only if the action was taken because the auditor objects to the issuer's accounting. n56 One commenter expressed this notion in terms of a clear *quid pro quo* linking the offering of a contract for non-audit services with the intent to fraudulently influence the audit. n57 We acknowledge that there may be many legitimate reasons to replace individuals on an audit or review engagement, or to award or cancel audit or non-audit services. Such actions alone do not violate the new rule. When such actions, however, become the consideration used by an officer or director, or person acting under the direction of an officer or director, to improperly influence the auditor, and that person knew or should have known that the result of his or her conduct could be materially misleading financial statements, then the actions fall within the scope of the rule.

Still other commenters suggested adding to the list activities such as: knowingly providing to the auditor inadequate or misleading information that is key to the audit, n58 transferring managers or principals from the audit engagement, n59 and when predicated by an intent to defraud, verbal abuse, creating undue time pressure on the auditors, not providing information to auditors on a timely basis, and not being available to discuss matters with auditors on a timely

basis. n60 In the appropriate circumstances and upon satisfaction of the criteria in the rule, each of these actions could result in improper influence on the auditor.

Finally, most commenters addressing the issue stated that the Commission should not place in the rule any examples of the types of conduct that might violate the rule, n61 and we have not done so.

Definition of "independent public or certified public accountant." The new rule addresses the improper influence of "any independent public or certified public accountant" engaged in the performance of an audit or review of an issuer's financial statements. n62 Prior to the adoption of the Act, similar phrases commonly were used in the securities laws and the Commission's regulations to refer to the accountant providing audit and review services to a Commission registrant. Although the Act, in anticipation of accounting firms registering with the Public Company Accounting Oversight Board (the "Board"), n63 changed several of these references, n64 such terms continue to appear in certain sections of the securities laws n65 and related schedules. n66 We believe that section 303 of the Act includes all accountants n67 engaged in auditing or reviewing an issuer's financial statements or issuing attestation reports n68 to be filed with the Commission. Once firms are registered with the Board, the term "independent public or certified public accountant," as used in the new rule, would include registered public accounting firms n69 and persons associated with such a public accounting firm, n70 as defined in the Act. While some commenters expressed concern with the use of different definitions to describe the independent auditor, n71 they generally did not object to the use of the term in the new rule. n72

"Engaged in the performance of an audit." New rules 13b2-2(b)(1) and (c)(2) track the language in section 303(a) of the Act regarding the improper influence of an accountant "engaged in the performance of an audit" of the issuer's financial statements. Both the Commission n73 and the accounting profession n74 have recognized that the need for an auditor to maintain an independent and unbiased attitude begins when the accountant is selected to perform audit or review services and continues until there is a formal or informal public notification that the professional relationship has ended. n75 To effectuate the intent of Congress, we believe the phrase "engaged in the performance of an audit" should be given a broad reading. We believe Congress intended that the phrase encompass the professional engagement period and any other time the auditor is called upon to make decisions or judgments regarding the issuer's financial statements, including during negotiations for retention of the auditor and subsequent to the professional engagement period when the auditor is considering whether to issue a consent on the use of prior years' audit reports. The new rules, therefore, would apply throughout the professional engagement and after the professional engagement has ended when the auditor is considering whether to consent to the use of, reissue, or withdraw prior audit reports. In limited circumstances, the new rules also may apply before the professional engagement period begins. For example, the new rules would apply if an officer, director, or person acting under the direction of an officer or director, offers to engage an accounting firm subject to a condition that could result in rendering the financial statements materially misleading, such as a condition that the firm issue an unqualified audit report on financial statements that do not conform with generally accepted accounting principles, or a condition that the firm limit the scope or performance of audit or review procedures in violation of generally accepted auditing standards.

Commenters generally agreed with this approach. n76 Some suggested that we define in the rule the phrase "engaged in the performance of the audit." n77 We believe, however, that the longer discussion in this release provides a better context to understand the meaning of the phrase.

"Rendering financial statements materially misleading." One of the criteria that must be met in order for the improper influence on the auditor by officers, directors, or persons acting under their direction to be actionable under the new rule is that the improper influence, if successful, could result in "rendering [the issuer's] financial statements materially misleading." n78 Because the financial statements are prepared by management and the auditor conducts an audit or review of those financial statements, the auditor would not directly "render [the] financial statements materially misleading." Rather, the auditor might be improperly influenced to, among other things, issue an unwarranted report on the financial statements, n79 including suggesting or acquiescing in the use of inappropriate accounting treatments n80 or not proposing adjustments required for the financial statements to conform with generally accepted accounting

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principles. n81 An auditor also might be coerced, manipulated, misled, or fraudulently influenced not to perform audit or review procedures that, if performed, might divulge material misstatements in the financial statements. Other examples of activities that would fall within the rule would be for an officer, director, or person acting under an officer or director's direction, to improperly influence an auditor either not to withdraw a previously issued audit report when required by generally accepted auditing standards, n82 or not to communicate appropriate matters to the audit committee. n83 New rule 13b2-2(b)(2) makes it clear that subparagraph (b)(1) would apply in such circumstances. As noted, the rule is not limited to the audit of the annual financial statements, but would include, among other things, improperly influencing an auditor during a review of interim financial statements n84 or in connection with the issuance of a consent to the use of an auditor's report. n85 Conducting reviews of interim financial statements and issuing consents to use past audit reports are sufficiently connected to the audit process, and improper influences during those processes are sufficiently connected to the harms that the Act seeks to prevent, that they should be within the scope of the rule. The list of examples in the rule is only illustrative; other actions also could result in rendering the financial statements materially misleading.

Many commenters indicated that the examples in paragraph (b)(2) were appropriate and should be retained. n86 Some commenters suggested that the list of examples be expanded to include improperly influencing the auditor to permit the inconsistent use of generally accepted accounting principles ("GAAP") or the use of "non-preferable" GAAP in the issuer's financial statements. n87 Others suggested including improperly influencing an auditor in connection with the auditor's report on an issuer's assertions about its internal controls. n88 Another commenter suggested that the examples be replaced with a statement that actions that could result in "rendering the financial statements materially misleading" include improperly influencing an auditor during the performance of any procedures by the auditor. n89 We believe that the list of examples in paragraph (b)(2) is sufficiently broad to include the majority of instances, including under appropriate circumstances those addressed by commenters, where improperly influencing an auditor could result in the issuer publishing misleading financial statements. As noted above, the list of examples is not all-inclusive. Other actions, in appropriate circumstances, could result in rendering the issuer's financial statements materially misleading.

"Knew or should have known." Section 303(a) states that conduct by an officer, director, or person acting under the direction of the officer or director designed to improperly influence an issuer's auditor is actionable if undertaken "for the purpose of rendering [the issuer's] financial statements materially misleading." We proposed, however, the rule state that an officer, director, or person acting under the direction of the officer, who engaged in conduct to improperly influence an auditor would be culpable if he or she "knew or was unreasonable in not knowing" that the improper influence, if successful, could result in rendering financial statements materially misleading. In the proposing release we noted that we would consider changing this wording to another phrase to convey that proving a particular purpose or intent is not required. We are adopting in the final rule the phrase "knew or should have known," which historically has indicated the existence of a negligence standard. n90 As noted elsewhere in this release, this standard is consistent with the Commission's enforcement actions in this area. n91

Several commenters suggested that the rule should contain the statutory language, which they believe requires a fraudulent intent, instead of the proposed language, which they believe reflected a negligence standard. n92 Other commenters, however, indicated that the proposed language should be adopted n93 or that, at a minimum, a reasonableness standard is appropriate when evaluating the actions of officers and directors. n94

We believe that the adopted language, particularly in the absence of any private right of action under the rule, n95 best achieves the purpose of restoring investor confidence in the audit process. n96 For example, if an officer of an issuer coerces an auditor not to conduct certain audit procedures required by generally accepted auditing standards ("GAAS") because the officer wants to conceal his embezzlement of funds from the issuer, then it is possible that his actions might not be found to be for the "purpose of rendering the financial statements misleading." If that officer, however, knew or should have known that not performing the procedures could result in the auditor not detecting and seeking correction of material errors in the financial statements, then we believe the officer's conduct should be subject to the rule. Excusing this conduct from the scope of the rule would be inconsistent with the restoration of investor

confidence in financial statements and in the integrity of the audit process.

Response to Other Significant Comments. In the proposing release, we asked if we should replace the statement in paragraphs (b)(1) and (c) of the rule that no person acting "under the direction" of an officer or director shall improperly influence the auditors of the issuer's financial statements, with a statement that no person acting "at the behest of" or "on behalf of" an officer or director shall improperly influence the auditors. Although some commenters supported use of the phrase "on behalf of," n97 in general commenters opposed changing this aspect of the proposed rule. n98 We agree that there may be circumstances where a person acting on behalf of an officer or director would be considered to be acting under the direction of that officer or director as contemplated by the rule. We believe, however, that the rule, as proposed and adopted, is sufficiently clear. Replacing "under the direction of" with "on behalf of" might be construed as narrowing the scope of the rule, and having both phrases in the rule might create confusion in the interpretation of the rule. Accordingly, we have adopted the rule as proposed.

We also asked in the proposing release if we should replace the word "fraudulently" in paragraphs (b)(1) and (c)(2) of the rule with the word "improperly" or some other word to convey a mental state short of scienter. Although some commenters noted that there is a need for the Commission to adopt rules intended to enhance investor confidence in issuers' financial statements, n99 commenters generally opposed this change as exceeding the purpose and scope of section 303 of the Act. n100 The new rule retains the statutory language of "fraudulently influence" because we are concerned about a lack of specificity associated with the word "improperly" in the context of the rule. As discussed above, "fraudulently" modifies only influence and not "coerce, manipulate or mislead."

Finally, commenters questioned whether an auditor would have an obligation to report violations of the new rule as "illegal acts" under section 10A(b) of the Exchange Act. n101 Section 10A defines an "illegal act" to be an act or omission that violates any law or any rule or regulation having the force of law. n102 Accordingly, violations of the new rule are illegal acts within section 10A and should be dealt with as required by that section. n103

C. Issues Related to Investment Companies

In the case of registered investment companies and business development companies, n104 the prohibition on improper influence on the conduct of audits covers not only officers and directors of the investment company itself, but also officers and directors of the investment company's investment adviser, sponsor, depositor, trustee, and administrator. n105 These service providers perform virtually all of the management, administrative, and other services necessary to the investment company's operations, including preparation of the financial statements. We are also amending existing rule 13b2-2 to cover officers and directors of these entities. n106

One commenter suggested expanding the scope of the persons covered by the prohibition, to include accounting personnel working for an investment company's service providers. n107 Consistent with the language of section 303(a) and the scope of the rule for operating companies, we have not expressly included these persons, although we note that they would be covered by the rule if they are acting under the direction of an officer or director of the investment company or its investment adviser, sponsor, depositor, trustee, or administrator. By contrast, another commenter argued that the prohibition should extend to officers and directors of an investment company's investment adviser, because the investment adviser acts, in effect, in an executive capacity with a fund, but should not extend to other service providers. n108 We have determined not to narrow the service providers covered by the new rule in this manner, because any of the investment adviser, sponsor, depositor, trustee, or administrator may have responsibility for preparation of an investment company's financial statements, and therefore its officers and directors may be in a position to exercise improper influence over the investment company's audit.

§ III. Paperwork Reduction Act

The Paperwork Reduction Act is not applicable to the rules because they do not impose any collection of information requirements.

§ IV. Costs and Benefits

The new rules implement a Congressional mandate. We recognize that any implementation of the Act likely will result in costs and benefits and have an effect on the economy. We are sensitive to the costs and benefits imposed by our rules and, in the proposing release, we identified certain costs and benefits of the proposed rule.

The new rules prohibit officers and directors of an issuer, and persons acting under the direction of an officer or director, from taking any action to coerce, manipulate mislead, or fraudulently influence the auditor of the issuer's financial statements if that person knew or should have known that such action, if successful, could result in rendering the financial statements materially misleading.

Some commenters were concerned that the rules could have a chilling effect on communications between the auditor and third parties, n109 or dampen the debate on accounting issues between auditors and issuers. n110 Such a chilling effect on communications between third parties and auditors, or between auditors and the issuer, could result in an added cost associated with the rule. We believe, however, that the conduct addressed by the new rules generally was prohibited under provisions of the securities laws that existed before enactment of the Sarbanes-Oxley Act. n111 Because the new rule is consistent with previous law, rules, and cases n112 we do not anticipate that the new rules will increase significantly costs for issuers or accounting firms.

Nonetheless, the Act and new rules might prompt some issuers to adopt procedures or guidelines that would assure additional care is used by an issuer's officers and directors, and others acting under their direction, in communicating with auditors of the issuer's financial statements. For example, some issuers might require that more discussions include members of senior management or the issuer's legal counsel. Because no particular procedures related to such communications are required, and the nature and scope of those procedures are likely to vary among issuers, it is difficult to provide an accurate cost estimate.

As noted above, in some circumstances the new rules might apply before the professional engagement period begins. For example, the rules would apply if an officer, director, or person acting under the direction of an officer or director, offers to engage an accounting firm on the condition that the firm either issue an unqualified audit report on financial statements that do not conform with generally accepted accounting principles, or limit the scope or performance of audit or review procedures in violation of generally accepted auditing standards. We believe, however, that such conduct would not be permitted under existing laws and regulations and, accordingly, the rules should not result in a significant increase in costs for issuers.

Potential benefits of the rules include increased investor confidence in the integrity of the audit process and, in turn, in the reliability of reported financial information. One of the most important factors in the successful operation of our securities markets is the trust that investors have in the reliability of the information used to make voting and investment decisions. n113

Section 303(a) and the new rules are designed to provide added assurance that the full-disclosure purposes of the securities laws are fulfilled, n114 and to help restore the faith of America's investors in the integrity of the audit process and in the reliability of reported financial information. If section 303 of the Act and the new rules lead to increased investor confidence in financial reporting, they also might facilitate capital formation. An increased willingness of investors to participate in the securities markets could result in issuers being able to lower their cost of capital.

Commenters generally agreed that the costs associated with the new rules are not significant. n115 One commenter, however, indicated that increased costs might be associated with more litigation and increased liability exposure for accounting firms. n116 Because there is no private right of action under section 303 or the new rule, n117 we expect that

such costs will not be significant.

§ V. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Act Analysis has been prepared in accordance with 5 *U.S.C. 604*. It relates to revised rule 13b2-2 of Regulation 13B-2, which implements the statutory prohibition on officers and directors of an issuer, and persons acting under their direction, improperly influencing the conduct of an audit or review of the issuer's financial statements.

A. Reasons for, and Objectives of, the Rules

The purpose of the new rules is to implement section 303(a) of the Act. The rules prohibit officers and directors of issuers, including "small businesses," and persons acting under their direction, from improperly influencing an accounting firm's audit or review of the issuer's financial statements. Regardless of the application of section 303(a) and the new rules, such conduct would violate the anti-fraud or other provisions of the securities laws or aid and abet or cause the issuer's violations of those sections. The new rules, and section 303(a) of the Act, provide the Commission with an additional means to address such conduct and are intended to enhance the credibility of financial statements.

B. Significant Issues Raised by Public Comments

Some commenters indicated that the cost of compliance with the rules is not significant and that there should be no differences in the rules for small companies. n118 Another commenter stated that special rules are not necessary for small entities if the definitions of officer and director are sufficiently broad to include persons who normally have the responsibility for governance of an entity. n119 As noted above, under the securities laws and the Commission's regulations, the definition of "officer" includes not only those with certain corporate titles but also those performing corresponding functions with respect to any organization, n120 and the definition of "director" includes not only directors of corporations but also those performing similar functions with respect to any organization. n121 Such definitions are sufficiently broad to include persons responsible for governance of an entity.

One comment letter, responding to the Commission's rule proposals related to sections 404, 406 and 407 of the Act, as well as section 303, encouraged the Commission to exempt small companies from the "onerous and sometimes impossible rules for board membership." n122 These comments, however, would appear to address the requirements related to the disclosure of an "audit committee financial expert" under section 407 and not improperly influencing auditors under section 303. This commenter also suggested that we "nurture and encourage business formation and finance" and not impose "insurmountable difficulties for the smaller companies." n123 We believe that enhanced investor confidence in the audit process will encourage capital formation by all companies and that the new rule, which addresses conduct that generally was unlawful prior to the enactment of the Act, does not place "insurmountable difficulties" on small companies.

Another commenter stated that the Commission should be mindful of difficulties some smaller institutions face "in seeking auditing firm alternatives and complying with other new regulatory requirements due to limited staff resources." n124 Although the rule might encourage some companies to exercise additional care in communicating with auditors, the rule does not impose any specific requirements on companies and should not result in the use of additional staff resources. Accordingly, we do not believe that it imposes significant costs on small entities.

C. Small Entities Subject to the Rules

The rules affect small registrants that are small entities. Exchange Act Rule 0-10(a) n125 and 1933 Act Rule 157 n126 define a company to be a "small business" or "small organization" if it had total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that approximately 2,500 companies are small entities, other than investment companies.

For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year. n127 We estimate that approximately 225 investment companies meet this definition.

D. Reporting, Recordkeeping and Other Compliance Requirements

The enactment of section 303(a) of the Act and the adoption of the rules might result in some issuers adopting more detailed procedures for communications between the company and the accounting firm that audits the company's financial statements. These procedures might result in an insignificant increase in costs associated with compliance with the securities laws.

We received no comments or data indicating the extent of burden that might be imposed on small entities. As noted above, we assume the burden would be minor for most issuers.

E. Agency Action to Minimize Effects on Small Entities

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the amendments, we considered the following alternatives:

1. The establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities;
2. The clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities;
3. The use of performance rather than design standards; and
4. An exemption from coverage of the amendments, or any part thereof, for small entities.

Section 303(a) of the Act does not provide an exemption for small businesses. The section does provide, however, that the rules adopted by the Commission should be "as necessary and appropriate in the public interest and for the protection of investors."

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We considered not applying the rules to small business issuers. We believe, however, that investors in small companies, just as investors in large companies, would want and benefit from the added confidence in reported financial information that comes from knowing that efforts to improperly influence the performance of the audit have been prohibited.

We are using a performance standard rather than a design standard. In addition, Congress has dictated the timetable for this rulemaking.

§ VI. Consideration of Impact Economy, Burden On Competition, and Promotion of Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act n128 requires us, when adopting rules under the Exchange Act, to consider the impact on competition of any rule we adopt. Section 2(b) of the 1933 Act, n129 section 3(f) of the Exchange Act, n130 and section 2(c) of the Investment Company Act of 1940, n131 require us, when engaging in rulemaking where we are required to consider or determine whether the action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

The new rules prohibit improper influences on auditors in connection with their reviews and audits of financial statements filed with the Commission. The proposals, therefore, should enhance investor confidence in the audit process and in the quality of information available to them, and lead to a more efficient market.

Because of the nature of the new rules, we do not believe that they would impose any burden on competition. They prohibit equally all officers and directors of public companies (and persons acting under their direction) from improperly influencing the auditor.

As noted in the cost-benefit section, if section 303 of the Act and the new rules lead to increased investor confidence in financial reporting, they also may facilitate capital formation. An increased willingness of investors to participate in the securities markets might result in issuers being able to lower their cost of capital.

We received no comments indicating that the rule would impact competition, efficiency or capital formation.

§ VII. Statutory Authority

We are adopting the new rules under the authority set forth in sections 3(a) and 303 of the Act; Schedule A and sections 5, 6, 7, 8, 10 and 19 of the 1933 Act; Sections 3, 10A, 12, 13, 14, 15, 17 and 23 of the Exchange Act; and Sections 6, 8, 20, 30, 31 and 38 of the Investment Company Act of 1940. TEXT OF RULES AND AMENDMENTS

List of Subjects in 17 CFR Part 240 Securities

In accordance with the foregoing, Title 17, Chapter II, of the Code of Federal Regulations is amended as follows:
SEC Release No. 34-47890

1.

The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78 l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

2.

Section 240.13b2-2 is revised to read as follows:

§ § 240.13b2-2. Representations and conduct in connection with the preparation of required reports and documents.

(a)

No director or officer of an issuer shall, directly or indirectly:

(1)

Make or cause to be made a materially false or misleading statement to an accountant in connection with; or

(2)

Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading, to an accountant in connection with:

(i)

Any audit, review or examination of the financial statements of the issuer required to be made pursuant to this subpart; or

(ii)

The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise.

(b)

(1)

No officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are

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required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.

(2)

For purposes of paragraphs (b)(1) and (c)(2) of this section, actions that, "if successful, could result in rendering the issuer's financial statements materially misleading" include, but are not limited to, actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead, or fraudulently influence an auditor:

(i)

To issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards, or other professional or regulatory standards);

(ii)

Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;

(iii)

Not to withdraw an issued report; or

(iv)

Not to communicate matters to an issuer's audit committee.

(c)

In addition, in the case of an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), or a business development company as defined in section 2(a)(48) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(48)*), no officer or director of the company's investment adviser, sponsor, depositor, trustee, or administrator (or, in the case of paragraph (c)(2) of this section, any other person acting under the direction thereof) shall, directly or indirectly:

(1)

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(i)

Make or cause to be made a materially false or misleading statement to an accountant in connection with; or

(ii)

Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with:

(A)

Any audit, review, or examination of the financial statements of the investment company required to be made pursuant to this subpart; or

(B)

The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise; or

(2)

Take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that investment company that are required

to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the investment company's financial statements materially misleading.

By the Commission.

Margaret H. McFarland
Deputy Secretary

May 20, 2003 SEC Release NO. 33-8185

Final Rule:
Implementation of Standards of Professional Conduct for Attorneys

Securities and Exchange Commission
17 CFR Part 205
[Release Nos. 33-8185; 34-47276; IC-25919; File No. S7-45-02]
RIN 3235-AI72

Agency: Securities and Exchange Commission

Action: Final rule

Summary: The Securities and Exchange Commission ("Commission") is adopting a final rule establishing standards of professional conduct for attorneys who appear and practice before the Commission on behalf of issuers. Section 307 of the Sarbanes-Oxley Act of 2002 requires the Commission to prescribe minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers. The standards must include a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer up-the-ladder within the company to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and, if they do not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors. Proposed Part 205 responds to this directive and is intended to protect investors and increase their confidence in public companies by ensuring that attorneys who work for those companies respond appropriately to evidence of material misconduct. We are still considering the "noisy withdrawal" provisions of our original proposal under section 307; in a related proposing release we discuss this part of the original proposal and seek comment on additional alternatives.

Effective Date: August 5, 2003.

For Further Information Contact: Timothy N. McGarey or Edward C. Schweitzer at 202-942 -0835.

§ I. Executive Summary

Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act") (*15 U.S.C. 7245*) n1 mandates that the Commission issue rules prescribing minimum standards of professional conduct for attorneys appearing and practicing before it in any way in the representation of issuers, including at a minimum a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer or any agent thereof to appropriate officers within the issuer and, thereafter, to the highest authority within the issuer, if the initial report does not result in an appropriate response. The Act directs the Commission to issue these rules within 180 days. n2

On November 21, 2002, in response to this directive, we published for comment proposed Part 205, entitled "Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission in the Representation of an Issuer." The proposed rule prescribed minimum standards of professional conduct for attorneys appearing and practicing before us in any way in the representation of an issuer. The proposed rule took a broad view of who could be found to be appearing and practicing before us. It covered lawyers licensed in foreign jurisdictions, whether or not they were also admitted in the United States. In addition to a rigorous up-the-ladder reporting requirement, the proposed rule incorporated several corollary provisions. Under certain circumstances, these provisions permitted or required attorneys to effect a so-called "noisy withdrawal" by notifying the Commission that they have withdrawn from the representation of the issuer, and permitted attorneys to report evidence of material violations to the Commission.

Our proposing release n3 generated significant comment and extensive debate. We received a total of 167 timely comment letters: 123 from domestic parties and 44 from foreign parties. In addition to soliciting comments, on December 17, 2002 the Commission hosted a Roundtable discussion concerning the impact of the rules upon foreign attorneys. Many of these comments focused on the following issues: the scope of the proposed rule (including, particularly, its application to attorneys who either are not admitted to practice in the United States, or are admitted in the United States but who do not practice in the field of securities law); the proposed rule's "noisy withdrawal" provision (including the Commission's authority to promulgate this portion of the rule and the provision's impact upon the attorney-client relationship); and the triggering standard for an attorney's duty to report evidence of wrongdoing. In light of the compressed time period resulting from the 180-day implementation deadline prescribed in the Act, a number of commenters requested that the Commission allow additional time for consideration of several aspects of the proposed rule, including the application of the rule to non-United States lawyers and the impact of the "noisy withdrawal" and

related provisions.

The thoughtful and constructive suggestions we have received from a broad spectrum of commenters have enabled us better to understand interested parties' views concerning the operation and impact of the proposed rule. As more specifically discussed below, the final rule we adopt today has been significantly modified in light of these comments and suggestions. Thus, the triggering standard for reporting evidence of a material violation has been modified to clarify and confirm that an attorney's actions will be evaluated against an objective standard. The documentation requirements imposed upon attorneys and issuers under the proposed rule have been eliminated, and a "safe harbor" provision has been added to protect attorneys, law firms, issuers and officers and directors of issuers. In response to the large number of comments requesting that we defer the immediate implementation of a final rule to accord affected persons adequate time to assess the duties imposed thereunder, we have deferred the effective date of the rule until 180 days after publication in the Federal Register.

We believe that the final rule responds fully to the mandate of Section 307 to require reporting of evidence of material violations up-the-ladder within an issuer, thereby allowing issuers to take necessary remedial action expeditiously and reduce any adverse impact upon investors. The final rule strikes an appropriate balance between our initial rule proposal on up-the-ladder reporting and the various views expressed by commenters while still achieving this important goal.

At the same time, the Commission considers it important to move forward in its assessment of rules under Section 307 requiring attorney withdrawal and notice to the Commission in cases where an issuer's officers and directors fail to respond appropriately to violations that threaten substantial injury to the issuer or investors. Accordingly, we are extending the comment period on the "noisy withdrawal" and related provisions of the proposed rule and are issuing a separate release soliciting comment on this issue. In that release, we are also proposing and soliciting comment on an alternative procedure to the "noisy withdrawal" provisions. Under this proposed alternative, in the event that an attorney withdraws from representation of an issuer after failing to receive an appropriate response to reported evidence of a material violation, the issuer would be required to disclose its counsel's withdrawal to the Commission as a material event. In the same release, we are soliciting additional comment on the final rules we are adopting, particularly insofar as adoption of the "noisy withdrawal" provisions of the proposed alternative might require conforming changes to the final rule.

Interested parties should submit comments within 60 days of the date of publication of the proposing release in the Federal Register. This will provide additional time for interested parties to comment on the impact of these provisions while still allowing for their implementation as of the effective date of the final rule.

§ II. Section-by-Section Discussion of the Final Rule

205.1. Purpose and Scope

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

Proposed Section 205.1 stated that this part will govern "[w]here the standards of a state where an attorney is admitted or practices conflict with this part." In the proposing release, we specifically raised the question whether this part should "preempt conflicting state ethical rules which impose a lower obligation" upon attorneys. n4

A number of commenters questioned the Commission's authority to preempt state ethics rules, at least without

being explicitly authorized and directed to do so by Congress. n5 Another comment letter noted that the *Constitution's Commerce Clause* grants the federal government the power to regulate the securities industry, that the Sarbanes-Oxley Act requires the Commission to establish rules setting forth minimum standards of conduct for attorneys appearing and practicing before it, and that, under the *Supremacy Clause*, duly adopted Commission rules will preempt conflicting state rules. n6 Finally, several commenters questioned why the Commission would seek to supplant state ethical rules which impose a higher obligation upon attorneys. n7

The language which we adopt today clarifies that this part does not preempt ethical rules in United States jurisdictions that establish more rigorous obligations than imposed by this part. At the same time, the Commission reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdiction in which an attorney is admitted or practices.

Section 205.2. Definitions

For purposes of this part, the following definitions apply:

(a)

Appearing and practicing before the Commission:

(1)

Means:

(i)

Transacting any business with the Commission, including communications in any form;

(ii)

Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii)

Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv)

Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2)

Does not include an attorney who:

(i)

Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii)

Is a non-appearing foreign attorney.

The definition of the term "appearing and practicing" included in the proposed rule was based upon Rule 102(f) of our Rules of Practice, and covered, *inter alia*, an attorney's advising a client (1) that a statement, opinion, or other writing does not need to be filed with or incorporated into any type of submission to the Commission or its staff, or (2) that the issuer is not required to submit or file any registration statement, notification, application, report, communication or other document with the Commission or its staff. This broad definition was intended to reflect the reality that materials filed with the Commission frequently contain information contributed, edited or prepared by individuals who are not necessarily responsible for the actual filing of the materials, and was consistent with the position the Commission has taken as *amicus curiae* in cases involving liability under Section 10(b) of the Exchange Act (15 U.S.C. 78j(b)).

A number of commenters argued that the proposed definition of "appearing and practicing" was overly broad. The American Bar Association ("ABA") stated that the definition in the proposed rule would unfairly:

subject to the rules attorneys who do not practice securities law and may have only limited or tangential involvement with particular SEC filings and documents. For example, it could inappropriately encompass non-securities specialists who do no more than prepare or review limited portions of a filing, lawyers who respond to auditors' letters or prepare work product in the ordinary course unrelated to securities matters that may be used for that purpose, and lawyers preparing documents that eventually may be filed as exhibits... . We also believe it is inappropriate for the Commission to include lawyers who simply advise on the availability of exemptions from registration. n8

The ABA recommended that the definition be modified to apply "only to those lawyers with significant responsibility for the company's compliance with United States securities law, including satisfaction of registration, filing and disclosure obligations, or with overall responsibility for advising on legal compliance and corporate governance matters under United States law." n9

On the other hand, several commenters supported the more expansive definition set forth in the proposed rule.

A comment letter submitted by a group of 50 academics specifically affirmed their:

support [for] the Commission's inclusion of lawyers who advise and/or draft, but do not sign, documents filed with the Commission, as well as lawyers who advise that documents need not be filed with the Commission. Any other rule would facilitate circumvention of these rules by encouraging corporate managers and corporate counsel to confine lawyer signatures on Commission documents or filings to a bare minimum to ensure no up-the-ladder reporting of wrongdoing. That would risk gutting these rules and § 307. n10

The definition contained in the final rule addresses several of the concerns raised by commenters. Attorneys who advise that, under the federal securities laws, a particular document need not be incorporated into a filing, registration statement or other submission to the Commission will be covered by the revised definition. In addition, an attorney must have notice that a document he or she is preparing or assisting in preparing will be submitted to the Commission to be deemed to be "appearing and practicing" under the revised definition. The definition in the final rule thereby also clarifies that an attorney's preparation of a document (such as a contract) which he or she never intended or had notice would be submitted to the Commission, or incorporated into a document submitted to the Commission, but which subsequently is submitted to the Commission as an exhibit to or in connection with a filing, does not constitute "appearing and practicing" before the Commission.

As discussed below, commenters also raised concerns regarding the potential application of the rule to attorneys who, while admitted to practice in a state or other United States jurisdiction, were not providing legal services to an issuer. Under the final rule, attorneys need not serve in the legal department of an issuer to be covered by the final rule, but they must be providing legal services to an issuer within the context of an attorney-client relationship. An attorney-client relationship may exist even in the absence of a formal retainer or other agreement. Moreover, in some cases, an attorney and an issuer may have an attorney-client relationship within the meaning of the rule even though the attorney-client privilege would not be available with respect to communications between the attorney and the issuer.

The Commission intends that the issue whether an attorney-client relationship exists for purposes of this part will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer. Thus, whether the provision of legal services under particular circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under this part. This portion of the definition will also have the effect of excluding from coverage attorneys at public broker-dealers and other issuers who are licensed to practice law and who may transact business with the Commission, but who are not in the legal department and do not provide legal services within the context of an attorney-client relationship. Non-appearing foreign attorneys, as defined below, also are not covered by this definition.

205.2(b) provides:

(b)

Appropriate response means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1)

That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2)

That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3)

That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i)

Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii)

Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

The definition of "appropriate response" emphasizes that an attorney's evaluation of, and the appropriateness of an issuer's response to, evidence of material violations will be measured against a reasonableness standard. The Commission's intent is to permit attorneys to exercise their judgment as to whether a response to a report is appropriate, so long as their determination of what is an "appropriate response" is reasonable.

Many of the comments on this paragraph focused on the proposal's standard that an attorney has received an appropriate response when the attorney "reasonably believes," based on the issuer's response, that there either is or was no material violation, or that the issuer has adopted appropriate remedial measures. They suggested, among other things, that the paragraph be amended to state that the attorney could rely upon the factual representations and legal determinations that a reasonable attorney would rely upon, n11 or that the Commission adopt the ABA's Model Rules' definition of "reasonably believes." n12 Others opined that the "reasonably believes" standard was inappropriate because it would impose on lawyers who are not expert in the securities laws a standard based on the "reasonable" securities law expert. n13 Others opined that the standard should be modified to require the lawyer's "actual understanding," rather than reasonable belief, regarding a "clear" material violation, n14 while others urged that the standard must be objective. n15

Other commenters felt that the paragraph did not properly address situations, which the commenters felt would be frequent, where an issuer's inquiry into the report of a possible material violation would be "inconclusive." n16 Others expressed the belief that the rule did not give a reporting lawyer sufficient guidance "such that a reporting attorney can with confidence, and without speculation, determine whether he or she has received an appropriate

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response." n17 Some comments questioned whether reporting attorneys would be able to judge whether discipline or corrective measures were sufficient to constitute an appropriate response. n18 One suggested that the paragraph be modified to provide that an attorney has received an appropriate response when the chief legal officer ("CLO") states that he or she has fulfilled the obligations set forth in Section 205.3(b)(3), unless the attorney is reasonably certain that the representations are untrue. n19 Some commenters found the term "and/or" in subparagraph (b)(2) of the proposed paragraph confusing. n20 Others questioned whether the provision that the issuer "rectify" the material violation should be read to contemplate restitution to injured parties, with one stating that it did not believe Congress intended to impose upon attorneys an obligation to require issuers to make restitution, n21 while others read the proposed rule as "impl[y]ing that the appropriateness of a response need not include compensation of injured parties," and accordingly supported this standard. n22 A few commenters noted that under subparagraph (b)(2) a response is appropriate only if the issuer has already "adopted remedial measures," and thus apparently does not apply if the issuer is in the process of adopting them. They urged that the Commission provide that an appropriate response includes ongoing remedial measures. n23

A few comments were directed at the discussion accompanying the proposed rule. One suggestion was that the Commission make clear that the factors it will consider in determining whether an outside law firm's response that no violation has occurred constitutes an appropriate response include a description of the scope of the investigation undertaken by the law firm and the relationship between the issuer and the firm. They also urged the Commission to expressly state that the greater or more credible the evidence that triggered the report, the more detailed an investigation into the matter must be. n24 One commenter also suggested that the Commission withdraw the statement in the release of the proposed rule that Section 205.2(b) "permits" attorneys "to exercise their judgment," finding that language both superfluous and conveying a signal that the Commission will be loathe to second-guess a lawyer's judgment that a response is "appropriate." n25

Several commenters suggested that the proposed rule should exempt internal investigations of reported evidence of a material violation. n26 Commenters were concerned that the reporting and disclosure requirements in the proposed rules might discourage issuers from obtaining legal advice and undertaking internal investigations and that, as a result, some violations might not be discovered or resolved. n27 Thus, some commenters urged that an issuer must be permitted "to retain counsel to investigate the claim and respond to it, including defense in litigation, without being at risk of violating the rule." n28 Some commenters stated that "counsel conducting an internal investigation" should not be subject to the rule's reporting and disclosure requirements. n29

The proposing release stated that "[i]t would not be an inappropriate response to reported evidence of a material violation for an issuer's CLO to direct defense counsel to assert either a colorable defense or a colorable basis for contending that the staff should not prevail. Such directions from the CLO, therefore, would not require defense counsel to report any evidence of a material violation to the issuer's directors." n30 Several commenters were concerned over a possible chilling effect on an attorney's representation of an issuer in a Commission investigation or administrative proceeding if the attorney were subject to reporting and disclosure requirements. n31 Some noted that an issuer's disagreement in good faith with the Commission over a matter in litigation should not raise a reporting obligation under the rules. n32 Others suggested that the definition of "appropriate response" include the assertion of "a colorable defense or the obligation of the Commission staff to bear the burden of proving its case." n33 Some commenters stressed that an attorney representing an issuer should be able to take any position for which there is an evidentiary foundation and a nonfrivolous legal basis. n34 The commenters did not want the final rules to impair an advocate's ability to present non-frivolous arguments. Some commenters noted that an issuer has no right to use an attorney to conceal ongoing violations or plan further violations of the law. n35

The standard set forth in the final version of Section 205.2(b) requires the attorney to "reasonably believe" either that there is no material violation or that the issuer has taken proper remedial steps. The term "reasonably believes" is defined in Section 205.2(m). In providing that the attorney's belief that a response was appropriate be reasonable, the Commission is allowing the attorney to take into account, and the Commission to weigh, all attendant circumstances. The circumstances a reporting attorney might weigh in assessing whether he or she could reasonably

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believe that an issuer's response was appropriate would include the amount and weight of the evidence of a material violation, the severity of the apparent material violation and the scope of the investigation into the report. While some commenters suggested that a reporting attorney should be able to rely completely on the assurance of an issuer's CLO that there was no material violation or that the issuer was undertaking an appropriate response, the Commission believes that this information, while certainly relevant to the determination whether an attorney could reasonably believe that a response was appropriate, cannot be dispositive of the issue. Otherwise, an issuer could simply have its CLO reply to the reporting attorney that "there is no material violation," without taking any steps to investigate and/or remedy material violations. Such a result would clearly be contrary to Congress' intent in enacting Section 307. On the other hand, it is anticipated that an attorney, in determining whether a response is appropriate, may rely on reasonable and appropriate factual representations and legal determinations of persons on whom a reasonable attorney would rely.

Some commenters expressed confusion over the "and/or" connectors in the proposed subparagraph (b)(2), and they have been eliminated in the final rule. The Commission believes that the revisions to this subparagraph make clear that the issuer must adopt appropriate remedial measures or sanctions to prevent future violations, redress past violations, and stop ongoing violations and consider the feasibility of restitution. The concern that under subparagraph (b)(2) any issuer's response to a reporting attorney that remedial measures are ongoing but not completed must be deemed to be inappropriate, thereby requiring reporting up-the-ladder, appears to be overstated. Many remedial measures, such as disclosures and the cessation of ongoing material violations, will occur in short order once the decision has been made to pursue them. Beyond this, the reasonable time period after which a reporting attorney is obligated to report further up-the-ladder would include a reasonable period of time for the issuer to complete its ongoing remediation.

By broadening the definition of "appropriate response," subparagraph (b)(3) responds to a variety of concerns raised by commenters. Subparagraph (b)(3) permits an issuer to assert as an appropriate response that it has directed its attorney, whether employed or retained by it, to undertake an internal review of reported evidence of a material violation and has substantially implemented the recommendations made by an attorney after reasonable investigation and evaluation of the reported evidence. However, the attorney retained or directed to conduct the evaluation must have been retained or directed with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to 205.3(b)(3), or a qualified legal compliance committee.

Subparagraph (b)(3) also explicitly incorporates into the final rule our view, expressed in the proposing release, that "[i]t would not be an inappropriate response to reported evidence of a material violation for an issuer's CLO to direct defense counsel to assert either a colorable defense or a colorable basis for contending that the staff should not prevail." n36 Subparagraph (b)(3) incorporates this standard into the definition of "appropriate response" by permitting an issuer to respond to a report that it has been advised by its attorney that he or she may assert a colorable defense on behalf of the issuer in response to the reported evidence "in any investigation or judicial or administrative proceeding," including by asserting a colorable basis that the Commission or other charging party should not prevail. n37 The provision would apply only where the defense could be asserted consistent with an attorney's professional obligation. Once again, the attorney opining that he or she may assert a colorable defense must have been retained or directed to evaluate the matter with the consent of the issuer's board of directors, a committee thereunder to whom a report could be made pursuant to Section 205(b)(3), or a qualified legal compliance committee.

We noted in our proposing release our intention that the rule not "impair zealous advocacy, which is essential to the Commission's processes." n38 The attorney conducting an internal investigation that is contemplated under subparagraph (b)(3) may engage in full and frank exchanges of information with the issuer he or she represents. Moreover, as noted above, subparagraph (b)(3) expressly provides that the assertion of colorable defenses in an investigation or judicial or administrative proceeding is an appropriate response to reported evidence of a material violation. Concerns over a chilling effect on advocacy should thus be allayed. At the same time, by including a requirement that this response be undertaken with the consent of the issuer's board of directors, or an appropriate committee thereof, the revised definition is intended to protect against the possibility that a chief legal officer would avoid further reporting "up-the-ladder" by merely retaining a new attorney to investigate so as to assert a colorable, but

perhaps weak, defense.

The term "colorable defense" does not encompass all defenses, but rather is intended to incorporate standards governing the positions that an attorney appropriately may take before the tribunal before whom he or she is practicing. For example, in Commission administrative proceedings, existing Rule of Practice 153(b)(1)(ii), *17 CFR 201.153(b)(1)(ii)*, provides that by signing a filing with the Commission, the attorney certifies that "to the best of his or her knowledge, information, and belief, formed after reasonable inquiry, the filing is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law." An issuer's right to counsel is thus not impaired where the attorney is restricted to presenting colorable defenses, including by requiring the Commission staff to bear the burden of proving its case. Of course, as some commenters noted, an issuer has no right to use an attorney to conceal ongoing violations or plan further violations of the law.

205.2(c) provides:

(c)

Attorney means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.

Commenters suggested that the proposed rule's definition of the term "attorney" was unnecessarily broad. A number of commenters suggested that it was inappropriate to apply the rule to foreign attorneys, arguing that foreign attorneys, and attorneys representing or employed by multijurisdictional firms, are subject to statutes, rules, and ethical standards in those foreign jurisdictions that are different from, and potentially incompatible with, the requirements of this rule. n39 These points were amplified by foreign attorneys who attended a December 17, 2002 Roundtable discussion hosted by the Commission to address the issues raised by the application of the rule to foreign attorneys.

As noted above, and as set forth more fully below, the rule we adopt today adds a new defined term, "non-appearing foreign attorney," which addresses many of the concerns expressed regarding the application of the rule to foreign attorneys. In addition, other commenters argued that the proposed rule's definition of "attorney" applied to a large number of individuals employed by issuers who are admitted to practice, but who do not serve in a legal capacity. By significantly narrowing the definition of the term "appearing and practicing" as set forth above, we have addressed many of the concerns expressed by commenters concerning the application of the rule to individuals admitted to practice who are employed in non-legal positions and do not provide legal services.

205.2(d) provides:

(d)

Breach of fiduciary duty refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

The definition we adopt today has been slightly modified from the definition included in the proposing release. Several commenters suggested that the definition in the proposing release should be amended to include breaches of fiduciary duty arising under federal or state statutes. n40 The phrase "under an applicable federal or state statute" has been added to clarify that breaches of fiduciary duties imposed by federal and state statutes are covered by the rule.

205.2(e) provides:

(e)

Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.

This revised definition of "evidence of a material violation" clarifies aspects of the objective standard that the Commission sought to achieve in the definition originally proposed. n41 The definition of "evidence of a material violation" originally proposed prompted extensive comment because (read together with the rule's other definitions) it defines the trigger for an attorney's obligation under the rule to report up-the-ladder to an issuer's CLO or qualified legal compliance committee ("QLCC") (in section 205.3(b)). Some commenters, including some practicing attorneys, found the proposed reporting trigger too high. n42 Many legal scholars endorsed the framework of increasingly higher triggers for reporting proposed by the Commission at successive stages in the reporting process but considered the Commission's attempt at articulating an objective standard unworkable and suggested changes to the language in the proposed rule. n43 Nearly all practicing lawyers who commented found the reporting trigger in the rule too low and called instead for a subjective standard, requiring "actual belief" that a material violation has occurred, is ongoing, or is about to occur before the attorney would be obligated to make an initial report within the client issuer. n44 The revised definition incorporates suggested changes into an objective standard that is designed to facilitate the effective operation of the rule and to encourage the reporting of evidence of material violations.

Evidence of a material violation must first be credible evidence. n45 An attorney is obligated to report when, based upon that credible evidence, "it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." This formulation, while intended to adopt an objective standard, also recognizes that there is a range of conduct in which an attorney may engage without being unreasonable. n46 The "circumstances" are the circumstances at the time the attorney decides whether he or she is obligated to report the information. These circumstances may include, among others, the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult. Under the revised definition, an attorney is not required (or expected) to report "gossip, hearsay, [or] innuendo." n47 Nor is the rule's reporting obligation triggered by "a combination of circumstances from which the attorney, in retrospect, should have drawn an inference," as one commenter feared.

On the other hand, the rule's definition of "evidence of a material violation" makes clear that the initial duty to report up-the-ladder is not triggered only when the attorney "knows" that a material violation has occurred n48 or when the attorney "conclude[s] there has been a violation, and no reasonable fact finder could conclude otherwise." n49 That threshold for initial reporting within the issuer is too high. Under the Commission's rule, evidence of a material violation must be reported in all circumstances in which it would be unreasonable for a prudent and competent attorney not to conclude that it is "reasonably likely" that a material violation has occurred, is ongoing, or is about to occur. To be "reasonably likely" a material violation must be more than a mere possibility, but it need not be "more likely than not." n50 If a material violation is reasonably likely, an attorney must report evidence of this violation. The term "reasonably likely" qualifies each of the three instances when a report must be made. Thus, a report is required when it is reasonably likely a violation has occurred, when it is reasonably likely a violation is ongoing or when reasonably likely a violation is about to occur.

205.2(f) provides:

(f)

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Foreign government issuer means a foreign issuer as defined in 17 CFR 230.405 eligible to register securities on Schedule B of the Securities Act of 1933 (15 U.S.C. 77a et seq. , Schedule B).

We adopt the definition for this new term prescribed under Rule 405.

205.2(g) provides:

(g)

In the representation of an issuer means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

The definition we adopt today has been modified from the definition included in the proposing release. The phrase "providing legal services" has been substituted for the term "acting." Some commenters objected that the term "acting" was both imprecise and overly broad, and that the concept of "representation of an issuer" should "apply only to attorneys who are rendering legal advice to the organizational client ... and therefore have the professional obligations of an attorney." n51 The substitution of the term "providing legal services" responds to these concerns. We believe that this change, combined with the narrowing of the definition of the term "appearing and practicing" as set forth above, addresses the concerns expressed by the ABA and others. n52

For the reasons explained in the proposing release, n53 an attorney employed by an investment adviser who prepares, or assists in preparing, materials for a registered investment company that the attorney has reason to believe will be submitted to or filed with the Commission by or on behalf of a registered investment company is appearing and practicing before the Commission under this definition.

Although some commenters objected to this construction of the definition of "in the representation of an issuer," n54 those commenters did not contest either the fact that such an attorney, though employed by the investment adviser rather than the investment company, is providing legal services for the investment company or the logical implication of that fact: that the attorney employed by the investment adviser is accordingly representing the investment company before the Commission. n55 Indeed, the Investment Company Institute ("ICI") opposes the Commission's construction of its rule because, the ICI asserts, the Commission's construction might make investment advisers limit the participation of attorneys employed or retained by the investment adviser in preparing filings for investment companies, thereby forcing the investment companies "to retain their own counsel" to do exactly the same work now performed by attorneys for the investment adviser. n56

205.2(h) provides:

(h)

Issuer means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78 l), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term "issuer" includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

The definition for the term "issuer" we adopt today incorporates the definition set forth in Section 2(a)(7) of the

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Act, which in turn incorporates the definition contained in the Exchange Act. The definition has been modified to specifically exclude foreign government issuers, defined above. n57

The definition also has been modified to make clear that, for purposes of the terms "appearing and practicing" before the Commission and "in the representation of an issuer," the term "issuer" includes any person controlled by an issuer (e.g., a wholly-owned subsidiary), where the attorney provides legal services to that person for the benefit of or on behalf of an issuer. We consider the change important to achieving the objectives of Section 307 in light of the statutory reference to appearing and practicing "in any way" in the representation of an issuer. Under the revised definition, an attorney employed or retained by a non-public subsidiary of a public parent issuer will be viewed as "appearing and practicing" before the Commission "in the representation of an issuer" whenever acting "on behalf of, or at the behest, or for the benefit of" the parent. This language, consistent with the Commission's comment in the proposing release (although now limited to persons controlled by an issuer) would encompass any subsidiary covered by an umbrella representation agreement or understanding, whether explicit or implicit, under which the attorney represents the parent company and its subsidiaries, and can invoke privilege claims with respect to all communications involving the parent and its subsidiaries. Similarly, an attorney at a non-public subsidiary appears and practices before the Commission in the representation of an issuer when he or she is assigned work by the parent (e.g., preparation of a portion of a disclosure document) which will be consolidated into material submitted to the Commission by the parent, or if he or she is performing work at the direction of the parent and discovers evidence of misconduct which is material to the parent. The definition of the term is also intended to reflect the duty of an attorney retained by an issuer to report to the issuer evidence of misconduct by an agent of the issuer (e.g., an underwriter) if the misconduct would have a material impact upon the issuer. n58

205.2(i) provides:

(i)

Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

The definition we adopt today modifies the definition set forth in the proposed rule by adding the phrases "United States federal or state" and "arising under United States federal or state law." This modification clarifies that material violations must arise under United States law (federal or state), and do not include violations of foreign laws. The final rule does not define the word "material," because that term has a well-established meaning under the federal securities laws n59 and the Commission intends for that same meaning to apply here.

205.2(j) provides:

(j)

Non-appearing foreign attorney means an attorney:

(1)

Who is admitted to practice law in a jurisdiction outside the United States;

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(2)

Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and

(3)

Who:

(i)

Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or

(ii)

Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

The final rule provides that a "non-appearing foreign attorney" does not "appear and practice before the Commission" for purposes of the rule. In brief, the definition excludes from the rule those attorneys who: (1) are admitted to practice law in a jurisdiction outside the United States; (2) do not hold themselves out as practicing, or giving legal advice regarding, United States law; and (3) conduct activities that would constitute appearing and practicing before the Commission only (i) incidentally to a foreign law practice, or (ii) in consultation with United States counsel. A non-United States attorney must satisfy all three criteria of the definition to be excluded from the rule.

The effect of this definition will be to exclude many, but not all, foreign attorneys from the rule's coverage. Foreign attorneys who provide legal advice regarding United States securities law, other than in consultation with United States counsel, are subject to the rule if they conduct activities that constitute appearing and practicing before the Commission. For example, an attorney licensed in Canada who independently advises an issuer regarding the application of Commission regulations to a periodic filing with the Commission is subject to the rule. Non-United States attorneys who do not hold themselves out as practicing United States law, but who engage in activities that constitute appearing and practicing before the Commission, are subject to the rule unless they appear and practice before the Commission only incidentally to a foreign law practice or in consultation with United States counsel.

Proposed Part 205 drew no distinction between the obligations of United States and foreign attorneys. The proposing release requested comment on the effects of the proposed rule on attorneys who are licensed in foreign jurisdictions or otherwise subject to foreign statutes, rules and ethical standards. The Commission recognized that the proposed rule could raise difficult issues for foreign lawyers and international law firms because applicable foreign standards might be incompatible with the proposed rule. The Commission also recognized that non-United States lawyers play significant roles in connection with Commission filings by both foreign and United States issuers.

On December 17, 2002, the Commission hosted a Roundtable on the International Impact of the Proposed Rules Regarding Attorney Conduct. The Roundtable offered foreign participants the opportunity to share their views on

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the application of the proposed rule outside of the United States. The participants consisted of international regulators, professional associations, and law firms, among others. Participants at the Roundtable expressed concern about many aspects of the proposed rule. Some objected to the scope of the proposed definition of "appearing and practicing before the Commission," noting that a foreign attorney who prepares a contract or other document that subsequently is filed as an exhibit to a Commission filing might be covered by the rule. In addition, some of the participants stated that foreign attorneys with little or no experience or training in United States securities law may not be competent to determine whether a material violation has occurred that would trigger reporting requirements. Others stated that the "noisy withdrawal" and disaffirmation requirements of the proposed rule would conflict with the laws and principles of confidentiality and the attorney-client privilege recognized in certain foreign jurisdictions.

The Commission received more than 40 comment letters that addressed the international aspects of the proposed attorney conduct rule. Many suggested that non-United States attorneys should be exempt from the rule entirely, arguing that the Commission would violate principles of international comity by exercising jurisdiction over the legal profession outside of the United States. Others recommended that the Commission take additional time to consider these conflict issues, and provide a temporary exemption from the rule for non-United States attorneys. The majority of commenters asserted that the proposed rule's "noisy withdrawal" and disaffirmation requirements would conflict with their obligations under the laws of their home jurisdictions.

Section 205.2(j) and the final definition of "appearing and practicing before the Commission" under section 205.2(a) together address many of the concerns expressed by foreign lawyers. Foreign lawyers who are concerned that they may not have the expertise to identify material violations of United States law may avoid being subject to the rule by declining to advise their clients on United States law or by seeking the assistance of United States counsel when undertaking any activity that could constitute appearing and practicing before the Commission. Mere preparation of a document that may be included as an exhibit to a filing with the Commission does not constitute "appearing and practicing before the Commission" under the final rule, unless the attorney has notice that the document will be filed with or submitted to the Commission and he or she provides advice on United States securities law in preparing the document.

The Commission respects the views of the many commenters who expressed concerns about the extraterritorial effects of a rule regulating the conduct of attorneys licensed in foreign jurisdictions. The Commission considers it appropriate, however, to prescribe standards of conduct for an attorney who, although licensed to practice law in a foreign jurisdiction, appears and practices on behalf of his clients before the Commission in a manner that goes beyond the activities permitted to a non-appearing foreign attorney. Non-United States attorneys who believe that the requirements of the rule conflict with law or professional standards in their home jurisdiction may avoid being subject to the rule by consulting with United States counsel whenever they engage in any activity that constitutes appearing and practicing before the Commission. In addition, as discussed in Section 205.6(d) below, the Commission is also adopting a provision to protect a lawyer practicing outside the United States in circumstances where foreign law prohibits compliance with the Commission's rule.

205.2(k) provides:

(k)

Qualified legal compliance committee means a committee of an issuer (which also may be an audit or other committee of the issuer) that:

(1)

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Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*);

(2)

Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under § 205.3;

(3)

Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i)

To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in § 205.3(b)(4));

(ii)

To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A)

Notify the audit committee or the full board of directors;

(B)

Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C)

Retain such additional expert personnel as the committee deems necessary; and

(iii)

At the conclusion of any such investigation, to:

(A)

Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B)

Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4)

Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

A QLCC, as here defined, is part of an alternative procedure for reporting evidence of a material violation. That alternative procedure is set out in Section 205.3(c) of the rule.

The definition of a QLCC in Section 205.2(k) of the final rule contains a few modifications from the definition in the proposed rule. In the first clause of the definition, the final rule provides that an audit or other committee of the issuer may serve as the QLCC. As a result, the issuer is not required to form a QLCC as a new corporate structure, unless it wishes to, so long as another committee of the issuer meets all of the requisite criteria for a QLCC and agrees to function as a QLCC in addition to its separate duties and responsibilities. This change responds to comments that issuers should not be required to create a new committee to serve as a QLCC, so long as an existing committee contains the required number of independent directors. n60

Subsection 205.2(k)(1) of the final rule, which addresses the composition of the QLCC, provides that if an issuer has no audit committee, the requirement to appoint at least one member of the audit committee to the QLCC may be met by appointing instead a member from an equivalent committee of independent directors. The Commission does not intend to limit use of the QLCC mechanism only to those issuers that have an audit committee. However, the Commission believes that the requirement that the QLCC be comprised of members who are not employed directly or indirectly by the issuer is warranted and appropriate, and thus disagrees with a commenter's suggestion to permit non-independent board members to be on the QLCC. n61

Subsection 205.2(k)(3)(iii)(A) has been modified to clarify that the QLCC shall have the authority and responsibility to recommend that an issuer implement an appropriate response to evidence of a material violation, but not to require the committee to direct the issuer to take action. This modification responds to comments that the proposed rule would be in conflict with established corporate governance models insofar as the QLCC would have the

explicit authority to compel a board of directors to take certain remedial actions. n62

The proposed rule did not specify whether the QLCC could act if its members did not all agree. In response to comments expressing concern over this point, n63 language has been included in subsections 205.2(k)(3) and (4) of the final rule to clarify that decisions and actions of the QLCC must be made and taken based upon majority vote. Unanimity is not required for a QLCC to operate; nor should an individual member of a QLCC act contrary to the collective decision of the QLCC. Accordingly, the final rule specifies that a QLCC may make its recommendations and take other actions by majority vote.

Commenters suggested both that issuers would have great difficulty finding qualified persons to serve on a QLCC because of the burdens and risks of such service, n64 and that many companies will utilize a QLCC because reporting evidence of a material violation to a QLCC relieves an attorney of responsibility to assess the issuer's response. n65 The Commission does not know how widespread adoption of the QLCC alternative will be, but encourages issuers to do so as a means of effective corporate governance. In any event, the Commission does not intend service on a QLCC to increase the liability of any member of a board of directors under state law and, indeed, expressly finds that it would be inconsistent with the public interest for a court to so conclude.

As in the proposed rule, the final rule provides that members of the QLCC may not be "employed, directly or indirectly, by the issuer." This language, which is also included in Section 205.3(b)(3), is drawn directly from Section 307 of the Sarbanes-Oxley Act. The Commission considers it appropriate and consistent with the mandate of the Act to ensure a high degree of independence in QLCC members and members of committees to whom reports are made under Section 205.3(b)(3). Accordingly, the Commission anticipates that these provisions will be amended to conform to final rules defining who is an "independent" director under Section 301 of the Act, upon adoption of those rules.

205.2(l) provides:

(l)

Reasonable or *reasonably* denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

The definition of "reasonable" or "reasonably" is based on Rule 1.0(h) of the ABA's Model Rules of Professional Conduct, modified to emphasize that a range of conduct may be reasonable.

205.2(m) provides:

(m)

Reasonably believes means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.

This definition is based on the definition of "reasonable belief" or "reasonably believes" in Rule 1.0(i) of the ABA's Model Rules of Professional Conduct, modified to emphasize that the range of possible reasonable beliefs regarding a matter may be broad -- limited for the purposes of this rule by beliefs that are unreasonable. Because the definition no longer is used in connection with the definition of "evidence of a material violation," the proposed rule's attempt to exclude the subjective element in "reasonable belief" has been abandoned.

205.2(n) provides:

(n)

Report means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

The definition for this term has not been changed from the one included in the proposed rule.

Section 205.3 Issuer as client.

205.3(a) provides:

(a)

Representing an Issuer. An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.

This section makes explicit that the client of an attorney representing an issuer before the Commission is the issuer as an entity and not the issuer's individual officers or employees that the attorney regularly interacts with and advises on the issuer's behalf. Most commenters supported the second sentence of the subsection as it is consistent with a lawyer's recognized obligations under accepted notions of professional responsibility. n66 Thus, this sentence remains unchanged in the final rule.

The proposed rule provided that an attorney "shall act in the best interest of the issuer and its shareholders." Commenters raised three principal concerns regarding that provision: it misstates an attorney's duty under traditional ethical standards in charging an attorney with acting in the "best interest" of the issuer; it suggests attorneys have a duty to shareholders creating a risk that the failure to observe that duty could form the basis for a private action against the attorney by any of these shareholders; n67 and it appears to contradict the view expressed by the Commission in the proposing release that "nothing in Section 307 creates a private right of action against an attorney." n68 As the Commission agrees, in part, with these comments, it has modified language in the final rule.

As to the first concern, the Commission recognizes that it is the client issuer, acting through its management, who chooses the objectives the lawyer must pursue, even when unwise, so long as they are not illegal or unethical. However, we disagree with the comment to the extent it suggests counsel is never charged with acting in the best interests of the issuer. ABA Model Rule 1.13 provides that an attorney is obligated to act in the "best interests" of an issuer in circumstances contemplated by this rule: that is, when an individual associated with the organization is violating a legal duty, *and* the behavior "is likely to result in substantial injury" to the organization. In those situations, it is indeed appropriate for counsel to act in the best interests of the issuer by reporting up-the-ladder. n69 However, the Commission appreciates that, with respect to corporate decisions traditionally reserved for management, counsel is not obligated to act in the "best interests" of the issuer. Thus, the reference in the proposed rule to the attorney having a duty to act in the best interests of the issuer has been deleted from the final rule. The sentence has also been modified to make it clear the lawyer "owes his or her professional and ethical duties to the issuer as an organization."

As to the second concern, the courts have recognized that counsel to an issuer does not generally owe a legal obligation to the constituents of an issuer -- including shareholders. n70 The Commission does not want the final rule to suggest it is creating a fiduciary duty to shareholders that does not currently exist. Accordingly, we have deleted from the final rule the reference to the attorney being obligated to act in the best interest of shareholders. This modification should also address the third concern as the Commission does not intend to create a private right of action against

attorneys or any other person under any provision of this part. Indeed, the final rule contains a new provision, 205.7, that expressly provides that nothing in this part is intended to or does create a private right of action.

205.3(b) provides:

(b)

Duty to report evidence of a material violation. (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

Section 205.3(b) clarifies an attorney's duty to protect the interests of the issuer the attorney represents by reporting within the issuer evidence of a material violation by any officer, director, employee, or agent of the issuer. The section was broadly approved by commenters. Paragraph (b)(1) describes the first step that an attorney representing an issuer is required to take after he or she becomes aware of evidence of a material violation, now defined in Section 205.2. The definition of "evidence of a material violation" originally proposed was controversial and has been modified (as discussed above). Paragraph (b)(1), however, was otherwise generally approved. n71

Section 205.3(b)(2) in Proposed Rule: Withdrawn

(2)

The attorney reporting evidence of a material violation shall take steps reasonable under the circumstances to document the report and the response thereto and shall retain such documentation for a reasonable time.

The language set forth from proposed subsection 205.3(b)(2) of the proposed rule has been withdrawn.

In the final rules we have eliminated all requirements that reports and responses be documented and maintained for a reasonable period. Under the proposed rule, a lawyer would have been required to document his or her report of evidence of a material violation (205.3(b)(2)); the CLO would have been required to document any inquiry in response to a report (205.3(b)(3)); a reporting attorney would have been required to document when he or she received an appropriate response to a report (205.3(b)(2)); and an attorney who believed he or she did not receive an appropriate response to a report would have been required to document that response (205.3(b)(8)(ii)).

The Commission proposed the documentation requirements because it believed that up-the-ladder reporting would be handled more thoughtfully if those involved memorialized their decisions. It was also the Commission's view that documentation would benefit reporting attorneys as it would provide them with a contemporaneous written record of their actions that they could use in their defense if their up-the-ladder reporting subsequently became the subject of litigation. To that end, the Commission proposed 205.3(e)(1) (which is codified in the final rule as section 205.3(d)(1)) that specifically authorizes an attorney to use "[a]ny report under this section ... or any response thereto ... in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue." Moreover, the Commission noted (*see* note 52 to the proposing release) that in at least one reported judicial decision, an associate at a law firm who had memorialized his reasons for resigning from the firm over a dispute regarding the adequacy of disclosures in a registration statement, was dismissed as a defendant in subsequent litigation over the appropriateness of

those disclosures because his contemporaneous record demonstrated he had not participated in the fraud.

Nevertheless, the comments that the Commission received to the proposed documentation requirements were almost unanimously in opposition to its inclusion in the final rule. A number of commenters expressed concern that the documentation requirement could be an impediment to open and candid discussions between attorneys and their issuer clients. Those commenters were of the view it would stultify the consultation process because if the client knows the lawyer is documenting discussions regarding a potential material violation, managers are less likely to be honest and forthcoming. n72

Other commenters expressed concern that the documentation requirement has the potential to create a conflict of interest between the lawyer and his or her client. For example, one commenter stated that it "places counsel to the issuer in the untenable position of having to protect himself or herself while trying to advise his or her client." n73 Similarly, another commenter pointed out that documentation would "occur at exactly the time when there was disagreement between an attorney and the client. At the very least, requiring the attorney to produce such product by virtue of his or her separate obligation to the Commission is bound to present potential for conflict of interest." n74 Indeed, it was pointed out, there may be occasions where the preparation of documentation is not in the best interests of the client. n75

Additionally, commenters opined that the documentation requirement might increase the issuer's vulnerability in litigation. They noted that a report will be a "treasure trove of selectively damning evidence" n76 and, while the Commission may be of the view that such documentation should be protected by the attorney-client privilege, the applicability of the privilege will be decided by the courts. Thus, there is considerable uncertainty as to whether it will be protected. At a minimum, it was contended, assertions of privilege will be met with significant and prolonged legal challenges. n77

At least at the present time, the potential harms from mandating documentation may not justify the potential benefits. In all likelihood, in the absence of an affirmative documentation requirement, prudent counsel will consider whether to advise a client in writing that it may be violating the law. n78 In other situations, responsible corporate officials may direct that such matters be documented. In those situations, the Commission's goal will be met, but not in an atmosphere where the issuer and the attorney may perceive that their interests are in conflict.

205.3(b)(2) provides:

(2)

The chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer (or the equivalent thereof) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof. In lieu of causing an inquiry under this paragraph (b), a chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a qualified legal compliance committee under paragraph (c)(2) of this section if the issuer has duly established a qualified legal compliance committee prior to the report of evidence of a material violation.

Paragraph (b)(2) (corresponding to paragraph (b)(3) of the proposed rule, as revised) describes the responsibilities of the issuer's CLO (or the equivalent thereof) in handling reported evidence of a material violation. The

final rule adds a provision expressly allowing the CLO to make use of an issuer's QLCC. The revision eliminates the CLO's documentation requirement and, for the time being, the CLO's obligation, as part of the QLCC process, to notify the Commission in the unlikely event that the issuer fails to take appropriate remedial actions recommended by the QLCC after a determination by the QLCC that there has been or is about to be a material violation. It also changes language that would have required a CLO who reasonably believed that a material violation had occurred, was ongoing, or was about to occur to "take any necessary steps to ensure that the issuer adopts an appropriate response" to language that would, under the same circumstances, require the CLO to "take all reasonable steps to cause the issuer to adopt an appropriate response." These are the points on which the corresponding paragraph in the proposed rule was criticized. n79 Reporting up-the-ladder was otherwise consistently supported. The CLO is responsible for investigating the reported evidence of a material violation for the reasons set out in the proposing release. n80 The second sentence of this paragraph has been modified to clarify the circumstances under which the CLO must advise a reporting attorney that no violation has been found. Thus, the term "determines" has been substituted for "reasonably believes" in the second sentence. This change makes the second sentence consistent with the first sentence which requires the CLO to cause an inquiry to be conducted "to determine" whether a violation has occurred, is ongoing, or is about to occur. Other minor textual changes have been made to the paragraph that do not alter its substantive requirements.

205.3(b)(3) provides:

(3)

Unless an attorney who has made a report under paragraph (b)(1) of this section reasonably believes that the chief legal officer or the chief executive officer of the issuer (or the equivalent thereof) has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to:

(i)

The audit committee of the issuer's board of directors;

(ii)

Another committee of the issuer's board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*) (if the issuer's board of directors has no audit committee); or

(iii)

The issuer's board of directors (if the issuer's board of directors has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*)).

This paragraph describes the circumstances under which an attorney who has reported evidence of a material violation to the issuer's CLO and/or CEO is obliged to report that evidence further up-the-ladder within the client issuer.

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The paragraph tracks the statutory language in Section 307 of the Act, is not controversial, and is adopted without change from the corresponding paragraph in the proposed rule--(b)(4)--for the reasons set out in the proposing release. n81

205.3(b)(4) provides:

(4)

If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's chief legal officer and chief executive officer (or the equivalents thereof) under paragraph (b)(1) of this section, the attorney may report such evidence as provided under paragraph (b)(3) of this section.

The basis for paragraph (b)(4) is implicit in Section 307 of the Act. This bypass provision, however, is not controversial, was not the subject of comment, and is adopted without any substantive change from the corresponding paragraph -- (b)(5) -- of the proposed rule for the reasons set out in the proposing release. n82

205.3(b)(5) provides:

(5)

An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(3), or (b)(4) of this section shall be deemed to be appearing and practicing before the Commission. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported under paragraph (b)(1), (b)(3), or (b)(4) of this section from a duty to respond to the reporting attorney.

Paragraph (b)(5) addresses circumstances in which those to whom evidence of a material violation is reported direct others, either in-house attorneys or outside attorneys retained for that purpose, to investigate the possible violation. It elicited only a few comments, all of them negative. n83 The thrust of these comments was that issuers would be reluctant to retain counsel to investigate reports if those attorneys might trigger up-the-ladder reporting that could result in reporting out to the Commission. The definition of "appropriate response" in section 205.2(b) of the final rule has been modified to address these comments. Further, the modifications to the proposed rule reflected in final rule sections 205.3(b)(6) and (b)(7) below, will relieve attorneys retained or directed to investigate or litigate reports of violations from reporting up-the-ladder in a number of instances.

Paragraph (b)(5) is adopted essentially as proposed. This paragraph -- numbered (b)(6) in the proposed rule--makes two points: first, that the investigating attorneys are themselves appearing and practicing before the Commission and are accordingly bound by the requirements of the proposed rule; and, second, that the officers or directors who caused them to investigate remain obligated to respond to the attorney who initially reported the evidence of a material violation that other attorneys have been directed to investigate.

205.3(b)(6) and (b)(7) provide:

(6)

An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

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(i)

The attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof) to investigate such evidence of a material violation and:

(A)

The attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof); and

(B)

Except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee; or

(ii)

The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee.

(7)

An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if such attorney was retained or directed by a qualified legal compliance committee:

(i)

To investigate such evidence of a material violation; or

(ii)

To assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or

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the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

As noted above in our discussion of paragraph (b)(5) of the final rule, a number of commenters expressed the view that the final rule should eliminate any requirement that attorneys report up-the-ladder when they are retained or directed to investigate a report of a material violation or to litigate whether a violation has occurred. New paragraphs (b)(6) and (b)(7) respond to these legitimate comments, and narrow considerably the instances when it is likely to be necessary for such an attorney to report up-the-ladder. Paragraph (b)(6) addresses the responsibilities of attorneys retained or directed to investigate or litigate reported violations by the chief legal officer (or the equivalent thereof); paragraph (b)(7) addresses circumstances where attorneys are retained or directed to investigate or litigate reported violations by a qualified legal compliance committee. Where an attorney is retained to investigate by the chief legal officer, the attorney has no obligation to report where the results of the investigation are provided to the chief legal officer and the attorney and the chief legal officer agree no violation has occurred and report the results of the inquiry to the issuer's board of directors or to an independent committee of the board. An attorney retained or directed by the chief legal officer to litigate a reported violation does not have a reporting obligation so long as he or she is able to assert a colorable defense on behalf of the issuer and the chief legal officer provides reports on the progress and outcome of the litigation to the issuer's board of directors. An attorney retained or directed by a qualified legal compliance committee to investigate a reported violation has no reporting obligations. Similarly, an attorney retained or directed by a qualified legal compliance committee to litigate a reported violation has no reporting obligation provided he or she may assert a colorable defense on behalf of the issuer.

205.3(b)(8) and (b)(9) provide:

(8)

An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section need do nothing more under this section with respect to his or her report.

(9)

An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section shall explain his or her reasons therefor to the chief legal officer (or the equivalent thereof), the chief executive officer (or the equivalent thereof), and directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section.

As proposed, paragraphs (b)(8) and (b)(9)--numbered (b)(7) and (b)(8) in the proposed rule--elicited no comment (apart from negative comments on documentation provisions that have been eliminated in the final rule). They are adopted without any other substantive change for reasons explained in the proposing release. n84

205.3(b)(10) provides:

(10)

An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under

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this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

Paragraph (b)(10) authorizes an attorney to notify an issuer's board of directors or any committee thereof if the attorney reasonably believes that he or she has been discharged for reporting evidence of a material violation under this section. This provision, an important corollary to the up-the-ladder reporting requirement, is designed to ensure that a chief legal officer (or the equivalent thereof) is not permitted to block a report to the issuer's board or other committee by discharging a reporting attorney.

This provision is similar in concept to paragraph (d)(4) of the proposed rule (as to which, as noted above, the Commission is seeking further comment), although it does not provide for reporting outside the issuer.

205.3(c) provides:

(c)

Alternative reporting procedures for attorneys retained or employed by an issuer that has established a qualified legal compliance committee. (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

(2)

A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements under § 205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c).

This alternative to the reporting requirements of section 205.3(b) would allow, though not require, an attorney to report evidence of a material violation directly to a committee of the board of directors that meets the definitional requirements for a QLCC. It would also relieve the reporting attorney of any further obligation once he or she had reported such evidence to an issuer's QLCC.

Under this alternative, the QLCC--itself a committee of the issuer's board of directors with special authority and special responsibility--would be responsible for carrying out the steps required by Section 307 of the Act: notifying the CLO of the report of evidence of a material violation (except where such notification would have been excused as futile under section 205.3(b)(4)); causing an investigation where appropriate; determining what remedial measures are appropriate where a material violation has occurred, is ongoing, or is about to occur; reporting the results of the investigation to the CLO, the CEO, and the full board of directors; and notifying the Commission if the issuer fails in any material respect to take any of those appropriate remedial measures.

More generally, the QLCC institutionalizes the process of reviewing reported evidence of a possible material violation. That would be a welcome development in itself. It may also produce broader synergistic benefits, such as heightening awareness of the importance of early reporting of possible material violations so that they can be prevented or stopped.

Probably the most important respect in which Section 205.3(c) differs from Section 205.3(b) is, as noted, that Section 205.3(c) relieves an attorney who has reported evidence of a material violation to a QLCC from any obligation "to assess the issuer's response to the reported evidence of a material violation." If the issuer fails, in any material respect to take any remedial action that the QLCC has recommended, then the QLCC, as well as the CLO and the CEO, all have the authority to take appropriate action, including notifying the Commission if the issuer fails to implement an appropriate response recommended by the QLCC.

Commenters generally approved of the QLCC in concept, although several proposed changes in how it would work. The American Bar Association agreed with the need for corporate governance mechanisms to ensure legal compliance once a material violation is reported to an issuer's board, but suggested that existing corporate governance reforms should be given time before new reforms are added. n85 Another commenter suggested that the QLCC should be only one of a number of acceptable governance models, with issuers having freedom to craft techniques suitable to their own circumstances. n86 The Commission recognizes these concerns, but believes the benefits of the QLCC model, as described above, and the absence of any requirement that an issuer form or utilize a QLCC, justify inclusion of this alternative in the final rule.

One commenter suggested that the Commission's final rules should make clear that, for a matter to be referred to a QLCC, the issuer must have a QLCC in place and is not permitted simply to establish a QLCC to respond to a specific incident. n87 This comment has been addressed in Section 205.3(c), which authorizes referral only to a QLCC that has been previously formed.

Commenters made a number of other suggestions regarding the QLCC provisions in the proposed rule. One commenter proposed that the Commission consider making creation of a QLCC mandatory for each issuer. n88 The Commission believes that keeping the QLCC as an alternative reporting mechanism is preferable, and that attorneys should be permitted to report up-the-ladder through their chief legal officers. Another commenter suggested that the QLCC proposal be modified to remove the "noisy withdrawal" provision. n89 The Commission has concluded that, in the extraordinary circumstance in which an appropriate response does not follow a QLCC's recommendation in response to evidence of a material violation, the QLCC should have the authority to take all appropriate action, including notifying the Commission, although it is not required to do so in every case. Another suggestion from a commentator was that the Commission offer a "safe harbor" for a chief legal officer who reports to a QLCC. n90 The Commission has provided a form of "safe harbor" against any inconsistent standard of a state or other United States jurisdiction in Section 205.6(c), and against a private action in Section 205.7.

Section 205.3(d) Issuer Confidences

205.3(d)(1) provides:

(1)

Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

Paragraph (d)(1) makes clear that an attorney may use any records the attorney may have made in the course of fulfilling his or her reporting obligations under this part to defend himself or herself against charges of misconduct. It is

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effectively equivalent to the ABA's present Model Rule 1.6(b)(3) and corresponding "self-defense" exceptions to client-confidentiality rules in every state. The Commission believes that it is important to make clear in the rule that attorneys can use any records they may have prepared in complying with the rule to protect themselves.

One comment expressed concern that this provision would empower the Commission to use such records against the attorney. That concern misreads this paragraph, which expressly refers to the use of these records "by an attorney" in a proceeding where the attorney's compliance with this part is in issue.

205.3(d)(2) provides:

(2)

An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i)

To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii)

To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in *18 U.S.C. 1621*; suborning perjury, proscribed in *18 U.S.C. 1622*; or committing any act proscribed in *18 U.S.C. 1001* that is likely to perpetrate a fraud upon the Commission; or

(iii)

To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

This paragraph thus permits, but does not require, an attorney to disclose, under specified circumstances, confidential information related to his appearing and practicing before the Commission in the representation of an issuer. It corresponds to the ABA's Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981-1982 and by the ABA's Commission of Evaluation of the Rules of Professional Conduct ("Ethics 2000 Commission") in 2000, n91 and as adopted in the vast majority of states. n92 It provides additional protection for investors by allowing, though not requiring, an attorney to disclose confidential information relating to his appearing and practicing before the Commission in the representation of an issuer to the extent the attorney reasonably believes necessary (1) to prevent the issuer from committing a material violation that the lawyer reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer or investors; (2) to prevent the issuer from perpetrating a fraud upon the Commission; or (3) to rectify the consequences of an issuer's material violations that caused or may cause substantial injury to the issuer's financial interest or property in the furtherance of which the attorney's services were used.

2-C Securities Enforcement: Counseling and Defense Scope

The proposed version of this rule provided that the attorney appearing or practicing before the Commission could disclose information to the Commission:

(i)

To prevent the issuer from committing an illegal act that the attorney reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer or investors;

(ii)

To prevent the issuer from committing an illegal act that the attorney reasonably believes is likely to perpetrate a fraud upon the Commission; or

(iii)

To rectify the consequences of the issuer's illegal act in the furtherance of which the attorney's services had been used.

Several comments stated that permitting attorneys to disclose illegal acts to the Commission, in the situations delineated by the proposed rule, would undermine the relationship of trust and confidence between lawyer and client, and may impede the ability of lawyers to steer their clients away from unlawful acts. n93 Other comments expressed concern that this provision conflicts with, and would (in their eyes impermissibly) preempt, the rules of professional conduct of certain jurisdictions (such as the District of Columbia) which bar the disclosure of information which an attorney is permitted to disclose under this paragraph, particularly where it permits the disclosure of past client misconduct. n94 Some aver that "it is not a lawyer's job" in representing an issuer before the Commission "to correct or rectify the consequences of [the issuer's] illegal actions, or even to prevent wrong-doing." n95

Other commenters noted that these disclosure provisions should be limited to illegal acts that are likely to have a material impact on the market for the issuer's securities, n96 or to ongoing criminal or fraudulent conduct by the issuer, n97 while others suggest that attorneys should only be permitted to disclose information where there is a risk of death or bodily harm, and not where only "monetary interests" are involved. n98 Many of the commenters voicing objections to this paragraph suggested that the Commission defer its promulgation until after further developments by state supreme courts n99 or further discussion. n100 Others, while criticizing the rule, noted that an attorney practicing before the Commission could comply with this permissive disclosure provision, but would have a duty to explain to the client at the outset this limitation on the "normal" duty of confidentiality. n101

Commenters supporting the paragraph, however, noted that at least four-fifths of the states now permit or require such disclosures as pertain to ongoing conduct, n102 and that those states that follow the minority rule "narrow[] the lawyer's options for responding to client conduct that could defraud investors and expose the lawyer to liability for legal work that the lawyer has already done." n103 Several of these comments noted that the Commission could or should have required that lawyers make these disclosures to it when the client insists on continuing fraud or pursuing future illegal conduct, n104 and urged the Commission to make clear that this paragraph does not override state ethics rules that make such disclosures mandatory. n105 Many commenters also stated that it was proper for this paragraph to preempt any state ethics rule that does not permit disclosure. n106 They also noted that the confidentiality interests of a corporate client are not infringed by lawyer disclosure under the circumstances required by the paragraph, as the paragraph addresses a situation where the lawyer reasonably believes that agents of an issuer are engaged in serious

illegality that the issuer has failed to remedy; in that situation, an instruction by an officer or even the board of the issuer to remain silent cannot be regarded as authorized. n107 Others generally supported the provision as injecting vitality into existing ethics rules, and stated that the Commission should not delay action on this provision. n108 One commenter emphasized the need to protect from retaliation attorneys who engage in the reporting mandated by Part 205. n109

The final version of this paragraph contains modifications or clarifications of the paragraph as proposed. In paragraph (2), the description of when an attorney may disclose client confidences is limited "to the extent the attorney reasonably believes necessary" to accomplish one of the objectives in the rule. In subparagraph (i), the term "material violation" has been substituted for "illegal act" to conform to the statutory language in Section 307. In subparagraph (ii), the final version identifies the illegal acts that might perpetrate a fraud upon the Commission in an investigation or administrative proceeding; each of the statutes now referenced in subparagraph (ii) were referenced in the release accompanying the proposed rule. n110 The term "perpetrate a fraud" in this paragraph covers conduct involving the knowing misrepresentation of a material fact to, or the concealment of a material fact from, the Commission with the intent to induce the Commission to take, or to refrain from taking, a particular action. Subparagraph (iii) has been modified to cover only material violations by the issuer, and now this material violation must be one that has "caused, or may cause, substantial injury to the financial interest or property of the issuer or investors" before the provision may be invoked.

With regard to the issues raised by the comments on this paragraph, as explained below, the Commission either has addressed the concerns voiced by the commenters, believes that the concerns are adequately addressed by the paragraph, or has found the concerns to be insufficient to warrant further modification. Although commenters raised a concern that permitting attorneys to disclose information to the Commission without a client's consent would undermine the issuers' trust in their attorneys, the vast majority of states already permit (and some even require) disclosure of information in the limited situations covered by this paragraph, n111 and the Commission has seen no evidence that those already-existing disclosure obligations have undermined the attorney-client relationship. In addition, the existing state law ethics rules support the proposition that generalized concerns about impacting the attorney-client relationship must yield to the public interest where an issuer seeks to commit a material violation that will materially damage investors, seek to perpetrate a fraud upon the Commission in enforcement proceedings, or has used the attorney's services to commit a material violation.

With regard to the comments that this paragraph would preempt state law ethics rules that do not permit disclosure of information concerning such acts, or the concerns expressed by commenters at the other end of the spectrum that this paragraph could be misread to supplant state ethics rules that require rather than permit disclosure, n112 the Commission refers to Section 205.1 and the related discussion above. Section 205.1 makes clear that Part 205 supplements state ethics rules and is not intended to limit the ability of any jurisdiction to impose higher obligations upon an attorney not inconsistent with Part 205. A mandatory disclosure requirement imposed by a state would be an additional requirement consistent with the Commission's permissive disclosure rule. The Commission also notes that, as this paragraph in most situations follows the permissive disclosure rules already in place in most jurisdictions, the conflict raised by these commenters is unlikely to arise in practice.

As for the comments suggesting that attorneys be permitted to disclose only information that would appear to have a material impact on the value of the issuer's securities, the Commission has, where appropriate, modified the paragraph in a manner that responds to that concern. Subparagraph (iii) has been limited to material violations, and subparagraph (i) limits its application to material violations that are likely to cause substantial injury to the financial interest or property of the issuer or investors.

Finally, the Commission concludes that it is not appropriate for it to wait for further developments. The Commission believes there has been ample discussion of this paragraph in the comments received, and that the major issues concerning this paragraph have been well identified. In addition, delay pending further developments does not promise to be fruitful: most state supreme courts already have rules in place that are consistent with this paragraph, and

there is no evidence when, if ever, state supreme courts (or legislative bodies) will revisit these issues, and the public interest in allowing lawyers appearing and practicing before the Commission to disclose the acts covered by this paragraph counsels against waiting indefinitely for further refinement of state ethics rules.

Subsection 205.3(e)(3) in Proposed Rule: Withdrawn

The proposed paragraph read:

Where an issuer, through its attorney, shares with the Commission information related to a material violation, pursuant to a confidentiality agreement, such sharing of information shall not constitute a waiver of any otherwise applicable privilege or protection as to other persons.

Several commenters stated that it was uncertain if the Sarbanes-Oxley Act granted the Commission the authority to promulgate a rule that would control determinations by state and federal courts whether a disclosure to the Commission, even if conditioned on a confidentiality agreement, waives the attorney-client privilege or work product protection, n113 and a few suggested that the proposed paragraph would conflict with *Federal Rule of Evidence 501*. n114 They noted that this is an unsettled issue in the courts, or suggested that the Commission's proposed rule runs contrary to the bulk of decisional authority on this issue. n115 A few also noted that proposed legislation before Congress in 1974, supported by the Commission, that would have enacted a provision permitting issuers to selectively waive privileges in disclosures to the Commission was ultimately not passed by Congress. n116 The concern was expressed that attorneys might disclose information to the Commission in the belief that the evidentiary privileges for that information were preserved, only to have a court subsequently rule that the privilege was waived. n117

The Commission has determined not to adopt the proposed rule on this "selective waiver" provision. The Commission is mindful of the concern that some courts might not adopt the Commission's analysis of this issue, and that this could lead to adverse consequences for the attorneys and issuers who disclose information to the Commission pursuant to a confidentiality agreement, believing that the evidentiary protections accorded that information remain preserved.

Nonetheless, the Commission finds that allowing issuers to produce internal reports to the Commission--including those prepared in response to reports under 205.3(b)--without waiving otherwise applicable privileges serves the public interest because it significantly enhances the Commission's ability to conduct expeditious investigations and obtain prompt relief, where appropriate, for defrauded investors. The Commission further finds that obtaining such otherwise protected reports advances the public interest, as the Commission only enters into confidentiality agreements when it has reason to believe that obtaining the reports will allow the Commission to save substantial time and resources in conducting investigations and/or provide more prompt monetary relief to investors. Although the Commission must verify that internal reports are accurate and complete and must conduct its own investigation, doing so is far less time consuming and less difficult than starting and conducting investigations without the internal reports. When the Commission can conduct expeditious and efficient investigations, it can then obtain appropriate remedies for investors more quickly. The public interest is thus clearly served when the Commission can promptly identify illegal conduct and provide compensation to victims of securities fraud.

The Commission also finds that preserving the privilege or protection for internal reports shared with the Commission does not harm private litigants or put them at any kind of strategic disadvantage. At worst, private litigants would be in exactly the same position that they would have been in if the Commission had not obtained the privileged or protected materials. Private litigants may even benefit from the Commission's ability to conduct more expeditious and thorough investigations. Indeed, many private securities actions follow the successful completion of a Commission investigation and enforcement action. Consequently, allowing the Commission access to otherwise privileged and inaccessible internal reports but denying access to others would not be unfair to private litigants but is appropriate in the public interest and for the protection of investors.

For these reasons, the Commission will continue to follow its policy of entering into confidentiality agreements where it determines that its receipt of information pursuant to those agreements will ultimately further the public interest, and will vigorously argue in defense of those confidentiality agreements where litigants argue that the disclosure of information pursuant to such agreements waives any privilege or protection.

Section 205.4. Responsibilities of Supervisory Attorneys

(a)

An attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer is a supervisory attorney. An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.

(b)

A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a), that he or she supervises or directs conforms to this part. To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.

(c)

A supervisory attorney is responsible for complying with the reporting requirements in § 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.

(d)

A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under § 205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.

Section 205.4 prescribes the responsibilities of a supervisory attorney, and is based in part upon Rule 5.1 of the ABA's Model Rules, which (1) mandates that supervisory attorneys (including partners at law firms and attorneys exercising similar management responsibilities at law firms) must make reasonable efforts to ensure that attorneys at the firm conform to the Rules of Professional Conduct; and (2) provides that a supervisory attorney may be held liable for violative conduct by another attorney which he or she knowingly ratifies or which he or she fails to prevent when able to do so.

Several commenters objected that the articulation of the responsibilities of supervisory attorneys included in the proposed rule rendered senior attorneys responsible for the actions of more junior attorneys whose activities they might not actually supervise or direct. For example, the ABA argued that defining a supervisory attorney to include individuals "who have supervisory authority over another attorney" would unfairly cover "all partners in a law firm and even senior associates," many of whom might not exercise actual supervisory authority regarding, or have any involvement with, the matter in question. n118 On the other hand, comments submitted by a distinguished group of

academics stated that the sections of the proposed rule prescribing the responsibilities of supervisor and subordinate attorneys were "necessary" and appropriate. n119

The language we adopt today confirms that a supervisory attorney to whom a subordinate attorney reports evidence of a material violation is responsible for complying with the reporting requirements prescribed under the rule. This language modifies the proposed rule by clarifying that only a senior attorney who actually directs or supervises the actions of a subordinate attorney appearing and practicing before the Commission is a supervisory attorney under the rule. A senior attorney who supervises or directs a subordinate on other matters unrelated to the subordinate's appearing and practicing before the Commission would not be a supervisory attorney under the final rule. Conversely, an attorney who typically does not exercise authority over a subordinate attorney but who does direct the subordinate attorney in the specific matter involving the subordinate's appearance and practice before the Commission is a supervisory attorney under the final rule. The final rule eliminates the proposed requirement that a supervisory attorney who believes that evidence of a material violation presented by a subordinate attorney need not be reported "up-the-ladder" document the basis for that conclusion. The final rule also eliminates the requirement that a supervisory attorney ensure a subordinate's compliance with the federal securities laws.

Section 205.5. Responsibilities of a Subordinate Attorney

(a)

An attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)) is a subordinate attorney.

(b)

A subordinate attorney shall comply with this part notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

(c)

A subordinate attorney complies with § 205.3 if the subordinate attorney reports to his or her supervising attorney under § 205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.

(d)

A subordinate attorney may take the steps permitted or required by § 205.3(b) or (c) if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation under § 205.3(b) has failed to comply with § 205.3.

Section 205.5 is based, in part, on Rule 5.2 of the ABA's Model Rules (which provides that subordinate attorneys remain bound by the Model Rules notwithstanding the fact that they acted at the direction of another person). This section confirms that a subordinate attorney is responsible for complying with the rule. We do not believe that a

subordinate attorney should be exempted from the application of the rule merely because he or she operates under the supervision or at the direction of another person. We believe that creation of such an exemption would seriously undermine Congress' intent to provide for the reporting of evidence of material violations to issuers. Indeed, because subordinate attorneys frequently perform a significant amount of work on behalf of issuers, we believe that subordinate attorneys are at least as likely (indeed, potentially more likely) to learn about evidence of material violations as supervisory attorneys.

This section attracted far less comment than section 205.4, and those comments which were received typically supported the concept of allowing a subordinate attorney to satisfy his or her obligations under the rule by reporting evidence of a material violation to a supervisory attorney. n120 The language we adopt today clarifies that a subordinate attorney must be appearing and practicing before the Commission to come under the rule, and conforms this section to the language in section 205.4 by providing that a senior attorney must actually direct or supervise the actions of a subordinate attorney (rather than have supervisory authority) to be a supervisory attorney under the rule.

New language has been added to this section to provide that an attorney who appears and practices before the Commission on a matter in the representation of an issuer under the supervision or direction of the issuer's CLO (or the equivalent thereto) is not a subordinate attorney. Accordingly, that person is required to comply with the reporting requirements of Section 205.3. For example, an issuer's Deputy General Counsel, who reports directly to the issuer's General Counsel (CLO) on a matter before the Commission, is not a subordinate attorney. Thus, the Deputy General Counsel is not relieved of any further reporting obligations by advising the CLO of evidence of a material violation. Further, in the event the Deputy General Counsel does not receive an appropriate response from the CLO, he or she is obligated to report further up-the-ladder within the issuer.

Section 205.6. Sanctions and Discipline

(a)

A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.

(b)

An attorney appearing and practicing before the Commission who violates any provision of this part is subject to the disciplinary authority of the Commission, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices. An administrative disciplinary proceeding initiated by the Commission for violation of this part may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the Commission.

(c)

An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

(d)

An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.

Paragraph 205.6(a) of the proposed rule tracked the language of Section 3(b) of the Act (which expressly states that a violation of the Act and rules promulgated thereunder shall be treated as a violation of the Exchange Act, subjecting any person committing such a violation to the same penalties as are prescribed for violations of the Exchange Act). Similarly, paragraph 205.6(b) of the proposed rule was based on Section 602 of the Act (adding Section 4C(a) to the Exchange Act, which incorporates that portion of Rule 102(e) of the Commission's Rules of Practice prescribing the state-of-mind requirements for Commission disciplinary actions against accountants who engage in improper professional conduct). Finally, paragraph 205.6(c) of the proposed rule stated that the Commission may discipline attorneys who violate the rule, regardless of whether the attorney is subject to prosecution or discipline for violation of a state ethical rule that applies to the same conduct.

Collectively, proposed section 205.6 (originally entitled "Sanctions") generated a number of comments. One commenter complained that sections 3(b) and 307 of the Act did not authorize Commission enforcement action against violators of the rule, and that violations should be handled in Commission disciplinary proceedings. n121 Several other commenters argued that paragraph 205.6(a) should specifically state that the Commission will not seek criminal penalties for violations of the rule. n122 Commenters also suggested that the juxtaposition of paragraphs 205.6(a) and (b) created confusion as to whether the Commission would treat violations of the rule as an Exchange Act violation or a violation of Rule 102(e). A number of commenters also suggested that the Commission should create a safe harbor, protecting attorneys who make a good faith attempt to comply with the rule and explicitly stating that the rule is only enforceable by the Commission and does not create a private right of action. n123

The language we today adopt in Section 205.6 has been extensively modified in light of these comments. The amended section is now titled "Sanctions and Discipline," emphasizing that the Commission intends to proceed against individuals violating Part 205 as it would against other violators of the federal securities laws and, when appropriate, to initiate proceedings under this rule seeking an appropriate disciplinary sanction. Paragraph 205.6(a) has been amended to clarify that only the Commission may bring an action for violation of the part. Paragraph 205.6(b) incorporates the language of paragraph 205.6(c) of the proposed rule, and adds new language specifying the sanctions available to the Commission in administrative disciplinary proceedings against attorneys who violate the part.

New paragraph 205.6(c), consistent with section 205.1, provides that attorneys who comply in good faith with this part shall not be subject to discipline for violations of inconsistent standards imposed by a state or other United States jurisdiction. Paragraph 205.6(c) has been drafted to apply only to an attorney's liability for violating inconsistent standards of a state or other U.S. jurisdiction. Thus, it is not available where the state or other jurisdiction imposes additional requirements on the attorney that are consistent with the Commission's rules. Moreover, this paragraph has no application in actions or proceedings brought by the Commission relating to violations of the federal securities laws or the Commission's rules or regulations thereunder. Further, the fact that an attorney may assert or establish in a state professional disciplinary proceeding, or in a private action, that he or she complied with this part, and complied in good faith, does not affect the Commission's ability or authority to bring an enforcement action or disciplinary proceeding against an attorney for a violation of this part. Indeed, even if a state ethics board or a court were to determine in an action not brought by the Commission that an attorney complied with this part or complied in good faith with this part, that determination would not preclude the Commission from bringing either an enforcement action or a disciplinary proceeding against that attorney for a violation of this part based on the same conduct.

New paragraph 205.6(d) addresses the conduct of non-U.S. attorneys who are subject to this part, because they do not meet the definition of non-appearing foreign attorney. As noted above, the new definition of non-appearing foreign attorney in paragraph 205.2(j) responds to the large number of comments received from lawyers practicing in other

jurisdictions stating that attorneys practicing in many foreign countries are subject to rules and regulations that render compliance with the part impossible. This point was also made at the December 17 Roundtable discussion. Several commenters also stated that attorneys who are admitted in United States jurisdictions but who practice in foreign countries are subject to similar restrictions. New paragraph 205.6(d) provides that attorneys in that situation must comply with the part to the maximum extent allowed by the regulations and laws to which they are subject.

Section 205.7. No Private Right of Action

(a)

Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b)

Authority to enforce compliance with this part is vested exclusively in the Commission.

In the proposing release, the Commission expressed its view that: "nothing in Section 307 creates a private right of action against an attorney... . Similarly, the Commission does not intend that the provisions of Part 205 create any private right of action against an attorney based on his or her compliance or non-compliance with its provisions." n124 Nevertheless, the Commission requested comments on whether it should provide in the final rule "a 'safe harbor' from civil suits" for attorneys who comply with the rule. n125 Numerous commenters agreed that the final rule should contain such a provision.

Several commenters suggested that the final rule contain a safe harbor similar to that provided for auditors in Section 10A(c) of the Exchange Act, *15 U.S.C. 78j-1(c)*, which provides that "[n]o independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report" to the Commission made by an issuer whose auditor has reported to its board a failure to take remedial action. n126 Other commenters recommended that the Commission adopt language similar to that in the Restatement (Third) of Law Governing Lawyers, Standards of Care § 52, which provides that "[p]roof of a violation of a rule or statute regulating the conduct of lawyers ... does not give rise to an implied cause of action for professional negligence or breach of fiduciary duty" n127 And others noted that the ABA Model Rules, Scope, & 20, provides that "[v]iolation of a Rule should not itself give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty has been breached." n128 Finally, numerous other commenters were of the view that a safe harbor should be created to protect lawyers from liability where they have attempted in good faith to comply with this part. n129

The Commission is persuaded that it is appropriate to include an express safe harbor provision in the rule, which is set forth in new Section 205.7, No Private Right of Action. Paragraph (a) makes it clear that Part 205 does not create a private cause of action against an attorney, a law firm or an issuer, based upon their compliance or non-compliance with the part. The Commission is of the view that the protection of this provision should extend to any entity that might be compelled to take action under this part; thus it extends to law firms and issuers. The Commission is also of the opinion that, for the safe harbor to be truly effective, it must extend to both compliance and non-compliance under this part.

Paragraph (b) provides that only the Commission may enforce the requirements of this part. The provision is intended to preclude, among other things, private injunctive actions seeking to compel persons to take actions under this part and private damages actions against such persons. Once again, the protection extends to all entities that have

obligations under this part.

§ III. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 ("PRA") n130 requires the agency to obtain approval from the Office of Management and Budget ("OMB") if an agency's rule would require a "collection of information," as defined by the PRA. As set forth in the proposing release, certain provisions of the rule, such as the requirement of written procedures for QLCCs, meet the "collection of information" requirement of the PRA. The information collection is necessary to implement the Standards of Professional Conduct for Attorneys prescribed by the proposed rule and required by Section 307 of the Sarbanes-Oxley Act of 2002. Specifically, the collection of information is intended to ensure that evidence of violations is communicated to appropriate officers and/or directors of issuers, so that they can adopt appropriate remedies and/or impose appropriate sanctions. In the rare cases in which a majority of a QLCC has concluded that an issuer did not act appropriately, the information may be communicated to the Commission. The collection of information is, therefore, an important component of the Commission's program to discourage violations of the federal securities laws and promote ethical behavior of attorneys appearing and practicing before the Commission.

The final rule would impose an up-the-ladder reporting requirement when attorneys appearing and practicing before the Commission become aware of evidence of a material violation by the issuer or any officer, director, employee, or agent of the issuer. An attorney must report such evidence to the issuer's CLO or to both the CLO and CEO. A subordinate attorney complies with the rule if he or she reports evidence of a material violation to his or her supervisory attorney (who is then responsible for complying with the rule's requirements). A subordinate attorney may also take the other steps described in the rule if the supervisor fails to comply.

If the CLO, after investigation, determines that there is no violation, he or she must so advise the reporting attorney. Unless the CLO reasonably believes that there is no violation, he or she must take reasonable steps to cause the issuer to adopt an appropriate response to stop, prevent or rectify any violation. The CLO must also report on the remedial measures or sanctions to the reporting attorney.

The rule also requires attorneys to take certain steps if the CLO or CEO does not provide an appropriate response to a report of evidence of a violation. These steps include reporting the evidence up-the-ladder to the audit committee, another committee consisting solely of independent directors if there is no audit committee, or to the board of directors if there is no such committee. If the attorney believes that the issuer has not made an appropriate response to the report, the attorney must explain the reasons for his or her belief to the CEO, CLO or directors to whom the report was made.

Alternatively, if an attorney other than a CLO reports the evidence to a QLCC, he or she need take no further action under the rule. The QLCC must have written procedures for the receipt, retention and consideration of reports of material violations, and must be authorized and responsible to notify the CLO and CEO of the report, determine whether an investigation is necessary and, if so, to notify the audit committee or the board of directors. The QLCC may also initiate an investigation to be conducted by the CLO or outside attorneys, and retain any necessary expert personnel. At the conclusion of the investigation, the QLCC may recommend that the issuer adopt appropriate remedial measures and/or impose sanctions, and notify the CLO, CEO, and board of directors of the results of the inquiry and appropriate remedial measures to be adopted. Where the QLCC decides, by a majority vote, that the issuer has failed to take any remedial measure that the QLCC has directed the issuer to take, the QLCC has the authority to notify the Commission. A CLO may also refer a report of evidence of a material violation to a QLCC, which then would have responsibility for taking the steps required by the rule.

The respondents to this collection of information would be attorneys who appear and practice before the Commission and, in certain cases, the issuer, and/or officers, directors and committees of the issuer. We proposed to require attorneys to document communications contemplated by the proposed rule. In response to commenters concerns, we are not specifying that the communications must be documented. We continue to believe that, in providing quality representation to issuers, attorneys report evidence of violations to others within the issuer, including the CLO, the

CEO, and, where necessary, the directors. In addition, officers and directors already investigate evidence of violations and report within the issuer the results of the investigation and the remedial steps they have taken or sanctions they have imposed. Attorneys who believe that they were discharged for making a report under the proposed rule might notify the issuer of that fact. Except as discussed below, we therefore believe that the reporting requirements imposed by the rule are "usual and customary" activities that do not add to the burden that would be imposed by the collection of information. n131

Certain aspects of the collection of information, however, impose a new burden. For an issuer to choose to establish a QLCC, the QLCC must adopt written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation. We are adopting this requirement and its collection of information requirement largely as proposed.

We estimate for purposes of the PRA that there are approximately 18,200 issuers that would be subject to the proposed rule. n132 We are unable to estimate precisely how many issuers will choose to form a QLCC. For these purposes, we estimate that approximately 20%, or 3,640, will choose to establish a QLCC. Establishing the written procedures required by the proposed rule should not impose a significant burden. We assume that an issuer would incur a greater burden in the year that it first establishes the procedures than in subsequent years, in which the burden would be incurred in updating, reviewing, or modifying the procedures. For purposes of the PRA, we assume that an issuer would spend six hours every three-year period on the procedures. This would result in an average burden of two hours per year. Thus, we estimate for purposes of the PRA that the total annual burden imposed by this collection of information would be 7,280 hours. We assume that half of those hours will be incurred by outside counsel at a rate of \$300 per hour. Using these assumptions, we estimate the collection of information would result in a cost of \$1,092,000.

We are not adopting at this time a requirement that attorneys make a "noisy withdrawal." We have amended the PRA submission to remove any burden from that collection of information. We are still considering that provision and, in a separate proposing release, we are requesting additional comments on it. In addition, we are separately proposing an alternative that, along with the "noisy withdrawal" proposal, also constitutes a collection of information under the PRA.

The Commission received two comments regarding the Paperwork Reduction Act section of the proposing release. One commenter indicated that the Commission has not considered the paperwork burdens of Part 205 on attorneys who do not specialize in securities law, but who may be considered to be appearing and practicing before the Commission under the rule. n133 The Commission believes that as adopted, the rule imposes little, if any, paperwork burdens on attorneys regardless of whether they specialize in securities law, especially in light of clarification to the rule's scope in the definition of "appearing and practicing." Another commenter suggested that the Commission's original estimate that one quarter of the 18,200 issuers subject to the rule will form QLCCs may be understated, but offered no alternate estimate. n134 The Commission estimated in the proposing release that one quarter of issuers would form QLCCs and received comments suggesting both that it would be difficult to find people to serve on QLCCs n135 and, on the other hand, many companies would use QLCCs. n136 Moreover, the Commission is not adopting at this time the "noisy withdrawal" proposal, which may tend to cause fewer companies to form QLCCs. Accordingly, the Commission estimates that under the rule, as adopted, 20% of issuers will form QLCCs.

The Commission submitted the collection of information to OMB for review in accordance with *44 U.S.C. 3507(d)* and *5 CFR 1320.11*, under the title of "Reports of Evidence of Material Violations." Because of the changes to the nature of the information collected and because of the separate proposal for an alternative to "noisy withdrawal," we have changed the name of the submission to "QLCC and Other Internal Reporting." OMB has not yet approved the collection; we will separately publish the OMB control number. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Compliance with the collection of information requirements is in some cases mandatory and in some cases voluntary depending upon the circumstances. Responses to the requirements to make disclosures to the Commission will not be kept confidential.

§ IV. Costs and Benefits

Part 205 implements Section 307 of the Sarbanes-Oxley Act. Part 205 will affect all attorneys who appear and practice before the Commission in the representation of an issuer and who become aware of evidence that tends to show that a material violation of federal or state securities laws, a material breach of fiduciary duty, or a similar material violation by the issuer or an officer, director, agent, or employee of the issuer has occurred, is ongoing, or is about to occur. The rule we are issuing today implements a Congressional mandate to prescribe "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers" Prior to passage of the Sarbanes-Oxley Act, attorneys appearing and practicing before the Commission were regulated as to their professional conduct primarily by the ethics standards of the various states where attorneys happened to practice. By passing the Sarbanes-Oxley Act, Congress has implicitly concluded that the benefits of setting such minimum federal standards justify their costs. We enumerate and discuss these costs and benefits below.

Part 205 implements an up-the-ladder reporting requirement upon attorneys representing an issuer before the Commission who become aware of a potential material violation about which a reasonably prudent investor would want to be informed. It is expected that, in the vast majority of instances of such reports, the situation will be addressed and remedied before it causes significant harm to investors.

In addition to these requirements, the rule would authorize a covered attorney to reveal to the Commission confidences or secrets relating to the attorney's representation of an issuer before the Commission to the extent the attorney reasonably believes it necessary to: (i) prevent the issuer from committing a material violation likely to cause substantial harm to the financial interest or property of the issuer or investors; (ii) prevent the issuer from perpetrating a fraud upon the Commission; or (iii) rectify the consequences of the issuer's illegal act that the attorney's services had furthered.

A. Benefits

Part 205 is designed to protect investors and increase their confidence in public companies by ensuring that attorneys who represent issuers report up the corporate ladder evidence of material violations by their officers and employees. The Commission recognizes that some attorneys may already follow up-the-ladder reporting procedures, especially where the conduct at issue is directly related to the matter on which the attorney represents the issuer, but believes it will prove beneficial if all attorneys who appear and practice before the Commission comply with this requirement.

Part 205 should protect investors by helping to prevent instances of significant corporate misconduct and fraud. The rule requires that attorneys report up-the-ladder when they become aware of evidence of a material violation. Although many attorneys already do this, some may not, especially if the violation is unrelated to the purpose for which they were retained. The rule gives issuers the option of forming a QLCC, consisting of at least one member of the issuer's audit committee and two or more independent directors, which would investigate reports of material violations and would be authorized to recommend that the issuer adopt appropriate remedial measures. The Commission believes that these requirements will make it more likely that companies will address instances of misconduct internally, and act to remedy violations at earlier stages.

Part 205 is intended to increase investor confidence. By requiring attorneys to report potential misconduct up-the-ladder within a corporation, the rule provides a measure of comfort to investors that evidence of fraud will be known and evaluated by the top authorities in a corporation, including its board of directors, and not dismissed by lower-level employees. Furthermore, investors will know that a company that forms a QLCC will have reports of misconduct evaluated by at least one member of the company's audit committee as well as two or more of its independent directors. Investors will also know that if an issuer fails to implement a recommendation that the QLCC

has recommended, the QLCC, after a majority vote, may notify the Commission.

Part 205 should serve to deter corporate misconduct and fraud. Corporate wrongdoers at the lower or middle levels of the corporate hierarchy will be aware that an attorney who becomes aware of their misconduct is obligated under the rule to report it up-the-ladder to the highest levels of the corporation. In the event that wrongdoing or fraud exists at the highest levels of a corporation, those committing the misconduct will similarly know that the corporation's attorneys are obligated to report any misconduct of which they become aware up-the-ladder to the corporation's board and its independent directors.

Part 205 may improve the governance of corporations that are subject to the rule. By mandating up-the-ladder reporting of violations, the rule helps to ensure that evidence of material violations will be addressed and remedied within the corporation, rather than misdirected or "swept under the rug." The formation of QLCCs may also serve to improve corporate governance. The Commission believes that some issuers will choose to adopt QLCCs, and that they may prove to be a recognized and effective means of reviewing reported evidence of material violations. Because a QLCC must consist of at least two independent directors (as well as one member of the corporation's audit committee), it will give greater authority to independent directors. This should serve as an important check on corporate management.

Part 205 will give attorneys who appear and practice before the Commission guidance and clarity regarding their ethical obligations when confronted with evidence of wrongdoing by their clients. Part 205 requires that attorneys report up-the-ladder when they become aware of potential material violations and thus complies with an express Congressional directive to set minimum standards of professional conduct for attorneys who appear and practice before it. These benefits are difficult to quantify.

B. Costs

Part 205 will impose costs on issuers and law firms representing them. For issuers, the rule will require the chief legal officer of an issuer to investigate and, where necessary, cause remedial actions and/or sanctions to be taken and/or imposed. It also will cause the CEO, QLCC, and board of directors of the issuer to review evidence of material violations. We believe that most issuers already have procedures for reviewing evidence of misconduct. Similarly, we expect that most issuers already incur costs with investigating such reports.

Those companies that choose to form a QLCC to implement this provision will incur costs. These costs might include increased compensation and insurance for QLCC members, and administrative costs to establish the committee. Additionally, for purposes of the PRA, we assume that 20% of issuers will form such a committee and incur an annualized paperwork cost of two hours for a total annual burden of 7,280 hours. Assuming outside counsel accounts for half of these hours at a cost of \$300 per hour,ⁿ¹³⁷ and inside counsel accounts for the other half at \$110 per hour,ⁿ¹³⁸ this would result in a cost of \$1,492,400.

For lawyers, the rule could have an effect upon malpractice insurance premiums, which could, in turn, increase the cost of attorney services to issuers. The Commission received three comments suggesting that the rule, and particularly the provisions requiring mandatory withdrawal and reporting to the Commission, would lead to an increase in the number of malpractice suits brought against attorneys.ⁿ¹³⁹ One of these comments, from an insurance carrier, indicated that the rule could cause malpractice insurance premiums for attorneys to rise by 10% to 50%.ⁿ¹⁴⁰ The Commission has made a number of changes to the rule in light of these comments. The Commission has clarified and made explicit in Section 205.7 that no private right of action exists based on compliance or non-compliance with the rule. In addition, the Commission has made it clear in Section 205.6(c) that an attorney who complies in good faith with the rule will not be subject to discipline or otherwise liable under an inconsistent state standard. Moreover, the rule, as adopted, will not require attorneys to withdraw or report to the Commission, but will only require reporting to the

Commission in the very limited circumstances occurring when a majority of a QLCC determines that an issuer has failed to take remedial action that was directed by the QLCC. Accordingly, the Commission believes that the rule will not have as great an effect on malpractice insurance premiums as suggested by commenters in response to the proposed rule.

Part 205 may also encourage some issuers to handle more legal matters in-house and may cause other issuers to limit the use of in-house counsel and rely more heavily on outside counsel, possibly increasing the cost of legal services. The Commission received one comment indicating that issuers would refer more matters to in-house counselⁿ¹⁴¹ and four comments indicating that the rule would result in more matters referred to outside counsel.ⁿ¹⁴² None of the commenters attempted to quantify the costs associated with these shifts. To the extent that the rule, as originally proposed, provided some perceived incentives to transfer functions to or from outside counsel, principally because of the "noisy withdrawal" requirements, we believe that those perceived incentives are not present in the rule as adopted.

There may also be some additional costs of the rule imposed on the market that are exceedingly difficult to predict or quantify. The Commission received comments indicating that the rule, and particularly the proposal regarding "noisy withdrawal," would cause issuers to be less willing to seek legal advice and would result in issuers being less forthcoming with their counsel.ⁿ¹⁴³ However, no commenters presented data or attempted to quantify any costs associated with this effect. The Commission also received comments indicating that the rule would not cause any decrease in attorney-client communication.ⁿ¹⁴⁴ Since the rule, as adopted, will not require mandatory withdrawal or disclosure to the Commission, we believe that Part 205 will not have any adverse impact on attorney-client communications.

§ V. Effect on Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act (*15 U.S.C. 78w(a)(2)*) requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. In addition, Section 2(b) of the Securities Act (*15 U.S.C. 77b(b)*), Section 3(f) of the Exchange Act (*15 U.S.C. 78c(f)*), and Section 2(c) of the Investment Company Act (*15 U.S.C. 80a-2(c)*), require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

Part 205 is intended to ensure that attorneys representing issuers before the Commission are governed by standards of conduct that increase disclosure of potential impropriety within an issuer so that prompt intervention and remediation can take place. Doing so should boost investor confidence in the financial markets. We anticipate that this rule will enhance the proper functioning of the capital markets and promote efficiency by reducing the likelihood that illegal behavior would remain undetected and unremedied for long periods of time. Part 205 will apply to all issuers and attorneys appearing before the Commission and is therefore unlikely to affect competition.

The Commission invited comment on this analysis, and received one comment on it.ⁿ¹⁴⁵ The commenter suggested that the rule could result in a large quantity of information being sent to a CLO or QLCC, which would be expensive and unwieldy to process, and would thus conflict with the goal of promoting efficiency, competition and capital formation. The Commission believes that Part 205 is consistent with the statutory goals and will substantially assist in attaining them by preventing corporate misconduct, restoring investor confidence and lowering the cost of capital.

§ VI. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the Regulatory Flexibility Act, *5 U.S.C. 601*. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with *5*

U.S.C. 603 and was made available to the public.

A. Need for the Rule

Part 205 complies with Section 307 of the Sarbanes-Oxley Act of 2002 (*15 U.S.C. 7245*), which requires the Commission to prescribe "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers" The standards must include a rule "requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" to the CLO or the CEO of the company (or the equivalent thereof); and, if they do not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors.

B. Significant Issues Raised by Public Comment

The Commission received no comments in response to the IRFA.

C. Small Entities Subject to Part 205

Part 205 would affect issuers and law firms that are small entities. Exchange Act Rule 0-10(a) (*17 CFR 240.0-10(a)*) defines an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of \$5 million or less on the last day of its most recent fiscal year. As of October 23, 2002, we estimated that there were approximately 2,500 issuers, other than investment companies, that may be considered small entities. For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year. ⁿ¹⁴⁶ We estimate that there are 211 small investment companies that would be subject to the rule. The revisions would apply to any small entity that is subject to Exchange Act reporting requirements.

Part 205 also would affect law firms that are small entities. The Small Business Administration has defined small business for purposes of "offices of lawyers" as those with under \$6 million in annual revenue. ⁿ¹⁴⁷ Because we do not directly regulate law firms appearing before the Commission, we do not have data to estimate the number of small law firms that practice before the Commission or, of those, how many have revenue of less than \$6 million. We sought comment on the number of small law firms affected by the rules, but received none.

D. Reporting, Recordkeeping and Other Compliance Requirements

Paragraph 205.3(b) prescribes the duty of an attorney who appears or practices before the Commission in the representation of an issuer to report evidence of a material violation that has occurred, is ongoing, or is about to occur. The attorney is initially directed to make this report to the issuer's CLO, or to the issuer's CLO and CEO.

When presented with a report of a possible material violation, the rule obligates the issuer's CLO to conduct a reasonable inquiry to determine whether the reported material violation has occurred, is occurring or may occur. A CLO who reasonably concludes that there has been no material violation must advise the reporting attorney of this conclusion. A CLO who concludes that a material violation has occurred, is occurring or is about to occur must take

reasonable steps to ensure that the issuer adopts appropriate remedial measures and/or sanctions, including appropriate disclosures. Furthermore, the CLO is required to report up-the-ladder within the issuer and to the reporting attorney what remedial measures have been adopted.

A reporting attorney who receives an appropriate response within a reasonable time has satisfied all obligations under the rule. In the event a reporting attorney does not receive an appropriate response within a reasonable time, he or she must report the evidence of a material violation to the issuer's audit committee, to another committee of independent directors if the issuer has no audit committee, or to the full board if the issuer has no such committee. Similarly, if the attorney reasonably believes that it would be futile to report evidence of a material violation to the CLO and CEO, the attorney may report directly to the issuer's audit committee, another committee of independent directors, or to the full board.

Alternatively, pursuant to paragraph 205.3(c), issuers may (but are not required to) establish a QLCC, consisting of at least one member of the issuer's audit committee and two or more independent members of the issuer's board, for the purpose of investigating reports of material violations made by attorneys. Such a QLCC would be authorized to recommend to the issuer that it adopt appropriate remedial measures to prevent ongoing or alleviate past material violations, and empowered to notify the Commission of the material violation if the QLCC decides, by a majority vote, that the issuer has failed to take any remedial measure that the QLCC has directed the issuer to take. The QLCC would be required to notify the board of the results of any inquiry. An attorney other than a CLO may satisfy entirely his or her reporting obligations under the rule by reporting evidence of a material violation to a QLCC. Further, a CLO to whom a report of a material violation has been made may refer the matter to a QLCC.

Paragraph 205.3(d) sets forth the specific circumstances under which an attorney is authorized to disclose confidential information related to his or her appearance and practice before the Commission in the representation of an issuer. Pursuant to this provision, an attorney may use any contemporaneous records he or she creates to defend against charges of attorney misconduct. Paragraph 205.3(d)(2) also allows an attorney to reveal confidential information to the extent necessary to prevent the commission of a material violation that the attorney reasonably believes will result either in perpetration of a fraud upon the Commission or in substantial injury to the financial or property interests of the issuer or investors. Similarly, the attorney may disclose confidential information to rectify an issuer's material violations when such actions have been advanced by the issuer's use of the attorney's services.

We expect that the various reporting requirements required by Part 205 would, at least to a limited extent, increase costs incurred by both small issuers and law firms. We believe that many of these reports are, however, already being made by those affected by the rule. We are unable to estimate the frequency with which reports would have to be prepared by small entities. The time required for the actual preparation of a report would vary, but should not be extensive. Small issuers and law firms may bolster, and in some instances institute, internal procedures to ensure compliance--although the rule does not dictate how these procedures should be implemented.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the rule, we considered the following alternatives: (a) the establishment of differing compliance or reporting requirements that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of the reporting requirements for small entities; (c) an exemption from coverage of the requirements, or any part thereof, for small entities; and (d) the use of performance rather than design standards. As discussed above, the Sarbanes-Oxley Act directs the Commission to implement rules requiring up-the-ladder reporting. The Act does not contain any exemption or other limitation for small entities. Small business issuers may have some difficulty staffing a QLCC, as we presume that they may have fewer independent directors. We note that issuers are not required to have a QLCC under the rule.

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The rule uses some performance standards and some design standards. While the rule establishes a framework for reporting evidence of material violations up-the-ladder, it does not set specific standards for how to comply with the rule's requirements. For the most part, rather than requiring reports to contain specific, detailed disclosures, the rule prescribes general requirements for reporting. This should give small entities flexibility in complying with the rule.

By permitting issuers to establish QLCCs as an alternative mechanism for attorneys to report evidence of misconduct or fraud, the rule presents a performance standard (as opposed to a design standard). A performance standard is characterized by the provision for alternative means of fulfilling the regulatory standard. It has the advantage of permitting market participants to choose the method of meeting the standard that presents the least cost to them. The provision of alternative reporting mechanisms within this rule should serve to lower overall costs to issuers attributable to the rule in precisely this manner.

We believe that utilizing different reporting or other compliance requirements for small entities would undermine the effective functioning of the reporting regime. The rule is designed to restore investor confidence in the reliability of the financial statements of the companies they invest in -- if small entities were not subject to such requirements, investors might be less inclined to invest in their securities. Further, we see no valid justification for imposing different standards of conduct upon small law firms than would apply to others who choose to appear and practice before the Commission. We also believe that the reporting requirements will be at least as well understood by small entities as would be any alternate formulation we might formulate to apply to them. Therefore, it does not seem necessary or appropriate to develop separate requirements for small entities.

§ VII. Statutory Authority

The Commission is adding a new Part 205 to Title 17, Chapter II, of the Code of Federal Regulations under the authority in Sections 3, 307, and 404 of the Sarbanes-Oxley Act of 2002, n148 Section 19 of the Securities Act of 1933, n149 Sections 3(b), 4C, 13, and 23 of the Securities Exchange Act of 1934, n150 Sections 38 and 39 of the Investment Company Act of 1940, n151 and Section 211 of the Investment Advisers Act of 1940. n152 Text of Rule

List of Subjects in 17 CFR Part 205 Standards of conduct for attorneys.

For the reasons set out in the preamble, the Commission amends Title 17, Chapter II, of the Code of Federal Regulations by adding Part 205 to read as follows:

PART 205 STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS APPEARING AND PRACTICING BEFORE THE COMMISSION IN THE REPRESENTATION OF AN ISSUER

205.1 Purpose and scope.

205.2 Definitions.

205.3 Issuer as client.

205.4 Responsibilities of supervisory attorneys.

205.5 Responsibilities of a subordinate attorney.

205.6 Sanctions and discipline.

205.7 No private right of action.

Authority: 15 U.S.C. 77s, 78d-3, 78w, 80a-37, 80a-38, 80b-11, 7202, 7245, and 7262.

§ § 205.1. Purpose and scope.

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

§ § 205.2. Definitions.

For purposes of this part, the following definitions apply:

(a)

Appearing and practicing before the Commission:

(1)

Means:

(i)

Transacting any business with the Commission, including communications in any form;

(ii)

Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii)

Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv)

Advising an issuer as to whether information or a statement, opinion, or other writing is required under the

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United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2)

Does not include an attorney who:

(i)

Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii)

Is a non-appearing foreign attorney.

(b)

Appropriate response means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1)

That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2)

That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3)

That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

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(i)

Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii)

Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

(c)

Attorney means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.

(d)

Breach of fiduciary duty refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

(e)

Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.

(f)

Foreign government issuer means a foreign issuer as defined in 17 CFR 230.405 eligible to register securities on Schedule B of the Securities Act of 1933 (15 U.S.C. 77a et seq. , Schedule B).

(g)

In the representation of an issuer means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

(h)

Issuer means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term "issuer" includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

(i)

Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

(j)

Non-appearing foreign attorney means an attorney:

(1)

Who is admitted to practice law in a jurisdiction outside the United States;

(2)

Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and

(3)

Who:

(i)

Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or

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(ii)

Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

(k)

Qualified legal compliance committee means a committee of an issuer (which also may be an audit or other committee of the issuer) that:

(1)

Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*);

(2)

Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under § 205.3;

(3)

Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i)

To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in § 205.3(b)(4));

(ii)

To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A)

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Notify the audit committee or the full board of directors;

(B)

Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C)

Retain such additional expert personnel as the committee deems necessary; and

(iii)

At the conclusion of any such investigation, to:

(A)

Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B)

Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4)

Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

(l)

Reasonable or reasonably denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

(m)

Reasonably believes means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.

(n)

Report means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

§ § 205.3. Issuer as client.

(a)

Representing an Issuer. An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.

(b)

Duty to report evidence of a material violation. If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

(2)

The chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer (or the equivalent thereof) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof. In lieu of causing an inquiry under this paragraph (b), a chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a qualified legal compliance committee under paragraph (c)(2) of this section if the issuer has duly established a qualified legal compliance committee prior to the report of evidence of a material violation.

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(3)

Unless an attorney who has made a report under paragraph (b)(1) of this section reasonably believes that the chief legal officer or the chief executive officer of the issuer (or the equivalent thereof) has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to:

(i)

The audit committee of the issuer's board of directors;

(ii)

Another committee of the issuer's board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*) (if the issuer's board of directors has no audit committee); or

(iii)

The issuer's board of directors (if the issuer's board of directors has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*)).

(4)

If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's chief legal officer and chief executive officer (or the equivalents thereof) under paragraph (b)(1) of this section, the attorney may report such evidence as provided under paragraph (b)(3) of this section.

(5)

An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(3), or (b)(4) of this section shall be deemed to be appearing and practicing before the Commission. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported under paragraph (b)(1), (b)(3), or (b)(4) of this section from a duty to respond to the reporting attorney.

(6)

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An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

(i)

The attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof) to investigate such evidence of a material violation and:

(A)

The attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof);
and

(B)

Except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee; or

(ii)

The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee.

(7)

An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if such attorney was retained or directed by a qualified legal compliance committee:

(i)

To investigate such evidence of a material violation; or

(ii)

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To assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

(8)

An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section need do nothing more under this section with respect to his or her report.

(9)

An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section shall explain his or her reasons therefor to the chief legal officer (or the equivalent thereof), the chief executive officer (or the equivalent thereof), and directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section.

(10)

An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

(c)

Alternative reporting procedures for attorneys retained or employed by an issuer that has established a qualified legal compliance committee. (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

(2)

A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements

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under § 205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c).

(d)

Issuer confidences. Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

(2)

An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i)

To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii)

To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in *18 U.S.C. 1621*; suborning perjury, proscribed in *18 U.S.C. 1622*; or committing any act proscribed in *18 U.S.C. 1001* that is likely to perpetrate a fraud upon the Commission; or

(iii)

To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

§ § 205.4. Responsibilities of supervisory attorneys.

(a)

An attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer is a supervisory attorney. An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.

(b)

A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a), that he or she supervises or directs conforms to this part. To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.

(c)

A supervisory attorney is responsible for complying with the reporting requirements in § 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.

(d)

A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under § 205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.

§ § 205.5. Responsibilities of a subordinate attorney.

(a)

An attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)) is a subordinate attorney.

(b)

A subordinate attorney shall comply with this part notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

(c)

A subordinate attorney complies with § 205.3 if the subordinate attorney reports to his or her supervising attorney under § 205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.

(d)

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A subordinate attorney may take the steps permitted or required by § 205.3(b) or (c) if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation under § 205.3(b) has failed to comply with § 205.3.

§ § 205.6. Sanctions and discipline.

(a)

A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.

(b)

An attorney appearing and practicing before the Commission who violates any provision of this part is subject to the disciplinary authority of the Commission, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices. An administrative disciplinary proceeding initiated by the Commission for violation of this part may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the Commission.

(c)

An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

(d)

An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.

§ § 205.7. No private right of action.

(a)

Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b)

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Authority to enforce compliance with this part is vested exclusively in the Commission.

By the Commission.

Jill M. Peterson
Assistant Secretary

Date: January 29, 2003

§ § 205.1. Purpose and scope.

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

§ § 205.2. Definitions.

For purposes of this part, the following definitions apply:

(a)

Appearing and practicing before the Commission:

(1)

Means:

(i)

Transacting any business with the Commission, including communications in any form;

(ii)

Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii)

Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the

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context of preparing, or participating in the preparation of, any such document; or

(iv)

Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2)

Does not include an attorney who:

(i)

Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii)

Is a non-appearing foreign attorney.

(b)

Appropriate response means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1)

That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2)

That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

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(3)

That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i)

Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii)

Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

(c)

Attorney means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.

(d)

Breach of fiduciary duty refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

(e)

Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.

(f)

Foreign government issuer means a foreign issuer as defined in 17 CFR 230.405 eligible to register securities on Schedule B of the Securities Act of 1933 (15 U.S.C. 77a et seq. , Schedule B).

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(g)

In the representation of an issuer means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

(h)

Issuer means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term "issuer" includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

(i)

Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

(j)

Non-appearing foreign attorney means an attorney:

(1)

Who is admitted to practice law in a jurisdiction outside the United States;

(2)

Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and

(3)

Who:

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(i)

Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or

(ii)

Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

(k)

Qualified legal compliance committee means a committee of an issuer (which also may be an audit or other committee of the issuer) that:

(1)

Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));

(2)

Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under § 205.3;

(3)

Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i)

To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in § 205.3(b)(4));

(ii)

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To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A)

Notify the audit committee or the full board of directors;

(B)

Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C)

Retain such additional expert personnel as the committee deems necessary; and

(iii)

At the conclusion of any such investigation, to:

(A)

Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B)

Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4)

Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

(l)

Reasonable or *reasonably* denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

(m)

Reasonably believes means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.

(n)

Report means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

§ § 205.3. Issuer as client.

(a)

Representing an Issuer. An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.

(b)

Duty to report evidence of a material violation. If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

(2)

The chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer (or the equivalent thereof) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all

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reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof. In lieu of causing an inquiry under this paragraph (b), a chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a qualified legal compliance committee under paragraph (c)(2) of this section if the issuer has duly established a qualified legal compliance committee prior to the report of evidence of a material violation.

(3)

Unless an attorney who has made a report under paragraph (b)(1) of this section reasonably believes that the chief legal officer or the chief executive officer of the issuer (or the equivalent thereof) has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to:

(i)

The audit committee of the issuer's board of directors;

(ii)

Another committee of the issuer's board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*) (if the issuer's board of directors has no audit committee); or

(iii)

The issuer's board of directors (if the issuer's board of directors has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(19)*)).

(4)

If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's chief legal officer and chief executive officer (or the equivalents thereof) under paragraph (b)(1) of this section, the attorney may report such evidence as provided under paragraph (b)(3) of this section.

(5)

An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(3), or (b)(4) of this section shall be deemed to be appearing and practicing before the Commission.

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Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported under paragraph (b)(1), (b)(3), or (b)(4) of this section from a duty to respond to the reporting attorney.

(6)

An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

(i)

The attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof) to investigate such evidence of a material violation and:

(A)

The attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof);
and

(B)

Except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee; or

(ii)

The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee.

(7)

An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if such attorney was retained or directed by a qualified legal compliance committee:

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(i)

To investigate such evidence of a material violation; or

(ii)

To assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

(8)

An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section need do nothing more under this section with respect to his or her report.

(9)

An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section shall explain his or her reasons therefor to the chief legal officer (or the equivalent thereof), the chief executive officer (or the equivalent thereof), and directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section.

(10)

An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

(c)

Alternative reporting procedures for attorneys retained or employed by an issuer that has established a qualified legal compliance committee. (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

(2)

A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements under § 205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c).

(d)

Issuer confidences. Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

(2)

An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i)

To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii)

To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in *18 U.S.C. 1621*; suborning perjury, proscribed in *18 U.S.C. 1622*; or committing any act proscribed in *18 U.S.C. 1001* that is likely to perpetrate a fraud upon the Commission; or

(iii)

To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

§ § 205.4. Responsibilities of supervisory attorneys.

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(a)

An attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer is a supervisory attorney. An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.

(b)

A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a), that he or she supervises or directs conforms to this part. To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.

(c)

A supervisory attorney is responsible for complying with the reporting requirements in § 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.

(d)

A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under § 205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.

§ § 205.5. Responsibilities of a subordinate attorney.

(a)

An attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)) is a subordinate attorney.

(b)

A subordinate attorney shall comply with this part notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

(c)

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A subordinate attorney complies with § 205.3 if the subordinate attorney reports to his or her supervising attorney under § 205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.

(d)

A subordinate attorney may take the steps permitted or required by § 205.3(b) or (c) if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation under § 205.3(b) has failed to comply with § 205.3.

§ § 205.6. Sanctions and discipline.

(a)

A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.

(b)

An attorney appearing and practicing before the Commission who violates any provision of this part is subject to the disciplinary authority of the Commission, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices. An administrative disciplinary proceeding initiated by the Commission for violation of this part may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the Commission.

(c)

An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

(d)

An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.

§ § 205.7. No private right of action.

(a)

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Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b)

Authority to enforce compliance with this part is vested exclusively in the Commission.

By the Commission.

Jill M. Peterson
Assistant Secretary

Date: January 29, 2003

FOOTNOTES:

(n26)Footnote 1. *17 CFR 240.13b2-1 et seq.*

(n27)Footnote 2. Pub. L. 107-204, *116 Stat. 745 (2002)*.

(n28)Footnote 3. Section 303 of the Act states:

(a) RULES TO PROHIBIT.--It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

(b) ENFORCEMENT.--In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section.

(c) NO PREEMPTION OF OTHER LAW.--The provisions of subsection (a) shall be in addition to, and shall not supersede or preempt, any other provision of law or any rule or regulation issued thereunder.

(d) DEADLINE FOR RULEMAKING.--The Commission shall--

(1) propose the rules or regulations required by this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules or regulations required by this section, not later than 270 days after that date of enactment.

(n29)Footnote 4. *17 CFR 240.13b2-1* states that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act of 1934 ("Exchange Act"). Section 13(b)(2) of the Exchange Act states:

Every issuer which has a class of securities registered pursuant to section 12 of this title and every issuer which is required to file reports pursuant to section 15(d) of this title shall (A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions

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and dispositions of the assets of the issuer.

(n30)Footnote 5. *17 CFR 240.13b2-2* states that no director or officer of an issuer, in connection with an audit or examination of the issuer's financial statements or the preparation of any document or report to be filed with the Commission, directly or indirectly shall (a) make or cause to be made a materially false or misleading statement to an accountant or (b) omit to state, or cause another person to omit to state, any material fact necessary to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant. In redesignating Rule 13b2-2 as Rule 13b2-2(a), technical changes have been made to clarify that the rule addresses false or misleading statements made "to an accountant in connection with" an audit, review or preparation of any document or report required to be filed with the Commission.

(n31)Footnote 6. The rules were proposed in Release Nos. 34-46685; IC-25773; File No. S7-39-02 (October 18, 2002) [*67 FR 65325*] ("proposing release").

(n32)Footnote 7. The new rules are included in Regulation 13B-2 under the Securities Exchange Act of 1934 ("Exchange Act"). Section 3(a)(8) of the Exchange Act, *15 U.S.C. 78c(a)(8)*, defines "issuer" as follows:

The term "issuer" means any person who issues or proposes to issue any security; except that with respect to certificates of deposit for securities, voting trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is, or is to be, used.

(n33)Footnote 8. Letter from Paul B. Uhlenhop, dated November 8, 2002.

(n34)Footnote 9. Section 2(a)(7) of the Act, which states:

The term "issuer" means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (*15 U.S.C. 78c*)), the securities of which are registered under section 12 of that Act (*15 U.S.C. 78l*), or that is required to file reports under section 15(d) (*15 U.S.C. 78o(d)*), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (*15 U.S.C. 77a et seq.*), and that it has not withdrawn.

(n35)Footnote 10. The Commission has broad rulemaking authority to prescribe illegal acts that contribute to the falsification of financial statements or the issuance of false or misleading audit reports. *See, e.g.*, sections 10, 10A and 23(a) of the Exchange Act, *15 U.S.C. 78j, 78j-1 and 78s(a)*. *See also* section 3(a) of the Sarbanes-Oxley Act of 2002, which states, "The Commission shall promulgate such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of this Act."

(n36)Footnote 11. Exchange Act Release No. 15570 (February 15, 1979) [*44 FR 10970*] .

(n37)Footnote 12. The rule applies to foreign private issuers as well as domestic issuers. In applying the rule to foreign private issuers, the terms "officer" and "director" would indicate those performing equivalent functions under the local laws and corporate governance practices where the issuer is domiciled.

(n38)Footnote 13. Rule 3b-2 under the Exchange Act, *17 CFR 240.3b-2*. A person may be an "officer" for

purposes of Rule 3b-2 regardless of the person's title or the legal entity with which he or she is associated. For example, officers of wholly owned subsidiaries of public companies and promoters may be "officers" of public companies.

The definition of "director" under the Exchange Act has a similar functional and flexible nature. *See* section 3(a)(7) of the Exchange Act, *15 U.S.C. 78c(a)(7)*, which states, "The term director' means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

(n39)Footnote 14. Rule 3b-7 under the Exchange Act, *17 CFR 240.3b-7*, states, "The term executive officer,' when used with reference to a registrant, means its president, vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration, or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant."

(n40)Footnote 15. Letter from the National Association of State Boards of Accountancy ("NASBA") dated November 25, 2002.

(n41)Footnote 16. Letter from Transparency International--USA, dated November 8, 2002.

(n42)Footnote 17. Letters from PricewaterhouseCoopers LLP ("PwC") dated November 25, 2002 and Transparency International--USA, dated November 8, 2002.

(n43)Footnote 18. *See, e.g.*, Section 10(b) of the Exchange Act, *15 U.S.C. 78j*, and *Rule 10b-5* thereunder, *17 CFR 240.10b-5*.

(n44)Footnote 19. *See, e.g.*, section 20(e) of the Exchange Act, *15 U.S.C. 78t(e)*.

(n45)Footnote 20. *See, e.g.*, section 21C of the Exchange Act, *15 U.S.C. 78u-3*.

(n46)Footnote 21. Section 303(b) of the Act states, "The Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section."

(n47)Footnote 22. *See, e.g.*, Webster's Dictionary (9th edition), which defines "direction" to include not only guidance or supervision of action or conduct but also explicit instruction.

(n48)Footnote 23. *See, e.g., In the Matter of Ronald G. Davies*, Accounting and Auditing Enforcement Release No. ("AAER") 1281 (June 29, 2000), which states, in part,

In early 1998, Davies learned information that should have alerted him to the fact that Hybrid's sales personnel had concealed the existence of the side letter from the Company's management and auditors. When Hybrid and its auditors, as part of the preparation of the Company's financial statements, sought confirmation that Ikon had received no right of return, Davies provided a misleading audit response to the Company. Davies actions described above allowed Hybrid personnel to circumvent internal controls and make false statements to the Company's auditors, and caused Hybrid to make material misrepresentations and file inaccurate reports with the Commission . Based on the foregoing, Davies caused violations of Sections 10(b), 13(a), 13(b)(5) of the Exchange Act and *Rules 10b-5*, 12b-20, 13a-13, 13b2-1, and 13b2-2 thereunder.

(n49)Footnote 24. *See, e.g., In the Matter of John K. Bradley*, AAER 1568 (June 5, 2002).

(n50)Footnote 25. "An unqualified opinion' [or unqualified report] states that the financial statements present

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fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles." AICPA, Statement on Auditing Standards No. ("SAS") 58, "Reports on Audited Financial Statements," P 10; Codification of Statements on Auditing Standards ("AU") § 508.10.

(n51)Footnote 26. Some of these individuals also would be covered under provisions of the rule tailored to investment companies. *See* section II.C. of this release, *Issues Related to Investment Companies*.

(n52)Footnote 27. *See, e.g.*, letters from Sidley Austin Brown & Wood dated December 30, 2002, BDO Seidman LLP dated November 25, 2002, Plains All American Pipeline L.P. dated November 25, 2002, Dechert dated November 25, 2002, National Association of Real Estate Investment Trusts dated November 25, 2002, and Compass Bancshares, Inc. dated November 25, 2002.

(n53)Footnote 28. *See, e.g.*, letter from Transparency International--USA, dated November 8, 2002.

(n54)Footnote 29. *See, e.g.*, letter from America's Community Bankers dated November 25, 2002.

(n55)Footnote 30. *See, e.g.*, letter from the American Institute of Certified Public Accountants dated November 25, 2002.

(n56)Footnote 31. *See, e.g.*, letter from PwC dated November 25, 2002.

(n57)Footnote 32. *See, e.g.*, letters from the American Bar Association dated December 13, 2002 and The Business Roundtable dated November 29, 2002.

(n58)Footnote 33. *See, e.g.*, letters from Wells Fargo dated November 22, 2002, Dorsey & Whitney dated November 25, 2002, Deloitte & Touche dated November 27, 2002, Sidley Austin Brown & Wood dated December 30, 2002, America's Community Bankers dated November 25, 2002, and BDO Seidman LLP dated November 25, 2002.

(n59)Footnote 34. *See, e.g.*, letter from Ernst & Young LLP dated November 25, 2002.

(n60)Footnote 35. *See, e.g.*, letters from Wells Fargo dated November 22, 2002, American Bar Association dated December 13, 2002, America's Community Bankers dated November 25, 2002, National Association of Real Estate Investment Trusts dated November 25, 2002, Intel Corporation dated November 26, 2002, and Compass Bancshares, Inc. dated November 25, 2002.

(n61)Footnote 36. *KPMG LLP v. Securities and Exchange Commission*, 289 F. 3d 109, 126 (D.C. Cir. 2002) , which states, "We affirm the Commission's determination that negligence is an appropriate basis for violations underlying a Section 21C cease-and-desist order ." *See In the Matter of KPMG Peat Marwick LLP*, AAER 1360 (January 19, 2001), which states, "We hold today that negligence is sufficient to establish causing' liability under Exchange Act section 21C(a), at least in cases in which a person is alleged to cause' a primary violation that does not require scienter. Therefore, if Peat Marwick acted at least negligently with respect to whether its conduct would contribute to PORTA's violations, Peat Marwick is liable under Section 21C(a) as a cause of those violations."

(n62)Footnote 37. *See, e.g.*, *In the Matter of Donald F. Marcus* and *In the Matter of Harry P. Adler*, AAER 1715 (February 10, 2003); *SEC v. John F. Mortell, et al.*, AAER 1569 (June 5, 2002); *In the Matter of Ronald G. Davies*, AAER 1281 (June 29, 2000); and *In the Matter of Terry R. Kuntz and Richard J. Scheer*, AAER 720 (September 26, 1995), which states, in part,

Kuntz and Scheer knew or should have known that their conduct contributed to the fraudulent activities of Assix management. The September 13, 1991 letter supplied by Kuntz, coupled with the invoices provided by Scheer, assisted Assix in filing a materially false and misleading Annual Report and Quarterly Report with the Commission . Accordingly, Kuntz's conduct in providing the September

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13, 1991 letter and Scheer's conduct in providing the invoices to the company caused Assix to violate Sections 10(b), 13(a) and 13(b) of the Exchange Act and *Rules 10b-5*, 12b-20, 13a-1, 13a-13 and 13b2-2 thereunder. By falsifying these documents, Kuntz and Scheer also caused Assix's violation of Rule 13b2-1 and Section 13(b)(2)(A). Further, Kuntz and Scheer also caused Assix's controller to violate 13b2-2 by providing materially false and misleading documents which were used by Assix's auditors .

In this instance, Kuntz and Scheer subverted the audit process by creating false documents which assisted Assix in filing materially false and misleading statements, recording false revenue, and lying to its auditors. The Commission will not tolerate conduct by third party vendors such as that described herein, which poses a very real threat to the integrity of the disclosure process.

(n63)Footnote 38. *Id.*

(n64)Footnote 39. *See, e.g., In the Matter of Terry R. Kuntz and Richard J. Scheer*, AAER 720 (September 26, 1995), which states, in part, "The Commission will not tolerate conduct by third party vendors, which poses a very real threat to the integrity of the disclosure process."

(n65)Footnote 40. *See, e.g., In the Matter of Donald F. Marcus and In the Matter of Harry P. Adler*, AAER 1715 (February 10, 2003); *SEC v. John F. Mortell, et al.*, AAER 1569 (June 5, 2002); *In the Matter of Ronald G. Davies*, AAER 1281 (June 29, 2000); and *In the Matter of Terry R. Kuntz and Richard J. Scheer*, AAER 720 (September 26, 1995).

(n66)Footnote 41. It is the act of coercing, manipulating, misleading, or fraudulently influencing the auditor, for the purpose of rendering misleading financial statements, that is unlawful. There is no requirement in section 303(a) of the Act that the purpose be achieved.

(n67)Footnote 42. *See, e.g.,* letters from Wells Fargo dated November 22, 2002, the American Bar Association dated December 13, 2002, Sidley Austin Brown & Wood dated December 20, 2002, BDO Seidman LLP dated November 25, 2002, and Dechert dated November 25, 2002.

(n68)Footnote 43. Letter from Dorsey & Whitney LLP dated November 25, 2002.

(n69)Footnote 44. Letter from Association for Investment Management and Research dated December 12, 2002.

(n70)Footnote 45. Letter from Ernst & Young dated November 25, 2002.

(n71)Footnote 46. *See* letter from Robert Waxman dated November 25, 2002.

(n72)Footnote 47. *See* letter from Dorsey & Whitney LLP dated November 25, 2002.

(n73)Footnote 48. *KPMG LLP v. Securities and Exchange Commission*, 289 F. 3d 109, 126 (D.C. Cir. 2002) , which states, "We affirm the Commission's determination that negligence is an appropriate basis for violations underlying a Section 21C cease-and-desist order ." *See In the Matter of KPMG Peat Marwick LLP*, AAER 1360 (January 19, 2001), which states, "We hold today that negligence is sufficient to establish causing' liability under Exchange Act section 21C(a), at least in cases in which a person is alleged to cause' a primary violation that does not require scienter. Therefore, if Peat Marwick acted at least negligently with respect to whether its conduct would contribute to PORTA's violations, Peat Marwick is liable under Section 21C(a) as a cause of those violations."

(n74)Footnote 49. *See, e.g., In the Matter of Donald F. Marcus and In the Matter of Harry P. Adler*, AAER 1715 (February 10, 2003); *SEC v. John F. Mortell, et al.*, AAER 1569 (June 5, 2002); *In the Matter of Ronald G. Davies*, AAER 1281 (June 29, 2000); and *In the Matter of Terry R. Kuntz and Richard J. Scheer*, AAER 720 (September 26,

1995).

(n75)Footnote 50. *See, e.g.*, letters from HarborView LLC dated October 29, 2002 and Council of Institutional Investors dated November 22, 2002.

(n76)Footnote 51. To the extent that the work of the internal auditor is used by the independent auditor in conducting an audit or review of the issuer's financial statements, however, misleading or inaccurate information provided to the internal auditor may be deemed to be provided to the independent auditor.

(n77)Footnote 52. *See, e.g.* letter from Deloitte & Touche dated November 27, 2002.

(n78)Footnote 53. *See, e.g.* letters from Deloitte & Touche dated November 27, 2002, European Commission dated November 25, 2002, and Ernst & Young dated November 25, 2002.

(n79)Footnote 54. Section 206 of the Act adds section 10A(l) to the Exchange Act, which states:

It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.

(n80)Footnote 55. Section 201 of the Act prohibits the auditor of the issuer's financial statements from providing certain non-audit services for that issuer and permits other non-audit services to be performed only if the service is pre-approved by the issuer's audit committee. Section 202 of the Act describes the pre-approval process.

(n81)Footnote 56. *See, e.g.*, letter from America's Community Bankers dated November 25, 2002.

(n82)Footnote 57. Letter from KPMG LLP dated November 25, 2002.

(n83)Footnote 58. *See, e.g.* letter from Deloitte & Touche dated November 27, 2002.

(n84)Footnote 59. *See, e.g.*, letter from Robert Waxman dated November 25, 2002.

(n85)Footnote 60. Letter from BDO Seidman LLP dated November 25, 2002.

(n86)Footnote 61. *See, e.g.*, letters from America's Community Bankers dated November 25, 2002, Software Finance & Tax Executives Council dated November 25, 2002, New York State Bar Association dated November 25, 2002, KPMG LLP dated November 25, 2002, and the American Institute of Certified Public Accountants dated November 25, 2002.

(n87)Footnote 62. Section 303(a) uses the phrase "independent public or certified accountant," which appears, for example, in items 25, 26 and 27 of Schedule A to the Securities Act of 1933. *15 U.S.C. 77aa(25), (26) and (27)*. Since the passage of the 1933 Act, however, the general reference to "certified accountant" has been replaced by "certified public accountant." To avoid any possible confusion, we have used "certified public accountant" in the new rules.

(n88)Footnote 63. *See* section 102 of the Act, which provides that beginning 180 days after the Commission determines that the Board, as established by Title I of the Act, is appropriately organized and has the capacity to carry out and enforce the requirements of that title, it shall be unlawful for any person that is not a registered public accounting firm to prepare any audit report with respect to any issuer.

(n89)Footnote 64. *See, e.g.*, sections 205(b) and (c) of the Act.

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(n90)Footnote 65. *See, e.g.*, section 13(a) of the Exchange Act, 15 U.S.C. 78m(a), and section 8(e) of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. 77h(e).

(n91)Footnote 66. *See, e.g.*, items 25, 26 and 27 of Schedule A of the 1933 Act, 15 U.S.C. 77aa(25), (26) and (27).

(n92)Footnote 67. The rule would apply regardless of whether the accountant was a certified public accountant. For example, some states require accountants to have years of experience before being deemed to be a CPA. Efforts to mislead such an individual during his or her performance of audit procedures would fall within the rules. In addition, the term "independent public or certified public accountant" includes accountants in foreign countries who engage in auditing or reviewing an issuer's financial statements or issuing attestation reports to be filed with the Commission, regardless of the title or designation used in those countries.

(n93)Footnote 68. *See, e.g.*, section 404 of the Act, which mandates that the Commission prescribe rules that require (1) each annual report filed under sections 13(a) and 15(d) of the Exchange Act contain a management statement of responsibilities for, and assessment of the effectiveness of, the issuer's internal control structure and procedures for financial reporting, and (2) the auditor to attest to, and report on, the assessment made by management.

(n94)Footnote 69. Section 2(a)(12) of the Act defines "registered public accounting firm" to mean "a public accounting firm registered with the Board in accordance with this Act."

(n95)Footnote 70. Section 2(a)(9)(A) of the Act defines "person associated with a public accounting firm" (or with a "registered public accounting firm") to mean "any individual proprietor, partner, shareholder, principal, accountant, or other professional employee of a public accounting firm, or any other independent contractor or entity that, in connection with the preparation or issuance of any audit report--(i) shares in the profits of, or receives compensation in any other form from, that firm, or (ii) participates as agent or otherwise on behalf of such accounting firm in any activity of that firm." The Board, in section 2(a)(9)(B) of the Act, is given limited authority to exempt persons performing only ministerial tasks.

(n96)Footnote 71. *See, e.g.*, letters from Independent Community Bankers of America dated November 25, 2002 and Robert Waxman dated November 25, 2002.

(n97)Footnote 72. *See, e.g.*, letter from PwC dated November 25, 2002.

(n98)Footnote 73. Rule 2-01(f)(5)(ii) of Regulation S-X, 15 CFR 210.2-01(f)(5)(ii), which defines the "professional engagement period" to be: "The period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission," and states: "(A) The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and (B) The professional engagement period ends when the audit client or the accountant notifies the Commission that the client is no longer that accountant's audit client."

(n99)Footnote 74. American Institute of Certified Public Accountants ("AICPA") Code of Professional Conduct, ET § 101.02, which states:

The period of a professional engagement starts when the [AICPA] member begins to perform any professional engagement requiring independence for an enterprise, lasts for the entire duration of the professional relationship, which could cover many periods, and ends with the formal or informal notification of the termination of the professional relationship either by the member, by the enterprise, or by the issuance of a report, whichever is later. Accordingly, the professional engagement does not end with the issuance of a report and recommence with the signing of the following year's engagement.

(n100)Footnote 75. Changes in the principal auditor of an issuer's financial statements are reported under item 4 of Form 8-K, 17 CFR 249.308. *See also* item 304 of Regulation S-K, 17 CFR 229.304, and item 304 of Regulation S-B, 17 CFR 228.304.

(n101)Footnote 76. *See, e.g.*, letters from Deloitte & Touche dated November 27, 2002, Independent Community Bankers of America dated November 25, 2002, the American Institute of Certified Public Accountants dated November 25, 2002, and Ernst & Young LLP dated November 25, 2002.

(n102)Footnote 77. *See, e.g.*, letters from America's Community Bankers dated November 25, 2002 and PwC dated November 25, 2002.

(n103)Footnote 78. There is no such requirement for Rule 13b2-1 or Rule 13b2-2.

(n104)Footnote 79. *See* Report of the Committee on Banking, Housing, and Urban Affairs, To Accompany S. 2673, "Public Company Accounting Reform and Investor Protection Act of 2002," 107th Cong., 2d Sess., (S.R. 107-205), at 26 (Comm. Print, July 3, 2002), which states that section 303 makes it unlawful for any officer or director of an issuer, or any person acting under the direction of an officer or director, to fraudulently influence, coerce, manipulate, or mislead the auditor of the issuer's financial statements "for the purpose of rendering the *audit report* misleading." (Emphasis added.)

(n105)Footnote 80. For example, an auditor might be fraudulently influenced to allow an issuer to correct material misstatements over time, or not to restate prior period financial statements, in violation of generally accepted accounting principles.

(n106)Footnote 81. *See* section 401(a) of the Act, which, among other things, adds section 13(i) to the Exchange Act, which requires that financial statements prepared in accordance with (or reconciled to) generally accepted accounting principles and filed with the Commission reflect all material correcting adjustments identified by a registered public accounting firm.

(n107)Footnote 82. *See, e.g.*, SAS 1, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," AU § 561.

(n108)Footnote 83. *See, e.g.*, section 204 of the Act, which adds section 10A(k) to the Exchange Act and requires each registered public accounting firm to report certain matters to the audit committee, and AICPA, SAS 61, "Communication With Audit Committees" (as amended by SAS 89 and SAS 90).

(n109)Footnote 84. *See* Rule 10-01(d) of Regulation S-X, 17 CFR 210.10-01(d).

(n110)Footnote 85. *See, e.g.*, section 7(a) of the Securities Act of 1933, 15 U.S.C. 77g, which states in part, "If any accountant is named as having prepared or certified any part of the registration statement, the written consent of such person shall be filed with the registration statement"; Rule 436 under the Securities Act of 1933, 17 CFR 230.436.

(n111)Footnote 86. *See, e.g.*, letters from National Association of State Boards of Accountancy dated November 25, 2002, Independent Community Bankers of America dated November 25, 2002, Plains All American Pipeline LP dated November 25, 2002, Ernst & Young LLP dated November 25, 2002, and PwC dated November 25, 2002. One commenter, however, suggested that the list of examples be removed. Letter from Intel Corporation dated November 25, 2002.

(n112)Footnote 87. Letter from Robert Waxman dated November 25, 2002.

(n113)Footnote 88. Letter from Transparency International--USA dated November 8, 2002.

(n114)Footnote 89. Letter from Deloitte & Touche dated November 27, 2002.

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(n115)Footnote 90. *See, e.g.*, section 21C(a) of the Exchange Act, 15 U.S.C. 78u-3, which authorizes the Commission to order a person to cease and desist from committing or causing violations, or future violations, of the federal securities laws due to actions that the person "knew or should have known" would contribute to the violation, and *KPMG LLP v. Securities and Exchange Commission*, 289 F. 3d 109, 126 (D.C. Cir. 2002), which states, "We affirm the Commission's determination that negligence is an appropriate basis for violations underlying a Section 21C cease-and-desist order."

(n116)Footnote 91. *See, e.g.*, *In the Matter of Donald F. Marcus* and *In the Matter of Harry P. Adler*, AAER 1715 (February 10, 2003); *SEC v. John F. Mortell, et al.*, AAER 1569 (June 5, 2002); *In the Matter of Ronald G. Davies*, AAER 1281 (June 29, 2000); and *In the Matter of Terry R. Kuntz and Richard J. Scheer*, AAER 720 (September 26, 1995).

(n117)Footnote 92. *See, e.g.*, letters from Wells Fargo dated November 22, 2002, Dorsey and Whitney LLP dated November 25, 2002, Sullivan & Cromwell dated November 25, 2002, The Business Roundtable dated November 29, 2002, America's Community Bankers dated November 25, 2002, Steven Hazen dated November 25, 2002, New York State Bar Association dated November 25, 2002, KPMG LLP dated November 25, 2002, and Plains All American Pipeline LP dated November 25, 2002.

(n118)Footnote 93. *See, e.g.*, letters from the American Institute of Certified Public Accountants dated November 25, 2002 and the National Association of State Boards of Accountancy dated November 25, 2002.

(n119)Footnote 94. *See, e.g.*, letter from Ernst & Young LLP dated November 25, 2002.

(n120)Footnote 95. We believe that the mental state requirements of the rules generally should be construed consistently with the existing rules in Regulation 13B-2. Because there is no private right of action, among other reasons, the Commission believes that a lesser standard of liability is appropriate. *See* Release No. 34-15570 (February 15, 1979); 44 *Federal Register* 10970. *See also*, Report of the Committee on Banking, Housing, and Urban Affairs, To Accompany S. 2673, "Public Company Accounting Reform and Investor Protection Act of 2002," 107th Cong., 2d Sess., (S.R. 107-205), at 26 (Comm. Print, July 3, 2002), which cites as a reason for enacting section 303 the testimony of witnesses who were concerned with addressing fraud and other "misconduct in the audit process."

(n121)Footnote 96. *See In the Matter of Terry R. Kuntz and Richard J. Scheer*, AAER 720 (September 26, 1995), which states, in part, "The Commission will not tolerate conduct by third party vendors, which poses a very real threat to the integrity of the disclosure process."

(n122)Footnote 97. *See, e.g.*, letters from Transparency International--USA dated November 8, 2002, National Association of State Boards of Accountancy dated November 25, 2002, and Independent Community Bankers of America dated November 25, 2002.

(n123)Footnote 98. *See, e.g.*, letters from the American Bar Association dated December 13, 2002, The Business Roundtable dated November 29, 2002, the New York State Bar Association dated November 25, 2002, BDO Seidman LLP dated November 25, 2002, Ernst & Young LLP dated November 25, 2002, and the National Association of Real Estate Investment Trusts dated November 25, 2002.

(n124)Footnote 99. *See, e.g.*, letter from Association for Investment Management and Research dated December 12, 2002.

(n125)Footnote 100. *See, e.g.*, letters from Wells Fargo dated November 22, 2002, Eastman Kodak Company received on November 25, 2002, Sullivan & Cromwell dated November 25, 2002, the American Bar Association dated December 13, 2002, The Business Roundtable dated November 29, 2002, America's Community Bankers dated November 25, 2002, the Software Finance & Tax Executives Council dated November 25, 2002, New York State Bar Association dated November 25, 2002, Independent Community Bankers of America dated November 25, 2002, Plains

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All American Pipeline LP dated November 25, 2002, Dechert dated November 25, 2002, Intel Corporation dated November 25, 2002, Compass Bancshares Inc. dated November 25, 2002, and Robert Waxman dated November 25, 2002.

(n126)Footnote 101. Letters from KPMG LLP dated November 25, 2002 and PwC dated November 25, 2002. Section 10A(a) of the Exchange Act, *15 U.S.C. 78j-1(a)*, requires auditors to conduct procedures designed to provide, among other things, reasonable assurance of the detection of illegal acts that would have a direct and material effect on the determination of financial statement amounts. Section 10A(b) of the Exchange Act, *15 U.S.C. 78j-1(b)*, states that if the accountant becomes aware of information indicating that an illegal act has or may have occurred the accountant shall perform additional procedures to determine whether it is likely an illegal act has occurred and, if so, its possible effect on the financial statements, and report the act to management and assure that the issuer's audit committee is informed of the act. If the accountant concludes that the illegal act has a material effect on the financial statements, appropriate remedial actions are not taken, and the failure to take such actions is reasonably expected to warrant a modified audit report or resignation from the audit engagement, then the auditor must report his or her conclusions to the issuer's board of directors. If the board does not notify the Commission that it has received such a report, then the auditor must furnish to the Commission a copy of its report.

(n127)Footnote 102. Section 10A(f) of the Exchange Act, *15 U.S.C. 78j-1(f)*.

(n128)Footnote 103. One commenter also suggested "technical corrections" to the rule to include "review" in paragraph (a)(2)(i) and "reissue" in paragraph (b)(2)(i). Letter from KPMG LLP dated November 25, 2002. We have made these corrections and a conforming change to paragraph (c)(1)(ii)(A).

(n129)Footnote 104. Business development companies are a category of closed-end investment companies that are not required to register under the Investment Company Act of 1940. See *15 U.S.C. § 80a-2(a)(48)* (defining business development companies).

(n130)Footnote 105. Rule 13b2-2(c)(2).

(n131)Footnote 106. Rule 13b2-2(c)(1).

(n132)Footnote 107. Letter from PwC dated November 25, 2002.

(n133)Footnote 108. Letter from Dechert dated November 25, 2002.

(n134)Footnote 109. See, e.g., letters from Wells Fargo dated November 22, 2002, Dorsey & Whitney dated November 25, 2002, Deloitte & Touche dated November 27, 2002, Sidley Austin Brown & Wood dated December 30, 2002, America's Community Bankers dated November 25, 2002, and BDO Seidman LLP dated November 25, 2002.

(n135)Footnote 110. See, e.g., letter from New York County Lawyers' Association dated December 3, 2002.

(n136)Footnote 111. See, e.g., *In the Matter of Donald F. Marcus* and *In the Matter of Harry P. Adler*, AAER 1715 (February 10, 2003); *SEC v. John F. Mortell, et al.*, AAER 1569 (June 5, 2002); *In the Matter of Ronald G. Davies*, AAER 1281 (June 29, 2000); and *In the Matter of Terry R. Kuntz and Richard J. Scheer*, AAER 720 (September 26, 1995).

(n137)Footnote 112. *Id.*

(n138)Footnote 113. See Accounting Series Release No. 296 (Aug. 20, 1981), which states in part:

(T)he capital formation process depends in large part on the confidence of investors in financial reporting. An investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding the corporations in which he has

invested or proposes to invest. The quality of information disseminated in the securities markets and the continuing conviction of individual investors that such information is reliable are thus key to the formation and effective allocation of capital. Accordingly, the audit function must be meaningfully performed and the accountant's independence not compromised.

(n139)Footnote 114. *See, e.g.*, H.R. Rep. No. 1383, 73rd Cong., 2d Sess., 11 (1934), which states:

Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.

This House Report also includes a letter from the Executive Assistant of the Committee on Stock List for the New York Stock Exchange, which recognizes management's need for accurate financial information and then states:

[U]nder the conditions of today, the next object in order of importance has become to give stockholders, in understandable form, such information in regard to the business as will avoid misleading them in any respect and as will put them in possession of all information needed, and which can be supplied in financial statements, to determine the true value of their investments . The exchange is interested in the accounts of companies as a source of reliable information for those who deal in stocks. It is not sufficient for the stock exchange that the accounts should be in conformity with law or even that they should be conservative; the stock exchange desires that they should be fully and fairly informative.

Id. at 12 .

(n140)Footnote 115. *See, e.g.*, letters from National Association of State Boards of Accountancy dated November 25, 2002 and PwC dated November 25, 2002.

(n141)Footnote 116. Letter from Independent Community Bankers of America dated November 25, 2002.

(n142)Footnote 117. Section 303(b) of the Act states, "In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation under this section."

(n143)Footnote 118. *See, e.g.* letters from PwC dated November 25, 2002 and Robert Waxman dated November 25, 2002.

(n144)Footnote 119. Letter from National Association of State Boards of Accountancy dated November 25, 2002.

(n145)Footnote 120. *See* Rules 3b-2 and 3b-7 under the Exchange Act, *17 CFR 240.3b-2* and *240.3b-7*.

(n146)Footnote 121. *See* section 3(a)(7) of the Exchange Act, *15 U.S.C. 78c(a)(7)*.

(n147)Footnote 122. Letter from Nicholas Taylor dated November 8, 2002.

(n148)Footnote 123. *Id.*

(n149)Footnote 124. Letter from Independent Community Bankers of America dated November 25, 2002.

(n150)Footnote 125. *17 CFR 240.0-10(a)*.

(n151)Footnote 126. *17 CFR 230.157*

(n152)Footnote 127. *17 CFR 270.0-10*.

(n153)Footnote 128. *15 U.S.C. 78w(a)(2)*.

(n154)Footnote 129. *15 U.S.C. 77b(b)*.

(n155)Footnote 130. *15 U.S.C. 78c(f)*.

(n156)Footnote 131. *15 U.S.C. 80a-2(c)*.

(n157)Footnote 1. Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act") (*15 U.S.C. 7245*) mandates that the Commission:

shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule --

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

(n158)Footnote 2. President Bush signed the Act on July 30, 2002.

(n159)Footnote 3. *See* Release 33-8150 (Nov. 21, 2002), *67 FR 71669* (Dec. 2, 2002) .

(n160)Footnote 4. *67 FR 71670, 71697* (Dec. 2, 2002) .

(n161)Footnote 5. *See* Comments of the Association of the Bar of the City of New York, at 28 ("There is nothing in Section 307 to suggest that Congress authorized the Commission to preempt state law and rules governing attorney conduct."); *see also* Comments of the American Bar Association, at 32 ; Comments of 77 law firms, at 2. While questioning the Commission's authority in this area, the American Bar Association ("ABA") nevertheless recognized that "the federal system of the United States may provide an arguable basis for the pre-emption of attorney-client and confidentiality obligations applicable to United States attorneys." *See* Comments of the American Bar Association, at 37 .

(n162)Footnote 6. *See* Comments of Susan P. Koniak *et al.*, at 28-29 .

(n163)Footnote 7. *See, e.g.*, Comments of Susan P. Koniak *et al.*, at 32 ; Comments of Richard W. Painter, at 8 ; Comments of Nancy J. Moore, at 3 .

(n164)Footnote 8. *See* Comments of the American Bar Association, at 12 .

(n165)Footnote 9. *Id.*; *see also* Comments of Sullivan & Cromwell, at 12-14 ; Comments of 77 law firms, at 7 (arguing that the scope of the definition of the term may incite efforts by attorneys to limit their involvement in certain

matters in an effort to avoid coming within the purview of the rule).

(n166)Footnote 10. *See* Comments of Susan P. Koniak *et al.*, at 33 .

(n167)Footnote 11. Comments of Thomas D. Morgan, at 5-6 ; Comments of Morrison & Foerster and eight other law firms, at 14 (paragraph 205.2(b) should be revised to read that in all situations it would be an appropriate response for an issuer to assert a colorable defense to any claim of material violation).

(n168)Footnote 12. Comments of Palmer & Dodge, Attachment at 2 ("The Model Rules state that 'reasonable belief' or 'reasonably believes' when used in reference to a lawyer denotes that the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable." Model Rule 1.0(i)). "Reasonable" and "reasonably," in turn, are defined as "denot[ing] the conduct of a reasonably prudent and competent lawyer." Model Rule 1.0(h). Along similar lines, one group of commenters suggested that the paragraph include language paralleling the Model Rule definition, setting as the standard the conclusion of "a prudent and competent attorney, acting reasonably under the same circumstances" that a response was appropriate. Comments of Susan P. Koniak *et al.*, at 12-13 , 15; *see also* Comments of the SIA/TBMA, at 18 (urging that the Commission modify this paragraph to protect an attorney whose judgment that an issuer's response was appropriate was "reasonable under the circumstances").

(n169)Footnote 13. Comments of the American Corporate Counsel Association, at 10 . This concern was also expressed by commenters who asserted that foreign lawyers, in particular, would not have sufficient practical knowledge of United States laws to determine what constitutes an appropriate response. *See, e.g.*, Comments of Nagashima Ohno & Tsunematsu, at 7 ; Comments of the SIA/TBMA, at 13 (reporting attorney's judgment should be evaluated in light of that attorney's training, experience and position).

(n170)Footnote 14. Comments of Covington & Burling, at 3 .

(n171)Footnote 15. Comments of Susan P. Koniak *et al.*, at 12-13 .

(n172)Footnote 16. Comments of Covington & Burling, at 3 .

(n173)Footnote 17. Comments of Richard Hall, Cravath Swaine & Moore, at 6-7 ; Comments of the Association of the Bar of the City of New York, at 12 ; Comments of Carter, Ledyard & Milburn, at 3 (stating that requiring an attorney, in deciding whether an issuer has made an appropriate response, to determine whether a material violation is about to occur, is an "impossibly predictive standard"); Comments of the Japan Federation of Bar Associations, at 3 (opining that the term "appropriate response" cannot be easily construed on its face).

(n174)Footnote 18. Comments of the SIA/TBMA, at 18 ; Comments of the Association of the Bar of the City of New York, at 12 ("[o]nce an attorney has reported and documented a possible violation, the attorney should be assured that good faith reliance upon the response protects the attorney).

(n175)Footnote 19. Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 14 ; Comments of the American Bar Association, at 22 ("[w]e believe it is important that the Commission recognize that a reporting attorney may rely on the considered judgment of the CLO so long as that judgment is in the range of reasonableness even though the attorney would not necessarily come out that way"); Comments of Skadden, Arps, Slate, Meagher & Flom, at 9-10 (reporting attorney should be able to rely upon the stated belief of the officer to whom he has reported the evidence of material violation that no material violation has occurred).

(n176)Footnote 20. Comments of JP Morgan & Chase, at 10-11 ; Comments of Debevoise & Plimpton, at 5 .

(n177)Footnote 21. Comments of JP Morgan & Chase, at 11 ; Comments of Debevoise & Plimpton, at 5-6 .

(n178)Footnote 22. Comments of the Corporation, Finance and Securities Law Section of the District of Columbia

Bar, at 14 .

(n179)Footnote 23. Comments of Carter, Ledyard & Milburn, at 3 ; Comments of Skadden, Arps, Slate, Meagher & Flom, at 9-10 (appropriate response should include a timely response that adequate measures are being taken).

(n180)Footnote 24. Comments of Susan P. Koniak *et al.*, at 13 ; Comments of Schiff Hardin & Waite, at 4-5 (criticizing the examples in the release of the proposed rule as undercutting the proposition that attorneys will be permitted to exercise their reasonable judgment, and stating that the Commission should clarify that the reasonableness of an issuer's response will vary depending on the circumstances and will not necessarily depend on the existence of a written legal opinion from outside counsel to the issuer); Comments of the SIA/TBMA, at 18 (suggesting revisions to Section 205.2(b) that would state that an appropriate response should be reasonable under the circumstances, measured by the magnitude and quality of the evidence of the violation, the severity of the violation, and whether there is a potential for ongoing or recurring violation).

(n181)Footnote 25. Comments of Susan P. Koniak *et al.*, at 12 .

(n182)Footnote 26. Comments of the SIA/TBMA, at 11 (stating that the Rules "should exempt outside counsel whom securities firms retain to conduct internal investigations").

(n183)Footnote 27. Comments of Carter, Ledyard & Milburn, at 6 (noting risk that proposed rules "might discourage persons from seeking legal representation"); Comments of the SIA/TBMA, at 11 .

(n184)Footnote 28. Comments of Weil Gotshal & Manges, at 7 .

(n185)Footnote 29. Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 4 ; Comments of the American Bar Association, at 30 .

(n186)Footnote 30. *67 FR at 71683* .

(n187)Footnote 31. Comments of Akin Gump Strauss Hauer & Feld, at 7-8 ; Comments of Cleary, Gottlieb, Steen & Hamilton, at 9 ("There would be an unavoidable chilling effect on the advocacy of lawyers who represent clients before the Commission in investigations and administrative proceedings if Rule 205 applies to them."); Comments of the Association of the Bar of the City of New York, at 19-20 (stating that it would be "unfair[]" to include attorneys who are adverse parties in enforcement or administrative proceedings within the reporting and withdrawal requirements of the proposed rules"); Comments of Susan P. Koniak *et al.*, at 36 (final rules should "avoid chilling legitimate and vigorous advocacy").

(n188)Footnote 32. Comments of Richard Hall, Cravath, Swaine & Moore, at 3 .

(n189)Footnote 33. Comments of Morrison & Foerster and eight other law firms, at 14.

(n190)Footnote 34. Comments of Securities Regulation Committee, Business Law Section, New York State Bar Association, at 6 (stating that "a lawyer need not subjectively believe that he or she has the 'better side of the argument' or that it is a position likely to prevail. The attorney is permitted to undertake the representation if he or she, after a reasonable investigation, believes that there is (or will be) evidentiary support for the position and that the assertions of law are nonfrivolous. *See, e.g., Rule 11, Fed. R. Civ. P.*"). *See also* Comments of Cleary, Gottlieb, Steen & Hamilton, at 9 ("Lawyers representing clients before the Commission must be free to make all non-frivolous arguments to the staff.").

(n191)Footnote 35. Comments of Susan P. Koniak, *et al.*, at 37 .

(n192)Footnote 36. The text of the final rule does not specifically include a reference to a "colorable basis for contending that the staff [or other litigant] should not prevail," nor does it specifically refer to requiring the Commission

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staff or other litigant to bear the burden of its case. The Commission, however, considers these and related actions permitted to an attorney, consistent with his or her professional obligations, to be included within the reference to asserting a "colorable defense."

(n193)Footnote 37. Subparagraph (b)(3) thereby also addresses the concern of some commenters that an attorney representing an issuer in connection with a Commission investigation or administrative proceeding not be required to report the information. Under subparagraph (b)(3), asserting a colorable defense on an issuer's behalf in an investigation or administrative proceeding may constitute an appropriate response, and no further reporting would be required.

(n194)Footnote 38. *67 FR at 71673* .

(n195)Footnote 39. *See, e.g.*, Comments of Skadden, Arps, Slate, Meagher and Flom, at 16 (noting that foreign private issuers usually consult with United States counsel on securities matters, and suggesting that limiting the definition of "attorney" to lawyers licensed in United States jurisdictions "will avoid the unfairness of subjecting foreign lawyers to the Proposed Rules without compromising the effectiveness of the rules.").

(n196)Footnote 40. *See* Comments of Richard W. Painter, at 10-11 ("Breaches of fiduciary duty to pension funds under federal law such as ERISA, and other similar violations would thus clearly be covered, whereas arguably they are not under the current definition in the Proposed Rules.").

(n197)Footnote 41. The proposed rule defines *evidence of a material violation* as "information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur" and *reasonable belief* as what "an attorney, acting reasonably, would believe."

(n198)Footnote 42. *E.g.*, Comments of John Bullock, at 1 ("the threshold for mandatory reporting by an attorney should be the level of evidence that a responsible corporate officer should want to know, so that the client can pursue an investigation and take appropriate action. The standard should therefore be 'some credible information that a material violation may have occurred, may be occurring, or may be about to occur.'").

(n199)Footnote 43. Comments of Richard W. Painter, at 6 (suggesting that "evidence that a violation is 'possible' could trigger the duty to report to the Chief Legal Officer, whereas evidence that a violation is 'likely' could trigger the duty to report to the full board or to the QLCC. Evidence that a violation was 'highly likely' or a 'near certainty' could trigger the requirement of a noisy withdrawal."); Comments of Susan P. Koniak *et al.*, at 9-11 , 15-17 (emphasizing the importance of distinguishing between a violation and evidence of one and suggesting the use of the phrase "credible evidence").

(n200)Footnote 44. Comments of Skadden Arps, Slate, Meagher & Flom, at 10 (proposing to define "*evidence of a material violation*" as "facts and circumstances known to an attorney which have caused the attorney to believe that a material violation has occurred, is occurring or is about to occur"); Comments of Chadbourne & Parke, at 7 (proposing "a subjective standard that an attorney 'knows' that a material violation has occurred, is occurring or is about to occur"); Comments of Sullivan & Cromwell, at 11 ("Evidence of a material violation means information of which the attorney is consciously aware that would, in the attorney's judgment, constitute a material violation that has occurred, is occurring, or is about to occur."); Comments of the American Bar Association, at 17 (recommending use of "the knowledge standard").

(n201)Footnote 45. *See* Comments of Susan P. Koniak *et al.*, at 18 .

(n202)Footnote 46. Comments of Richard W. Painter, at 5-6 .

(n203)Footnote 47. Comments of the Association of the Bar of the City of New York, at 10 .

(n204)Footnote 48. The standard was suggested, *e.g.*, in Comments of the American Bar Association, at 5 , 16-17.

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(n205)Footnote 49. Comments of Cleary, Gottlieb, Steen & Hamilton, at 5-6 (any lower trigger for reporting would be equivocal, would lead to disparate application of the rule, and would "chill" the attorney-client relationship).

(n206)Footnote 50. The Commission intends the definition of the term "reasonably likely" to be consistent with the discussion of the term included in the adopting release for the recently adopted final rule governing disclosure of off-balance sheet arrangements, enacted pursuant to § 401(a) of the Sarbanes-Oxley Act.

(n207)Footnote 51. Comments of the American Bar Association, at 14 ("It is not uncommon for persons who were attorneys and may still retain their license to move into other non-legal capacities in the organization... .These persons should be subject to no greater obligations to the organization than someone who is not an attorney."). However, the ABA stated that it believed that the rule "appropriately applied to any attorney for the issuer" who renders legal advice to the issuer. *Id.*

(n208)Footnote 52. We also note that the change should address concerns expressed that counsel to underwriters or similar persons might be covered by the rule.

(n209)Footnote 53. *67 FR at 71678-79* .

(n210)Footnote 54. *See, e.g.*, Comments of the Investment Company Institute at 1-5 (asserting that the Commission's construction of its rule may cause investment advisers to "limit or even eliminate the participation of their internal and outside lawyers in the preparation of fund filings and materials, and in providing day-to-day advice to advisory personnel responsible for managing funds, in order to ensure that such lawyers are not 'involved in the representation of an issuer' or 'practicing before the Commission' within the meaning of the proposed rule.").

(n211)Footnote 55. On the correctness of this inference, *see, e.g.*, Comments of Thomas D. Morgan at 3-4 (pointing out that "current law" makes an attorney employed by an investment adviser the "legal representative" of an investment company under these circumstances, although one has to take "a logical step" to reach that conclusion) (citing *Restatement (Third) of the Law Governing Lawyers* § 51(4)(2000)). An attorney-client relationship does not depend on payment for legal services performed. However, the legal services provided by an investment adviser to an investment company are usually performed pursuant to an advisory contract along with other services (such as investment advice) and are covered by the overall investment advisory fee.

(n212)Footnote 56. Comments of the Investment Company Institute, at 4 . As noted in the proposing release, *67 FR at 71678-79* , and below in the discussion of Section 205.3(b), an attorney employed by an investment adviser who becomes aware of evidence of a material violation that is material to an investment company while thus representing that investment company before the Commission has a duty to report such evidence up-the-ladder within the investment company. For the reasons explained in the proposing release and noted below, however, such reporting does no violence to the attorney-client privilege. *See Restatement (Third) of the Law Governing Lawyers*, § 75 and cmt. d (explaining that in a subsequent proceeding in which the co-client's interests are adverse there is normally no attorney-client privilege regarding either co-client's communications with their attorney during the co-client relationship).

(n213)Footnote 57. We also note that the changes should address concerns expressed that counsel to underwriters or similar persons might be covered by the rule.

(n214)Footnote 58. An attorney who represents a subsidiary or other person controlled by an issuer at the behest, for the benefit, or on behalf of a parent issuer who becomes aware of evidence of a material violation that is material to the issuer should report the evidence up-the-ladder through the issuer, as set forth in Section 205.3(b) of the rule.

(n215)Footnote 59. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 231-36 (1988) ; *TSC Indus. v. Northway, Inc*, 426 U.S. 438 (1976) .

(n216)Footnote 60. Comments of the American Corporate Counsel Association, at 9-10 ; Comments of

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Association of the Bar of the City of New York, at 42 ; Comments of Corporations Committee, Business Law Section, State Bar of California, at 12 ; Comments of Skadden, Arps, Slate, Meagher & Flom, at 12 , 20, 25.

(n217)Footnote 61. *See* Comments of America's Community Bankers, at 5-6 .

(n218)Footnote 62. Comments of Business Law Section, New York State Bar Association, at 14-15 ; Comments of the Business Roundtable, at 2-3 .

(n219)Footnote 63. Comments of the American Bar Association, at 27 ; Comments of Business Law Section, New York State Bar Association, at 15 .

(n220)Footnote 64. Comments of Clifford Chance, at 4-5 ; Comments of Emerson Electric Co., at 5 .

(n221)Footnote 65. Comments of Susan P. Koniak *et al.*, at 11 ; Comments of Richard W. Painter, at 5 ; Comments of Thomas D. Morgan, at 12 .

(n222)Footnote 66. *See* ABA Model Rule 1.13, "Organization as Client," at 1:139.

(n223)Footnote 67. *See, e.g.*, Comments of Cleary, Gottlieb, Steen & Hamilton, at 3-4 ; Comments of Corporations Committee, Business Law Section, The State Bar of California, at 7 ; Comments of the American Corporate Counsel Association, at 11 ; Comments of Task Force on Corporate Responsibility of the County of New York Lawyers' Association, at 2-3 .

(n224)Footnote 68. *See* Comments of the Association of the Bar of the City of New York, at 47-50 .

(n225)Footnote 69. *See* ABA Model Rule 1.13, at 1:139.

(n226)Footnote 70. Decisions in a number of states recognize that, under state law, an attorney for an issuer does not owe a fiduciary duty to shareholders. *See Pelletier v. Zweifel*, 921 F.2d 1465, 1491-92 n.60 (11th Cir.) *cert. denied*, 502 U.S. 955 (1991) (Under Georgia law "[I]t is a black letter principle of corporation law that a corporation's counsel does not owe ... [a] fiduciary duty to the corporation's shareholders"). *See also Skarbrevik v. Cohen, England & Whitfield*, 231 Cal. App. 3d 692, 703 (1991) (Under California law, "[a]n attorney representing a corporation does not become the representative of its stockholders merely because the attorney's actions on behalf of the corporation also benefit the stockholders; as attorney for the corporation, counsel's first duty is to the corporation."); *Egan v. McNamara*, 467 A.2d 733, 738 (DC 1983) ("According to the District of Columbia Code of Professional Responsibility (Code), an attorney represents, and therefore owes a duty to, the entity that retains him... . When retained to represent a corporation, he represents the entity, not its individual shareholders, officers, or directors.").

(n227)Footnote 71. The Comment of Federal Bar Counsel, at 12-13 , for example, objected to "becomes aware" in (b)(1) but appears to have done so in connection with the proposed definition of "evidence of a material violation." The revisions made to that definition appear to address those objections.

(n228)Footnote 72. *See, e.g.*, Comments of the American Bar Association, at 22 ; Comments of the American Corporate Counsel Association, at 5 ; Comments of the Association of the Bar of the City of New York, at 16 ; Comments of Cleary, Gottlieb, Steen & Hamilton, at 6 .

(n229)Footnote 73. Comments of Skadden, Arps, Slater, Meagher & Flom, at 23 .

(n230)Footnote 74. Comments of Corporations Committee, Business Law Section, the State Bar of California, at 10 .

(n231)Footnote 75. *Id.*

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(n232)Footnote 76. Comments of the American Corporate Counsel Association, at 5 .

(n233)Footnote 77. *See* Comments of Corporations Committee, Business Law Section, the State Bar of California, at 10 .

(n234)Footnote 78. *See* Comments of Cleary, Gottlieb, Steen & Hamilton, at 6 .

(n235)Footnote 79. *E.g.*, Comments of the SIA/TBMA, at 16 (CLO should be able to make use of the QLCC); Comments of J.P. Morgan Chase & Co., at 3 (CLO should not be required to notify the Commission that a material violation has occurred and disaffirm documents that the issuer has submitted to or filed with the Commission that the CLO believes are false or materially misleading); Comments of Compass Bancshares, at 2-3 (requiring CLO "to issue a response in writing to the attorney creates an undue burden on the CLO [in] responding to an issue which the CLO may not feel is warranted"); Comments of Charles Schwab & Co., at 1-2 (CLO "typically does not have authority to sanction employees outside of his or her chain of command, to require the business units to adopt new procedures, or even to make disclosure on behalf of the company without the concurrence of other executives").

(n236)Footnote 80. *67 FR at 71685-86* .

(n237)Footnote 81. *67 FR at 71686* .

(n238)Footnote 82. *67 FR at 71686* .

(n239)Footnote 83. *See* Comments of Schiff Hardin & Waite, at 4 (paragraph (b)(5) as proposed goes "too far" in deeming a lawyer engaged by an issuer to conduct an internal investigation of a possible material violation of the securities laws to be appearing and practicing before the Commission and that issuers will be reluctant to retain independent counsel to investigate if the independent counsel have "an obligation to effect a noisy withdrawal if they disagree with the client's response to the finding or recommendation resulting from the investigation"); Comments of the Chicago Bar Association, at 3 (paragraph as proposed is overbroad in requiring an outside lawyer engaged to investigate whether a violation has occurred to withdraw and notify the Commission if it disagrees with the issuer); Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 4-5 ("attorneys conducting an internal investigation, and not otherwise interacting with the Commission or even known to the Commission at that point, do not have a sufficient nexus with the Commission's processes" to be covered by the Commission's rules; making them subject to the Commission's rules will "make issuers less willing to retain, and attorneys less willing to conduct, such investigations"; and is unnecessary because section 205.3(b)(2) requires an issuer's CLO "to assess the timeliness and appropriateness of the issuer's response").

(n240)Footnote 84. *67 FR at 71687* .

(n241)Footnote 85. Comments of the American Bar Association, at 27-28 .

(n242)Footnote 86. Comments of the American Corporate Counsel Association, at 9-10 .

(n243)Footnote 87. Comments of Richard W. Painter, at 5 .

(n244)Footnote 88. Comments of Edward C. Brewer III, at 4 .

(n245)Footnote 89. Comments of the Association of the Bar of the City of New York, at 41-42 .

(n246)Footnote 90. *Id.*, at 42-43 .

(n247)Footnote 91. ABA, *Report of the Commission on Evaluation of the Rules of Professional Conduct* (November 2000), recommended permitting a lawyer to disclose confidential "information relating to the representation of a client to the extent the lawyer reasonably believes necessary ... to prevent the client from committing a crime or

fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services."

(n248)Footnote 92. Thirty-seven states permit an attorney to reveal confidential client information in order to prevent the client from committing criminal fraud. *See Restatement (Third) of the Law Governing Lawyers* (2000) § 67, Cmt. f, and Thomas D. Morgan & Ronald D. Rotunda, *Model Code of Professional Responsibility, Model Rules of Professional Conduct, and Other Selected Standards*, at 146 (reproducing the table prepared by the Attorneys' Liability Assurance Society ("ALAS") cited in the Restatement). The ABA's Model Rule 1.6, which *prohibits* disclosure of confidential client information even to prevent a criminal fraud, is a minority rule. In its *Carter and Johnson* decision (1981 WL 384414, at n.78), the Commission expressly did not address an attorney's obligation to disclose a client's intention to commit fraud or an illegal act.

(n249)Footnote 93. *See* comments of Joseph T. McLaughlin, Heller Ehrman, at 2 ; Comments of the Los Angeles County Bar Association, at 2 .

(n250)Footnote 94. Comments of Eleven Persons or Law Firms, at 8-9 ; Comments of the American Bar Association, at 33 (urging the Commission to refrain from considering the proposed disclosure provisions unless and until it receives express Congressional authority to preempt state privilege rules); Comments of 77 law firms, at 2; Comments of Latham & Watkins, at 5-6 ; Comments of Theodore Sonde, at 2 ; Comments of Schiff Hardin & Waite, at 7-8 ; Comments of Sheldon M. Jaffe, at 7-9 ; Comments of Emerson Electric, at 2 ; Comments of the Federal Bar Council, at 9-10 & n.9; Comments of JP Morgan & Chase, at 11 & n.3 (citing treatise for proposition that only six states permit disclosure to rectify past fraud).

(n251)Footnote 95. Comments of the Law Society of England and Wales, at 12 .

(n252)Footnote 96. Comments of the Los Angeles County Bar Association, at 2 ; Comments of Edward C. Brewer, III at 8 ; *see also* Comments of the Association of the Bar of the City of New York at 5 (supporting attorney disclosure of material facts to avoid assisting a criminal or fraudulent act by the client, or to correct prior representations made by the lawyer and believed by the lawyer still to be relied upon by a third person where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud).

(n253)Footnote 97. Comments of Theodore Sonde, at 2 .

(n254)Footnote 98. Comments of the American College of Trial Lawyers, at 6 .

(n255)Footnote 99. Comments of Conference of Chief Justices, at 4 .

(n256)Footnote 100. Comments of the Federal Bar Council, at 14 .

(n257)Footnote 101. Comments of the Law Society of England and Wales, at 12 .

(n258)Footnote 102. Comments of Morrison & Foerster and eight other law firms, Exhibit B (listing jurisdictions whose ethics rules permit or require attorneys to disclose clients' past and/or ongoing fraud); Comments of Edward C. Brewer, III, at 8 (the proposed rule for permissive disclosure of an issuer's "illegal act" is essentially no different than the existing Model Code provision).

(n259)Footnote 103. Comments of Richard W. Painter, at 6 .

(n260)Footnote 104. Comment of Edward C. Brewer, at 8 .

(n261)Footnote 105. Comments of Susan P. Koniak *et al.*, at 26-27 ; Comments of Nancy J. Moore, at 2-3 .

(n262)Footnote 106. Comments of Susan P. Koniak *et al.*, 27, 31-32.

(n263)Footnote 107. Comments of William H. Simon, at 3 .

(n264)Footnote 108. *See, e.g.*, Comments of Manning G. Warren III, at 1 ; Comments of Douglas A. Schafer, Comment of Elaine J. Mittleman at 2 ; Comments of Thomas Ross *et al.*, at 6-8 .

(n265)Footnote 109. Comment of Elaine J. Mittleman at 2 .

(n266)Footnote 110. *See 67 FR at 71693* .

(n267)Footnote 111. Comment of the American Corporate Counsel Association, at 7 (noting that permissive disclosure standards are "more in line with a majority of state professional rules of conduct").

(n268)Footnote 112. Specifically, New Jersey requires an attorney to reveal confidential "information relating to the representation of a client to the proper authorities ... to the extent the lawyer reasonably believes necessary to prevent the client: (1) [f]rom committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to result in ... substantial injury to the financial interest or property of another" or (2) such an act that "the lawyer reasonably believes is likely to perpetrate a fraud upon a tribunal." New Jersey Rule of Professional Conduct 1.6(b). Wisconsin's corresponding rule is virtually identical to New Jersey's, except that it makes no reference to "proper authorities." Wisconsin Supreme Court Rule 20:1.6. Florida requires a lawyer to reveal confidential information "to the extent the lawyer reasonably believes necessary ... to prevent a client from committing a crime." Florida Rule of Professional Conduct 4-1.6.

(n269)Footnote 113. Comments of Richard W. Painter, at 9 ("the only effective method" of assuring lawyers that the attorney-client privilege is not waived by disclosure to the Commission "is to seek an act of Congress establishing selective waiver and preempting inconsistent state law"); Comments of the American Bar Association, at 32 ; Comments of Susan P. Koniak *et al.*, at 44 .

(n270)Footnote 114. Comments of Sheldon Jaffe, at 10 . *Fed. R. Evid. 501* provides that "[e]xcept as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience. However, in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege of a witness, person, government, State, or political subdivision thereof shall be determined in accordance with State law."

(n271)Footnote 115. Comments of the American Bar Association, at 32 n. 21 ; Comments of Sheldon M. Jaffe, at 9-11 ; Comments of Edward C. Brewer, III, at 11 ; Comments of Latham & Watkins, at 5 ; Comments of Morrison & Foerster and eight other law firms, at 19.

(n272)Footnote 116. Comments of the American Bar Association, at 32 n. 22 ; Comments of Morrison & Foerster and eight other law firms, at 19. The Commission notes that the proposal in Congress to which these commenters refer would have applied the selective waiver doctrine to *all* documents produced to the Commission, and was not limited to productions conditioned upon an express confidentiality agreement. *See Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1425 (3d Cir. 1991) . Also, Congress did not reject the Commission's proposal; rather, the House Committee to which the proposal was submitted took no action. *See SEC Oversight and Technical Amendments: Hearing Before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, 98th Cong., 2d Sess 341 at 34, 51 (1984)*. Therefore, that the proposal before that House Committee in 1984 was not ultimately enacted carries no significance. *NAACP v. American Family Mut. Ins. Co.*, 978 F.2d 287, 299 (7th Cir. 1992) ("unsuccessful proposals to amend a law, in the years following passage, carry no significance").

(n273)Footnote 117. Comments of Richard W. Painter, at 9 ; Comments of Susan P. Koniak *et al.*, at 6 ;

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Comments of Latham & Watkins, at 5 ("[g]iven the high stakes associated with waiver of privilege, uncertainty as to interpretation of [Paragraph 205.3(e)(3)'s] requirements in this regard is troubling"); Comments of the SIA/TBMA at 15 ("[a]lthough we welcome this positive statement of Commission policy, given sharp disagreements among courts on the question of selective waiver, issuers and attorneys cannot be secure in their disclosures absent a statutory statement of express preemption").

(n274)Footnote 118. *See* Comments of the American Bar Association, at 22-23 . *See also* Comments of Skadden, Arps, Slate, Meagher & Flom, at 27 (arguing that the section should be eliminated entirely, or, alternatively, "narrowed to apply only to the supervisory attorney within a law firm or a law department who is directly responsible for the supervision of a subordinate attorney in connection with the representation of the issuer in the specific matter, regardless of whether the attorney supervises such subordinate attorney in other unrelated matters.").

(n275)Footnote 119. *See* Comments of Susan P. Koniak *et al.*, at 42 .

(n276)Footnote 120. *See* Comments of the American Bar Association, at 22 ("We believe the Commission correctly approaches in Rule 205.5 the treatment of subordinate lawyers who report to a supervisory attorney and in Rule 205.4(c) the shifting of responsibility for compliance to the supervisory attorney to which the matter was reported").

(n277)Footnote 121. *See* Comments of the Association of the Bar of the City of New York, at 43-44 .

(n278)Footnote 122. *Id.* at 46-47 . *See also* Comments of Morrison & Foerster and eight other law firms, at 21.

(n279)Footnote 123. *See* Comments of Skadden, Arps, Slate, Meagher and Flom, at 29 ; Comments of the SIA/TBMA, at 16 ; Comments of the American Bar Association, at 33 ; Comments of Sullivan & Cromwell, at 16-17 .

(n280)Footnote 124. *67 FR 71697* .

(n281)Footnote 125. *67 FR 71691* .

(n282)Footnote 126. *See* Comments of Attorney's Liability Assurance Society, Inc., at 20; Comments of the Association of the Bar of the City of New York, at 5 .

(n283)Footnote 127. *See* Comments of the American Bar Association, at 33-34 ; Comments of Morrison & Foerster and eight other law firms, at 21.

(n284)Footnote 128. *Id.* Comments of the American Bar Association, at 33-34 .

(n285)Footnote 129. *See, e.g.*, Comments of Skadden Arps Slate Meagher & Flom, at 29 ; Comments of the SIA/TBMA, at 21 ; Comments of the Investment Company Institute, at 7 .

(n286)Footnote 130. *44 U.S.C. 3501 et seq.*

(n287)Footnote 131. *See 5 CFR 1320.3(b)(2).*

(n288)Footnote 132. This estimate is based, in part, on the total number of operating companies that filed annual reports on Form 10-K (8,484), Form 10-KSB (3,820), Form 20-F (1,194) or Form 40-F (134) during the 2001 fiscal year, and an estimate of the average number of issuers that may have a registration statement filed under the Securities Act pending with the Commission at any time (100). In addition, we estimate that approximately 4,500 investment companies currently file periodic reports on Form N-SAR.

(n289)Footnote 133. Comments of the Mid-America Legal Foundation, at 3-4 .

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(n290)Footnote 134. Comments of Robert Eli Rosen, at 3 .

(n291)Footnote 135. Comments of Clifford Chance, at 4-5 ; Comments of Emerson Electric Co., at 5 .

(n292)Footnote 136. Comments of Susan P. Koniak *et al.*, at 11 ; Comments of Richard W. Painter, at 5 ; Comments of Thomas D. Morgan, at 12 .

(n293)Footnote 137. Estimate of outside counsel rate was obtained by contacting a number of law firms regularly involved in completing Commission documents. *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8138 (Oct. 22, 2002) and 33-8177 at n.69 (Jan. 23, 2003).

(n294)Footnote 138. Estimate of inside counsel rate is derived from the Securities Industry Association "Report on Management & Professional Earnings in the Securities Industry 2002," and represents the SIA value for an Assistant General Counsel in New York City.

(n295)Footnote 139. Comments of Chubb Specialty Insurance, at 2-3 ; Comments of the American Bar Association, at 26-7 ; Comments of Attorneys' Liability Assurance Society, Inc., at 8, 11.

(n296)Footnote 140. Comments of Chubb Specialty Insurance, at 5 .

(n297)Footnote 141. Comments of Carter, Ledyard & Milburn, at 2 .

(n298)Footnote 142. Comments of Committee on Investment Management Regulation, Association of the Bar of the City of New York, at 4 ; Comments of the American Corporate Counsel Association, at 4-5 ; Comments of Investment Company Institute, at 4 ; Comments of Debra M. Brown, at 2 .

(n299)Footnote 143. *See, e.g.*, Comments of the American Bar Association, at 26 .

(n300)Footnote 144. *See, e.g.*, Comments of Susan P. Koniak *et al.*, at 24 .

(n301)Footnote 145. Comments of Los Angeles County Bar Association, at 7-8 .

(n302)Footnote 146. *17 CFR 270.0-10.*

(n303)Footnote 147. *13 CFR 121.201.*

(n304)Footnote 148. *15 U.S.C. 7202, 7245, 7262.*

(n305)Footnote 149. *15 U.S.C. 77s.*

(n306)Footnote 150. *15 U.S.C. 78c(b), 78d-3, 78m, 78w.*

(n307)Footnote 151. *15 U.S.C. 80a-37, 80a-38.*

(n308)Footnote 152. *15 U.S.C. 80b-11.*



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§ 523. Exceptions to discharge.



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APPENDIX D Selected Provisions from Title 11, BANKRUPTCY CODE

2-D Securities Enforcement: Counseling and Defense § 523

§ 523 Exceptions to discharge.

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title [*11 USCS § 727, 1141, 1228(a), 1228(b), or 1328(b)*] does not discharge an individual debtor from any debt--

(1) for a tax or a customs duty--

(A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title [*11 USCS § 507(a)(2) or 507(a)(8)*], whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, or equivalent report or notice, if required--

(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained, by--

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing--

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive; or

(C)

(i) for purposes of subparagraph (A)--

(I) consumer debts owed to a single creditor and aggregating more than \$ 600 for luxury goods or services incurred by an individual debtor on or within 90 days before the order for relief under this title are presumed to be nondischargeable; and

(II) cash advances aggregating more than \$ 875 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 70 days before the order for relief under this title, are presumed to be nondischargeable; and

(ii) for purposes of this subparagraph--

(I) the terms "consumer", "credit", and "open end credit plan" have the same meanings as in section 103 of the Truth in Lending Act [15 USCS § 1602]; and

(II) the term "luxury goods or services" does not include goods or services reasonably necessary for the support or maintenance of the debtor or a dependent of the debtor.

(3) neither listed nor scheduled under section 521(1) of this title [11 USCS § 521(1)], with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit--

(A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or

(B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

(5) for a domestic support obligation;

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty--

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition;

(8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents, for--

(A)

(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or

(ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or

(B) any other educational loan that is a qualified education loan, as defined in *section 221(d)(1) of the Internal Revenue Code of 1986* [26 USCS § 221(d)(1)], incurred by a debtor who is an individual;

(9) for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance;

(10) that was or could have been listed or scheduled by the debtor in a prior case concerning the debtor under this title or under the Bankruptcy Act in which the debtor waived discharge, or was denied a discharge under section 727(a)(2), (3), (4), (5), (6), or (7) of this title [11 USCS § 727(a)(2), (3), (4), (5), (6), or (7)], or under section 14c(1), (2), (3), (4), (6), or (7) of such Act;

(11) provided in any final judgment, unreviewable order, or consent order or decree entered in any court of the United States or of any State, issued by a Federal depository institutions regulatory agency, or contained in any settlement agreement entered into by the debtor, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union;

(12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution, except that this paragraph shall not extend any such commitment which would otherwise be terminated due to any act of such agency; or

(13) for any payment of an order of restitution issued under title 18, United States Code;

(14) incurred to pay a tax to the United States that would be nondischargeable pursuant to paragraph (1);

(14A) incurred to pay a tax to a governmental unit, other than the United States, that would be nondischargeable under paragraph (1);

(14B) incurred to pay fines or penalties imposed under Federal election law;

(15) to a spouse, former spouse, or child of the debtor and not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, or a determination made in accordance with State or territorial law by a governmental unit;

(16) for a fee or assessment that becomes due and payable after the order for relief to a membership association with respect to the debtor's interest in a unit that has condominium ownership, in a share of a cooperative corporation, or a lot in a homeowners association, for as long as the debtor or the trustee has a legal, equitable, or possessory ownership interest in such unit, such corporation, or such lot, but nothing in this paragraph shall except from discharge the debt of a debtor for a membership association fee or assessment for a period arising before entry of the order for relief in a pending or subsequent bankruptcy case;

(17) for a fee imposed on a prisoner by any court for the filing of a case, motion, complaint, or appeal, or for other costs and expenses assessed with respect to such filing, regardless of an assertion of poverty by the debtor under subsection (b) or (f)(2) of section 1915 of title 28 [28 USCS § 1915] (or a similar non Federal law), or the debtor's status as a prisoner, as defined in section 1915(h) of title 28 [28 USCS § 1915(h)] (or a similar non Federal law);

(18) owed to a pension, profit sharing, stock bonus, or other plan established under *section 401, 403, 408, 408A, 414, 457, or 501(c) of the Internal Revenue Code of 1986* [26 USCS § 401, 403, 408, 408A, 414, 457, or 501(c)], under--

(A) a loan permitted under section 408(b)(1) of the Employee Retirement Income Security Act of 1974 [29 USCS § 1108(b)(1)], or subject to *section 72(p) of the Internal Revenue Code of 1986* [26 USCS § 72(p)]; or

(B) a loan from a thrift savings plan permitted under subchapter III of chapter 84 of title 5 [5 USCS §§ 8431 *et seq.*], that satisfies the requirements of section 8433(g) of such title [5 USCS § 8433(g)]; but nothing in this paragraph may be construed to provide that any loan made under a governmental plan under section 414(d) [26 USCS § 414(d)], or a contract or account under section 403(b) [26 USCS § 403(b)], of the Internal Revenue Code of 1986 constitutes a

claim or a debt under this title; or

(19) that--

(A) is for--

(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934 [15 USCS § 78c(a)(47)]), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or

(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and

(B) results, before, on, or after the date on which the petition was filed, from--

(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;

(ii) any settlement agreement entered into by the debtor; or

(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

For purposes of this subsection, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to *section 6020(a) of the Internal Revenue Code of 1986* [26 USCS § 6020(a)], or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to *section 6020(b) of the Internal Revenue Code of 1986* [26 USCS § 6020(b)], or a similar State or local law.

(b) Notwithstanding subsection (a) of this section, a debt that was excepted from discharge under subsection (a)(1), (a)(3), or (a)(8) of this section, under section 17a(1), 17a(3), or 17a(5) of the Bankruptcy Act, under section 439A of the Higher Education Act of 1965, or under section 733(g) of the Public Health Service Act in a prior case concerning the debtor under this title or under the Bankruptcy Act, is dischargeable in a case under this title unless, by the terms of subsection (a) of this section, such debt is not dischargeable in the case under this title.

(c)

(1) Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified in paragraph (2), (4), or (6) of subsection (a) of this section, unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (6), as the case may be, of subsection (a) of this section.

(2) Paragraph (1) shall not apply in the case of a Federal depository institutions regulatory agency seeking, in its capacity as conservator, receiver, or liquidating agent for an insured depository institution, to recover a debt described in subsection (a)(2), (a)(4), (a)(6), or (a)(11) owed to such institution by an institution affiliated party unless the receiver, conservator, or liquidating agent was appointed in time to reasonably comply, or for a Federal depository institutions regulatory agency acting in its corporate capacity as a successor to such receiver, conservator, or liquidating agent to reasonably comply, with subsection (a)(3)(B) as a creditor of such institution affiliated party with respect to such debt.

(d) If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

(e) Any institution affiliated party of an insured depository institution shall be considered to be acting in a fiduciary capacity with respect to the purposes of subsection (a)(4) or (11).



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2-E Securities Enforcement: Counseling and Defense § 371

§ 371 Conspiracy to commit offense or to defraud United States

If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.

If, however, the offense, the commission of which is the object of the conspiracy, is a misdemeanor only, the punishment for such conspiracy shall not exceed the maximum punishment provided for such misdemeanor.



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2-E Securities Enforcement: Counseling and Defense § 1001

§ 1001 Statements or entries generally

(a) Except as otherwise provided in this section, whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully--

(1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact;

(2) makes any materially false, fictitious, or fraudulent statement or representation; or

(3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry;

shall be fined under this title, imprisoned not more than 5 years or, if the offense involves international or domestic terrorism (as defined in section 2331 [18 USCS § 2331]), imprisoned not more than 8 years, or both. If the matter relates to an offense under chapter 109A, 109B, 110, or 117, or section 1591 [18 USCS §§ 2241 *et seq.*, 2250, 2251 *et seq.*, 2421 *et seq.*, or 1591], then the term of imprisonment imposed under this section shall be not more than 8 years.

(b) Subsection (a) does not apply to a party to a judicial proceeding, or that party's counsel, for statements, representations, writings or documents submitted by such party or counsel to a judge or magistrate in that proceeding.

(c) With respect to any matter within the jurisdiction of the legislative branch, subsection (a) shall apply only to--

(1) administrative matters, including a claim for payment, a matter related to the procurement of property or services, personnel or employment practices, or support services, or a document required by law, rule, or regulation to be submitted to the Congress or any office or officer within the legislative branch; or

(2) any investigation or review, conducted pursuant to the authority of any committee, subcommittee, commission or office of the Congress, consistent with applicable rules of the House or Senate.



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2-E Securities Enforcement: Counseling and Defense § 1341

§ 1341 Frauds and swindles

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation occurs in relation to, or involving any benefit authorized, transported, transmitted, transferred, disbursed, or paid in connection with, a presidentially declared major disaster or emergency (as those terms are defined in section 102 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (42 U.S.C. 5122)), or affects a financial institution, such person shall be fined not more than \$1,000,000 or imprisoned not more than 30 years, or both.



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2-E Securities Enforcement: Counseling and Defense § 1343

§ 1343 Fraud by wire, radio, or television

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation occurs in relation to, or involving any benefit authorized, transported, transmitted, transferred, disbursed, or paid in connection with, a presidentially declared major disaster or emergency (as those terms are defined in section 102 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (*42 U.S.C. 5122*)), or affects a financial institution, such person shall be fined not more than \$1,000,000 or imprisoned not more than 30 years, or both.



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2-E Securities Enforcement: Counseling and Defense § 1348

§ 1348 Securities and commodities fraud.

Whoever knowingly executes, or attempts to execute, a scheme or artifice--

(1) to defraud any person in connection with any commodity for future delivery, or any option on a commodity for future delivery, or any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (*15 U.S.C. 78l*) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (*15 U.S.C. 78o(d)*); or

(2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any commodity for future delivery, or any option on a commodity for future delivery, or any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (*15 U.S.C. 78l*) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (*15 U.S.C. 78o(d)*);

shall be fined under this title, or imprisoned not more than 25 years, or both.



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2-E Securities Enforcement: Counseling and Defense § 1349

§ 1349 Attempt and conspiracy

Any person who attempts or conspires to commit any offense under this chapter [*18 USCS §§ 1341 et seq.*] shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.



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2-E Securities Enforcement: Counseling and Defense § 1505

§ 1505 Obstruction of proceedings before departments, agencies, and committees

Whoever, with intent to avoid, evade, prevent, or obstruct compliance, in whole or in part, with any civil investigative demand duly and properly made under the Antitrust Civil Process Act [*15 USCS §§ 1311 et seq.*], willfully withholds, misrepresents, removes from any place, conceals, covers up, destroys, mutilates, alters, or by other means falsifies any documentary material, answers to written interrogatories, or oral testimony, which is the subject of such demand; or attempts to do so or solicits another to do so; or

Whoever corruptly, or by threats or force, or by any threatening letter or communication influences, obstructs, or impedes or endeavors to influence, obstruct, or impede the due and proper administration of the law under which any pending proceeding is being had before any department or agency of the United States, or the due and proper exercise of the power of inquiry under which any inquiry or investigation is being had by either House, or any committee of either House or any joint committee of the Congress--

Shall be fined under this title, imprisoned not more than 5 years or, if the offense involves international or domestic terrorism (as defined in section 2331 [*18 USCS § 2331*]), imprisoned not more than 8 years, or both.



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2-E Securities Enforcement: Counseling and Defense § 1513

§ 1513 Retaliating against a witness, victim, or an informant

(a)

(1) Whoever kills or attempts to kill another person with intent to retaliate against any person for--

(A) the attendance of a witness or party at an official proceeding, or any testimony given or any record, document, or other object produced by a witness in an official proceeding; or

(B) providing to a law enforcement officer any information relating to the commission or possible commission of a Federal offense or a violation of conditions of probation, supervised release, parole, or release pending judicial proceedings,

shall be punished as provided in paragraph (2).

(2) The punishment for an offense under this subsection is--

(A) in the case of a killing, the punishment provided in sections 1111 and 1112 [*18 USCS §§ 1111 and 1112*]; and

(B) in the case of an attempt, imprisonment for not more than 30 years.

(b) Whoever knowingly engages in any conduct and thereby causes bodily injury to another person or damages the

tangible property of another person, or threatens to do so, with intent to retaliate against any person for--

(1) the attendance of a witness or party at an official proceeding, or any testimony given or any record, document, or other object produced by a witness in an official proceeding; or

(2) any information relating to the commission or possible commission of a Federal offense or a violation of conditions of probation, supervised release, parole, or release pending judicial proceedings given by a person to a law enforcement officer;

or attempts to do so, shall be fined under this title or imprisoned not more than 20 years, or both.

(c) If the retaliation occurred because of attendance at or testimony in a criminal case, the maximum term of imprisonment which may be imposed for the offense under this section shall be the higher of that otherwise provided by law or the maximum term that could have been imposed for any offense charged in such case.

(d) There is extraterritorial Federal jurisdiction over an offense under this section.

(e) Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.

(f) Whoever conspires to commit any offense under this section shall be subject to the same penalties as those prescribed for the offense the commission of which was the object of the conspiracy.

(g) A prosecution under this section may be brought in the district in which the official proceeding (whether pending, about to be instituted, or completed) was intended to be affected, or in which the conduct constituting the alleged offense occurred.



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2-E Securities Enforcement: Counseling and Defense § 1519

§ 1519 Destruction, alteration, or falsification of records in Federal investigations and bankruptcy

Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.



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2-E Securities Enforcement: Counseling and Defense § 1520

§ 1520 Destruction of corporate audit records

(a)

(1) Any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1(a)*) applies, shall maintain all audit or review workpapers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded.

(2) The Securities and Exchange Commission shall promulgate, within 180 days, after adequate notice and an opportunity for comment, such rules and regulations, as are reasonably necessary, relating to the retention of relevant records such as workpapers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review, which is conducted by any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (*15 U.S.C. 78j-1(a)*) applies. The Commission may, from time to time, amend or supplement the rules and regulations that it is required to promulgate under this section, after adequate notice and an opportunity for comment, in order to ensure that such rules and regulations adequately comport with the purposes of this section.

(b) Whoever knowingly and willfully violates subsection (a)(1), or any rule or regulation promulgated by the Securities and Exchange Commission under subsection (a)(2), shall be fined under this title, imprisoned not more than 10 years, or both.

(c) Nothing in this section shall be deemed to diminish or relieve any person of any other duty or obligation imposed by Federal or State law or regulation to maintain, or refrain from destroying, any document.



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2-E Securities Enforcement: Counseling and Defense § 1621

§ 1621 Perjury generally

Whoever--

(1) having taken an oath before a competent tribunal, officer, or person, in any case in which a law of the United States authorizes an oath to be administered, that he will testify, declare, depose, or certify truly, or that any written testimony, declaration, deposition, or certificate by him subscribed, is true, willfully and contrary to such oath states or subscribes any material matter which he does not believe to be true; or

(2) in any declaration, certificate, verification, or statement under penalty of perjury as permitted under *section 1746 of title 28, United States Code*, willfully subscribes as true any material matter which he does not believe to be true; is guilty of perjury and shall, except as otherwise expressly provided by law, be fined under this title or imprisoned not more than five years, or both. This section is applicable whether the statement or subscription is made within or without the United States.



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2-E Securities Enforcement: Counseling and Defense § 1623

§ 1623 False declarations before grand jury or court

(a) Whoever under oath (or in any declaration, certificate, verification, or statement under penalty of perjury as permitted under *section 1746 of title 28, United States Code*) in any proceeding before or ancillary to any court or grand jury of the United States knowingly makes any false material declaration or makes or uses any other information, including any book, paper, document, record, recording, or other material, knowing the same to contain any false material declaration, shall be fined under this title or imprisoned not more than five years, or both.

(b) This section is applicable whether the conduct occurred within or without the United States.

(c) An indictment or information for violation of this section alleging that, in any proceedings before or ancillary to any court or grand jury of the United States, the defendant under oath has knowingly made two or more declarations, which are inconsistent to the degree that one of them is necessarily false, need not specify which declaration is false if--

(1) each declaration was material to the point in question, and

(2) each declaration was made within the period of the statute of limitations for the offense charged under this section. In any prosecution under this section, the falsity of a declaration set forth in the indictment or information shall be established sufficient for conviction by proof that the defendant while under oath made irreconcilably contradictory declarations material to the point in question in any proceeding before or ancillary to any court or grand jury. It shall be a defense to an indictment or information made pursuant to the first sentence of this subsection that the defendant at the time he made each declaration believed the declaration was true.

(d) Where, in the same continuous court or grand jury proceeding in which a declaration is made, the person making the declaration admits such declaration to be false, such admission shall bar prosecution under this section if, at the time the admission is made, the declaration has not substantially affected the proceeding, or it has not become manifest that such falsity has been or will be exposed.

(e) Proof beyond a reasonable doubt under this section is sufficient for conviction. It shall not be necessary that such proof be made by any particular number of witnesses or by documentary or other type of evidence.



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2-E Securities Enforcement: Counseling and Defense § 1956

§ 1956 Laundering of monetary instruments

(a)

(1) Whoever, knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity, conducts or attempts to conduct such a financial transaction which in fact involves the proceeds of specified unlawful activity--

(A)

(i) with the intent to promote the carrying on of specified unlawful activity; or

(ii) with intent to engage in conduct constituting a violation of *section 7201 or 7206 of the Internal Revenue Code of 1986* [26 USCS § 7201 or 7206]; or

(B) knowing that the transaction is designed in whole or in part--

(i) to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity; or

(ii) to avoid a transaction reporting requirement under State or Federal law,

shall be sentenced to a fine of not more than \$500,000 or twice the value of the property involved in the transaction,

whichever is greater, or imprisonment for not more than twenty years, or both. For purposes of this paragraph, a financial transaction shall be considered to be one involving the proceeds of specified unlawful activity if it is part of a set of parallel or dependent transactions, any one of which involves the proceeds of specified unlawful activity, and all of which are part of a single plan or arrangement.

(2) Whoever transports, transmits, or transfers, or attempts to transport, transmit, or transfer a monetary instrument or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside the United States--

(A) with the intent to promote the carrying on of specified unlawful activity; or

(B) knowing that the monetary instrument or funds involved in the transportation represent the proceeds of some form of unlawful activity and knowing that such transportation, transmission, or transfer is designed in whole or in part--

(i) to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity; or

(ii) to avoid a transaction reporting requirement under State or Federal law,

shall be sentenced to a fine of not more than \$500,000 or twice the value of the monetary instrument or funds involved in the transportation, transmission, or transfer, whichever is greater, or imprisonment for not more than twenty years, or both. For the purpose of the offense described in subparagraph (B), the defendant's knowledge may be established by proof that a law enforcement officer represented the matter specified in subparagraph (B) as true, and the defendant's subsequent statements or actions indicate that the defendant believed such representations to be true.

(3) Whoever, with the intent--

(A) to promote the carrying on of specified unlawful activity;

(B) to conceal or disguise the nature, location, source, ownership, or control of property believed to be the proceeds of specified unlawful activity; or

(C) to avoid a transaction reporting requirement under State or Federal law,

conducts or attempts to conduct a financial transaction involving property represented to be the proceeds of specified unlawful activity, or property used to conduct or facilitate specified unlawful activity, shall be fined under this title or imprisoned for not more than 20 years, or both. For purposes of this paragraph and paragraph (2), the term "represented" means any representation made by a law enforcement officer or by another person at the direction of, or with the approval of, a Federal official authorized to investigate or prosecute violations of this section.

(b) Penalties.

(1) In general. Whoever conducts or attempts to conduct a transaction described in subsection (a)(1) or (a)(3), or section 1957 [18 USCS § 1957], or a transportation, transmission, or transfer described in subsection (a)(2), is liable to the United States for a civil penalty of not more than the greater of--

(A) the foreign person commits an offense under subsection (a) involving a financial transaction that occurs in whole or in part in the United States;

(B) \$10,000.

(2) Jurisdiction over foreign persons. For purposes of adjudicating an action filed or enforcing a penalty ordered under this section, the district courts shall have jurisdiction over any foreign person, including any financial institution authorized under the laws of a foreign country, against whom the action is brought, if service of process upon the foreign person is made under the Federal Rules of Civil Procedure or the laws of the country in which the foreign person is found, and--

(A) the foreign person commits an offense under subsection (a) involving a financial transaction that occurs in whole or in part in the United States;

(B) the foreign person converts, to his or her own use, property in which the United States has an ownership interest by virtue of the entry of an order of forfeiture by a court of the United States; or

(C) the foreign person is a financial institution that maintains a bank account at a financial institution in the United States.

(3) Court authority over assets. A court may issue a pretrial restraining order or take any other action necessary to ensure that any bank account or other property held by the defendant in the United States is available to satisfy a

judgment under this section.

(4) Federal receiver.

(A) In general. A court may appoint a Federal Receiver, in accordance with subparagraph (B) of this paragraph, to collect, marshal, and take custody, control, and possession of all assets of the defendant, wherever located, to satisfy a civil judgment under this subsection, a forfeiture judgment under section 981 or 982 [*18 USCS § 981 or 982*], or a criminal sentence under section 1957 [*18 USCS § 1957*] or subsection (a) of this section, including an order of restitution to any victim of a specified unlawful activity.

(B) Appointment and authority. A Federal Receiver described in subparagraph (A)--

(i) may be appointed upon application of a Federal prosecutor or a Federal or State regulator, by the court having jurisdiction over the defendant in the case;

(ii) shall be an officer of the court, and the powers of the Federal Receiver shall include the powers set out in *section 754 of title 28, United States Code*; and

(iii) shall have standing equivalent to that of a Federal prosecutor for the purpose of submitting requests to obtain information regarding the assets of the defendant--

(I) from the Financial Crimes Enforcement Network of the Department of the Treasury; or

(II) from a foreign country pursuant to a mutual legal assistance treaty, multilateral agreement, or other arrangement for international law enforcement assistance, provided that such requests are in accordance with the policies and procedures of the Attorney General.

(c) As used in this section--

(1) the term "knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity" means that the person knew the property involved in the transaction represented proceeds from some form, though not necessarily which form, of activity that constitutes a felony under State, Federal, or foreign law,

regardless of whether or not such activity is specified in paragraph (7);

(2) the term "conducts" includes initiating, concluding, or participating in initiating, or concluding a transaction;

(3) the term "transaction" includes a purchase, sale, loan, pledge, gift, transfer, delivery, or other disposition, and with respect to a financial institution includes a deposit, withdrawal, transfer between accounts, exchange of currency, loan, extension of credit, purchase or sale of any stock, bond, certificate of deposit, or other monetary instrument, use of a safe deposit box, or any other payment, transfer, or delivery by, through, or to a financial institution, by whatever means effected;

(4) the term "financial transaction" means (A) a transaction which in any way or degree affects interstate or foreign commerce (i) involving the movement of funds by wire or other means or (ii) involving one or more monetary instruments, or (iii) involving the transfer of title to any real property, vehicle, vessel, or aircraft, or (B) a transaction involving the use of a financial institution which is engaged in, or the activities of which affect, interstate or foreign commerce in any way or degree;

(5) the term "monetary instruments" means (i) coin or currency of the United States or of any other country, travelers' checks, personal checks, bank checks, and money orders, or (ii) investment securities or negotiable instruments, in bearer form or otherwise in such form that title thereto passes upon delivery;

(6) the term "financial institution" includes--

(A) any financial institution, as defined in *section 5312(a)(2) of title 31, United States Code*, or the regulations promulgated thereunder; and

(B) any foreign bank, as defined in section 1 of the International Banking Act of 1978 (*12 U.S.C. 3101*);

(7) the term "specified unlawful activity" means--

(A) any act or activity constituting an offense listed in section 1961(1) of this title except an act which is indictable under subchapter II of chapter 53 of title 31 [*31 USCS §§ 5311 et seq.*];

(B) with respect to a financial transaction occurring in whole or in part in the United States, an offense against a foreign nation involving--

(i) the manufacture, importation, sale, or distribution of a controlled substance (as such term is defined for the purposes of the Controlled Substances Act);

(ii) murder, kidnapping, robbery, extortion, destruction of property by means of explosive or fire, or a crime of violence (as defined in section 16 [18 USCS § 16]);

(iii) fraud, or any scheme or attempt to defraud, by or against a foreign bank (as defined in paragraph 7 of section 1(b) of the International Banking Act of 1978 [12 USCS § 3101(7)][]);

(iv) bribery of a public official, or the misappropriation, theft, or embezzlement of public funds by or for the benefit of a public official;

(v) smuggling or export control violations involving--

(I) an item controlled on the United States Munitions List established under section 38 of the Arms Export Control Act (22 U.S.C. 2778); or

(II) an item controlled under regulations under the Export Administration Regulations (15 C.F.R. Parts 730 774);

(vi) an offense with respect to which the United States would be obligated by a multilateral treaty, either to extradite the alleged offender or to submit the case for prosecution, if the offender were found within the territory of the United States; or

(vii) trafficking in persons, selling or buying of children, sexual exploitation of children, or transporting, recruiting or harboring a person, including a child, for commercial sex acts;

(C) any act or acts constituting a continuing criminal enterprise, as that term is defined in section 408 of the Controlled Substances Act (21 U.S.C. 848);

(D) an offense under section 32 [18 USCS § 32] (relating to the destruction of aircraft), section 37 [18 USCS § 37] (relating to violence at international airports), section 115 [18 USCS § 115] (relating to influencing, impeding, or retaliating against a Federal official by threatening or injuring a family member), section 152 [18 USCS § 152] (relating to concealment of assets; false oaths and claims; bribery), section 175c [18 USCS § 175c] (relating to the variola virus), section 215 [18 USCS § 215] (relating to commissions or gifts for procuring loans), section 351 [18 USCS § 351] (relating to congressional or Cabinet officer assassination), any of sections 500 through 503 [18 USCS §§ 500 through 503] (relating to certain counterfeiting offenses), section 513 [18 USCS § 513] (relating to securities of States and private entities), section 541 [18 USCS § 541] (relating to goods falsely classified), section 542 [18 USCS § 542] (relating to entry of goods by means of false statements), section 545 [18 USCS § 545] (relating to smuggling goods into the United States), section 549 [18 USCS § 549] (relating to removing goods from Customs custody), section 554 [18 USCS § 554] (relating to smuggling goods from the United States), section 641 [18 USCS § 641] (relating to public money, property, or records), section 656 [18 USCS § 656] (relating to theft, embezzlement, or misapplication by bank officer or employee), section 657 [18 USCS § 657] (relating to lending, credit, and insurance institutions), section 658 [18 USCS § 658] (relating to property mortgaged or pledged to farm credit agencies), section 666 [18 USCS § 666] (relating to theft or bribery concerning programs receiving Federal funds), section 793, 794, or 798 [18 USCS § 793, 794, or 798] (relating to espionage), section 831 [18 USCS § 831] (relating to prohibited transactions involving nuclear materials), section 844 (f) or (i) [18 USCS § 844(f) or (i)] (relating to destruction by explosives or fire of Government property or property affecting interstate or foreign commerce), section 875 [18 USCS § 875] (relating to interstate communications), section 922(1) [18 USCS § 922(1)] (relating to the unlawful importation of firearms), section 924(n) [18 USCS § 924(n)] (relating to firearms trafficking), section 956 [18 USCS § 956] (relating to conspiracy to kill, kidnap, maim, or injure certain property in a foreign country), section 1005 [18 USCS § 1005] (relating to fraudulent bank entries), 1006 [18 USCS § 1006] (relating to fraudulent Federal credit institution entries), 1007 [18 USCS § 1007] (relating to Federal Deposit Insurance transactions), 1014 [18 USCS § 1014] (relating to fraudulent loan or credit applications), section 1030 [18 USCS § 1030] (relating to computer fraud and abuse), 1032 [18 USCS § 1032] (relating to concealment of assets from conservator, receiver, or liquidating agent of financial institution), section 1111 (relating to murder), section 1114 [18 USCS § 1114] (relating to murder of United States law enforcement officials), section 1116 [18 USCS § 1116] (relating to murder of foreign officials, official guests, or internationally protected persons), section 1201 [18 USCS § 1201] (relating to kidnaping), section 1203 [18 USCS § 1202] (relating to hostage taking), section 1361 [18 USCS § 1361] (relating to willful injury of Government property), section 1363 [18 USCS § 1363] (relating to destruction of property within the special maritime and territorial jurisdiction), section 1708 [18 USCS § 1708] (theft from the mail), section 1751 [18 USCS § 1751] (relating to Presidential assassination), section 2113 or 2114 [18 USCS § 2113 or 2114] (relating to bank and postal robbery and theft), section 2252A [18 USCS § 2252A] (relating to child pornography) where the child pornography contains a visual depiction of an actual minor engaging in sexually explicit conduct, section 2260 [18 USCS § 2260] (production of certain child pornography for importation into the United States), section 2280 [18 USCS § 2280] (relating to violence against maritime navigation), section 2281 [18 USCS § 2281] (relating to violence against maritime fixed platforms), section 2319 [18 USCS § 2319] (relating to copyright infringement), section 2320 [18 USCS § 2320] (relating to trafficking in counterfeit goods and services), section 2332 [18 USCS § 2332] (relating to terrorist acts abroad against United States nationals), section 2332a [18 USCS § 2332a] (relating to use of weapons of mass destruction), section 2332b [18 USCS § 2332b] (relating to international terrorist acts transcending national boundaries), section 2332g (relating to missile systems designed to destroy aircraft), section 2332h (relating to radiological dispersal devices), section 2339A or 2339B [18 USCS § 2339A or 2339B] (relating to providing material support to terrorists), section 2339C [18 USCS § 2339C] (relating to financing of terrorism), or section 2339D [18 USCS § 2339D] (relating to receiving military type training from a foreign terrorist organization) of this title, section 46502 of title 49, United States Code, a felony violation of the Chemical Diversion and Trafficking Act of 1988 (relating to precursor and essential chemicals), section 590 of the Tariff Act of 1930 (19 U.S.C. 1590) (relating to aviation smuggling), section 422 of the Controlled Substances Act [21 USCS § 863] (relating to transportation of drug paraphernalia), section 38(c) (relating to criminal violations) of the Arms Export Control Act [22 USCS § 2778(c)], section 11 (relating to violations) of the Export Administration Act of 1979 [50 USCS Appx. §

2410], section 206 (relating to penalties) of the International Emergency Economic Powers Act [50 USCS § 1705], section 16 (relating to offenses and punishment) of the Trading with the Enemy Act [50 USCS Appx § 16], any felony violation of section 15 of the Food and Nutrition Act of 2008 [7 USCS § 2024] (relating to supplemental nutrition assistance program benefits fraud) involving a quantity of benefits having a value of not less than \$ 5,000, any violation of section 543(a)(1) of the Housing Act of 1949 [42 USCS § 1490s(a)(1)] (relating to equity skimming), any felony violation of the Foreign Agents Registration Act of 1938 [22 USCS §§ 611 *et seq.*], any felony violation of the Foreign Corrupt Practices Act, or section 92 of the Atomic Energy Act of 1954 (42 U.S.C. 2122) (relating to prohibitions governing atomic weapons)[;]

(E) Environmental Crimes. a felony violation of the Federal Water Pollution Control Act (33 U.S.C. 1251 *et seq.*), the Ocean Dumping Act (33 U.S.C. 1401 *et seq.*), the Act to Prevent Pollution from Ships (33 U.S.C. 1901 *et seq.*), the Safe Drinking Water Act (42 U.S.C. 300f *et seq.*), or the Resources Conservation and Recovery Act (42 U.S.C. 6901 *et seq.*); or

(F) any act or activity constituting an offense involving a Federal health care offense;

(8) the term "State" includes a State of the United States, the District of Columbia, and any commonwealth, territory, or possession of the United States; and

(9) the term "proceeds" means any property derived from or obtained or retained, directly or indirectly, through some form of unlawful activity, including the gross receipts of such activity.

(d) Nothing in this section shall supersede any provision of Federal, State, or other law imposing criminal penalties or affording civil remedies in addition to those provided for in this section.

(e) Violations of this section may be investigated by such components of the Department of Justice as the Attorney General may direct, and by such components of the Department of the Treasury as the Secretary of the Treasury may direct, as appropriate, and, with respect to offenses over which the Department of Homeland Security has jurisdiction, by such components of the Department of Homeland Security as the Secretary of Homeland Security may direct, and, with respect to offenses over which the United States Postal Service has jurisdiction, by the Postal Service. Such authority of the Secretary of the Treasury, the Secretary of Homeland Security, and the Postal Service shall be exercised in accordance with an agreement which shall be entered into by the Secretary of the Treasury, the Secretary of Homeland Security, the Postal Service, and the Attorney General. Violations of this section involving offenses described in paragraph (c)(7)(E) may be investigated by such components of the Department of Justice as the Attorney General may direct, and the National Enforcement Investigations Center of the Environmental Protection Agency.

(f) There is extraterritorial jurisdiction over the conduct prohibited by this section if--

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(1) the conduct is by a United States citizen or, in the case of a non United States citizen, the conduct occurs in part in the United States; and

(2) the transaction or series of related transactions involves funds or monetary instruments of a value exceeding \$10,000.

(g) Notice of conviction of financial institutions. If any financial institution or any officer, director, or employee of any financial institution has been found guilty of an offense under this section, section 1957 or 1960 of this title [18 USCS § 1957 or 1960], or section 5322 or 5324 of title 31, the Attorney General shall provide written notice of such fact to the appropriate regulatory agency for the financial institution.

(h) Any person who conspires to commit any offense defined in this section or section 1957 [18 USCS § 1957] shall be subject to the same penalties as those prescribed for the offense the commission of which was the object of the conspiracy.

(i) Venue.

(1) Except as provided in paragraph (2), a prosecution for an offense under this section or section 1957 [18 USCS § 1957] may be brought in--

(A) any district in which the financial or monetary transaction is conducted; or

(B) any district where a prosecution for the underlying specified unlawful activity could be brought, if the defendant participated in the transfer of the proceeds of the specified unlawful activity from that district to the district where the financial or monetary transaction is conducted.

(2) A prosecution for an attempt or conspiracy offense under this section or section 1957 [18 USCS § 1957] may be brought in the district where venue would lie for the completed offense under paragraph (1), or in any other district where an act in furtherance of the attempt or conspiracy took place.

(3) For purposes of this section, a transfer of funds from 1 place to another, by wire or any other means, shall constitute a single, continuing transaction. Any person who conducts (as that term is defined in subsection (c)(2)) any

portion of the transaction may be charged in any district in which the transaction takes place.



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§ 1957 Engaging in monetary transactions in property derived from specified unlawful activity

(a) Whoever, in any of the circumstances set forth in subsection (d), knowingly engages or attempts to engage in a monetary transaction in criminally derived property that is of a value greater than \$ 10,000 and is derived from specified unlawful activity, shall be punished as provided in subsection (b).

(b)

(1) Except as provided in paragraph (2), the punishment for an offense under this section is a fine under title 18, United States Code, or imprisonment for not more than ten years or both.

(2) The court may impose an alternate fine to that imposable under paragraph (1) of not more than twice the amount of the criminally derived property involved in the transaction.

(c) In a prosecution for an offense under this section, the Government is not required to prove the defendant knew that the offense from which the criminally derived property was derived was specified unlawful activity.

(d) The circumstances referred to in subsection (a) are--

(1) that the offense under this section takes place in the United States or in the special maritime and territorial jurisdiction of the United States; or

(2) that the offense under this section takes place outside the United States and such special jurisdiction, but the defendant is a United States person (as defined in section 3077 of this title [18 USCS § 3077], but excluding the class described in paragraph (2)(D) of such section).

(e) Violations of this section may be investigated by such components of the Department of Justice as the Attorney General may direct, and by such components of the Department of the Treasury as the Secretary of the Treasury may direct, as appropriate, and, with respect to offenses over which the Department of Homeland Security has jurisdiction, by such components of the Department of Homeland Security as the Secretary of Homeland Security may direct, and, with respect to offenses over which the United States Postal Service has jurisdiction, by the Postal Service. Such authority of the Secretary of the Treasury, the Secretary of Homeland Security, and the Postal Service shall be exercised in accordance with an agreement which shall be entered into by the Secretary of the Treasury, the Secretary of Homeland Security, the Postal Service, and the Attorney General.

(f) As used in this section--

(1) the term "monetary transaction" means the deposit, withdrawal, transfer, or exchange, in or affecting interstate or foreign commerce, of funds or a monetary instrument (as defined in section 1956(c)(5) of this title [18 USCS § 1956(c)(5)]) by, through, or to a financial institution (as defined in section 1956 of this title [18 USCS § 1956]), including any transaction that would be a financial transaction under section 1956(c)(4)(B) of this title [18 USCS § 1956(c)(4)(B)], but such term does not include any transaction necessary to preserve a person's right to representation as guaranteed by the *sixth amendment to the Constitution*;

(2) the term "criminally derived property" means any property constituting, or derived from, proceeds obtained from a criminal offense; and

(3) the terms "specified unlawful activity" and "proceeds" shall have the meaning given those terms in section 1956 of this title [18 USCS § 1956].



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§ 1961 Definitions

As used in this chapter [*18 USCS §§ 1961 et seq.*]--

(1) "racketeering activity" means (A) any act or threat involving murder, kidnaping, gambling, arson, robbery, bribery, extortion, dealing in obscene matter, or dealing in a controlled substance or listed chemical (as defined in section 102 of the Controlled Substances Act [*21 USCS § 802*]), which is chargeable under State law and punishable by imprisonment for more than one year; (B) any act which is indictable under any of the following provisions of title 18, *United States Code: Section 201* [*18 USCS § 201*] (relating to bribery), section 224 [*18 USCS § 224*] (relating to sports bribery), sections 471, 472, and 473 [*18 USCS §§ 471, 472, and 473*] (relating to counterfeiting), section 659 [*18 USCS § 659*] (relating to theft from interstate shipment) if the act indictable under section 659 [*18 USCS § 659*] is felonious, section 664 [*18 USCS § 664*] (relating to embezzlement from pension and welfare funds), sections 891- 894 [*18 USCS §§ 891 through 894*] (relating to extortionate credit transactions), section 1028 [*18 USCS § 1028*] (relating to fraud and related activity in connection with identification documents), section 1029 [*18 USCS § 1029*] (relating to fraud and related activity in connection with access devices), section 1084 [*18 USCS § 1084*] (relating to the transmission of gambling information), section 1341 [*18 USCS § 1341*] (relating to mail fraud), section 1343 [*18 USCS § 1343*] (relating to wire fraud), section 1344 [*18 USCS § 1344*] (relating to financial institution fraud), section 1425 [*18 USCS § 1425*] (relating to the procurement of citizenship or nationalization unlawfully), section 1426 [*18 USCS § 1426*] (relating to the reproduction of naturalization or citizenship papers), section 1427 [*18 USCS § 1427*] (relating to the sale of naturalization or citizenship papers), sections 1461- 1465 [*18 USCS §§ 1461 through 1465*] (relating to obscene matter), section 1503 [*18 USCS § 1503*] (relating to obstruction of justice [influencing or injuring officer or juror generally]), section 1510 [*18 USCS § 1510*] (relating to obstruction of criminal investigations), section 1511 [*18 USCS § 1511*] (relating to the obstruction of State or local law enforcement), section 1512 [*18 USCS § 1512*] (relating to tampering with a witness, victim, or an informant), section 1513 [*18 USCS § 1513*] (relating to retaliating against a witness, victim, or an informant), section 1542 [*18 USCS § 1542*] (relating to false statement in application and use of passport), section 1543 [*18 USCS § 1543*] (relating to forgery or false use of passport), section 1544 [*18 USCS § 1544*] (relating to misuse of passport), section 1546 [*18 USCS § 1546*] (relating to fraud and misuse of visas, permits, and other documents), sections 1581- 1592 [*18 USCS §§ 1581-1592*] (relating to peonage, slavery, and trafficking in persons)[.], section 1951 [*18 USCS § 1951*] (relating to interference with commerce, robbery, or extortion), section

1952 [18 USCS § 1952] (relating to racketeering), section 1953 [18 USCS § 1953] (relating to interstate transportation of wagering paraphernalia), section 1954 [18 USCS § 1954] (relating to unlawful welfare fund payments), section 1955 [18 USCS § 1955] (relating to the prohibition of illegal gambling businesses), section 1956 [18 USCS § 1956] (relating to the laundering of monetary instruments), section 1957 [18 USCS § 1957] (relating to engaging in monetary transactions in property derived from specified unlawful activity), section 1958 [18 USCS § 1958] (relating to use of interstate commerce facilities in the commission of murder-for-hire), section 1960 [18 USCS § 1960] (relating to illegal money transmitters), sections 2251, 2251A, 2252, and 2260 [18 USCS §§ 2251, 2251A, 2252, and 2260] (relating to sexual exploitation of children), sections 2312 and 2313 [18 USCS §§ 2312 and 2313] (relating to interstate transportation of stolen motor vehicles), sections 2314 and 2315 [18 USCS §§ 2314 and 2315] (relating to interstate transportation of stolen property), section 2318 [18 USCS § 2318] (relating to trafficking in counterfeit labels for phonorecords, computer programs or computer program documentation or packaging and copies of motion pictures or other audiovisual works), section 2319 [18 USCS § 2319] (relating to criminal infringement of a copyright), section 2319A [18 USCS § 2319A] (relating to unauthorized fixation of and trafficking in sound recordings and music videos of live musical performances), section 2320 [18 USCS § 2320] (relating to trafficking in goods or services bearing counterfeit marks), section 2321 [18 USCS § 2321] (relating to trafficking in certain motor vehicles or motor vehicle parts), sections 2341- 2346 [18 USCS §§ 2431 through 2346] (relating to trafficking in contraband cigarettes), sections 2421- 24 [18 USCS §§ 2421 through 24] (relating to white slave traffic), sections 175- 178 [18 USCS §§ 175-178] (relating to biological weapons), sections 229- 229F [18 USCS §§ 229-229F] (relating to chemical weapons), section 831 [18 USCS § 831] (relating to nuclear materials), (C) an act which is indictable under title 29, *United States Code, section 186* [18 USCS § 186] (dealing with restrictions on payments and loans to labor organizations) or section 501(c) [18 USCS § 501(c)] (relating to embezzlement from union funds), (D) any offense involving fraud connected with a case under title 11 (except a case under section 157 of this title [18 USCS § 157]), fraud in the sale of securities, or the felonious manufacture, importation, receiving, concealment, buying, selling, or otherwise dealing in a controlled substance or listed chemical (as defined in section 102 of the Controlled Substances Act [21 USCS § 802]), punishable under any law of the United States, (E) any act which is indictable under the Currency and Foreign Transactions Reporting Act, (F) any act which is indictable under the Immigration and Nationality Act, section 274 [8 USCS § 1324] (relating to bringing in and harboring certain aliens), section 277 [8 USCS § 1327] (relating to aiding or assisting certain aliens to enter the United States), or section 278 [8 USCS § 1328] (relating to importation of alien for immoral purpose) if the act indictable under such section of such Act was committed for the purpose of financial gain, or (G) any act that is indictable under any provision listed in section 2332b(g)(5)(B) [18 USCS § 2332b(g)(5)(B)];

(2) "State" means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, any political subdivision, or any department, agency, or instrumentality thereof;

(3) "person" includes any individual or entity capable of holding a legal or beneficial interest in property;

(4) "enterprise" includes any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity;

(5) "pattern of racketeering activity" requires at least two acts of racketeering activity, one of which occurred after the effective date of this chapter and the last of which occurred within ten years (excluding any period of imprisonment) after the commission of a prior act of racketeering activity;

(6) "unlawful debt" means a debt (A) incurred or contracted in gambling activity which was in violation of the law of the United States, a State or political subdivision thereof, or which is unenforceable under State or Federal law in whole or in part as to principal or interest because of the laws relating to usury, and (B) which was incurred in connection with the business of gambling in violation of the law of the United States, a State or political subdivision thereof, or the business of lending money or a thing of value at a rate usurious under State or Federal law, where the usurious rate is at least twice the enforceable rate;

(7) "racketeering investigator" means any attorney or investigator so designated by the Attorney General and charged with the duty of enforcing or carrying into effect this chapter [18 USCS §§ 1961 et seq.];

(8) "racketeering investigation" means any inquiry conducted by any racketeering investigator for the purpose of ascertaining whether any person has been involved in any violation of this chapter [18 USCS §§ 1961 et seq.] or of any final order, judgment, or decree of any court of the United States, duly entered in any case or proceeding arising under this chapter [18 USCS §§ 1961 et seq.];

(9) "documentary material" includes any book, paper, document, record, recording, or other material; and

(10) "Attorney General" includes the Attorney General of the United States, the Deputy Attorney General of the United States, the Associate Attorney General of the United States, any Assistant Attorney General of the United States, or any employee of the Department of Justice or any employee of any department or agency of the United States so designated by the Attorney General to carry out the powers conferred on the Attorney General by this chapter [18 USCS §§ 1961 et seq.]. Any department or agency so designated may use in investigations authorized by this chapter [18 USCS §§ 1961 et seq.] either the investigative provisions of this chapter [18 USCS §§ 1961 et seq.] or the investigative power of such department or agency otherwise conferred by law.



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2-E Securities Enforcement: Counseling and Defense § 1962

§ 1962 RICO Prohibited activities

(a) It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal within the meaning of *section 2, title 18, United States Code*, to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce. A purchase of securities on the open market for purposes of investment, and without the intention of controlling or participating in the control of the issuer, or of assisting another to do so, shall not be unlawful under this subsection if the securities of the issuer held by the purchaser, the members of his immediate family, and his or their accomplices in any pattern or racketeering activity or the collection of an unlawful debt after such purchase do not amount in the aggregate to one percent of the outstanding securities of any one class, and do not confer, either in law or in fact, the power to elect one or more directors of the issuer.

(b) It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

(d) It shall be unlawful for any person to conspire to violate any of the provisions of subsection (a), (b), or (c) of this section.



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§ 1963 Criminal penalties.

(a) Whoever violates any provision of section 1962 of this chapter [*18 USCS § 1962*] shall be fined under this title or imprisoned not more than 20 years (or for life if the violation is based on a racketeering activity for which the maximum penalty includes life imprisonment), or both, and shall forfeit to the United States, irrespective of any provision of State law--

(1) any interest the person has acquired or maintained in violation of section 1962 [*18 USCS § 1962*];

(2) any--

(A) interest in;

(B) security of;

(C) claim against; or

(D) property or contractual right of any kind affording a source of influence over;

any enterprise which the person has established, operated, controlled, conducted, or participated in the conduct of, in violation of section 1962 [*18 USCS § 1962*]; and

(3) any property constituting, or derived from, any proceeds which the person obtained, directly or indirectly, from racketeering activity or unlawful debt collection in violation of section 1962 [18 USCS § 1962].

The court, in imposing sentence on such person shall order, in addition to any other sentence imposed pursuant to this section, that the person forfeit to the United States all property described in this subsection. In lieu of a fine otherwise authorized by this section, a defendant who derives profits or other proceeds from an offense may be fined not more than twice the gross profits or other proceeds.

(b) Property subject to criminal forfeiture under this section includes--

(1) real property, including things growing on, affixed to, and found in land; and

(2) tangible and intangible personal property, including rights, privileges, interests, claims, and securities.

(c) All right, title, and interest in property described in subsection (a) vests in the United States upon the commission of the act giving rise to forfeiture under this section. Any such property that is subsequently transferred to a person other than the defendant may be the subject of a special verdict of forfeiture and thereafter shall be ordered forfeited to the United States, unless the transferee establishes in a hearing pursuant to subsection (1) that he is a bona fide purchaser for value of such property who at the time of purchase was reasonably without cause to believe that the property was subject to forfeiture under this section.

(d)

(1) Upon application of the United States, the court may enter a restraining order or injunction, require the execution of a satisfactory performance bond, or take any other action to preserve the availability of property described in subsection (a) for forfeiture under this section--

(A) upon the filing of an indictment or information charging a violation of section 1962 of this chapter [18 USCS § 1962] and alleging that the property with respect to which the order is sought would, in the event of conviction, be subject to forfeiture under this section; or

(B) prior to the filing of such an indictment or information, if, after notice to persons appearing to have an interest in the property and opportunity for a hearing, the court determines that--

(i) there is a substantial probability that the United States will prevail on the issue of forfeiture and that failure to enter the order will result in the property being destroyed, removed from the jurisdiction of the court, or otherwise made unavailable for forfeiture; and

(ii) the need to preserve the availability of the property through the entry of the requested order outweighs the hardship on any party against whom the order is to be entered:

Provided, however, That an order entered pursuant to subparagraph (B) shall be effective for not more than ninety days, unless extended by the court for good cause shown or unless an indictment or information described in subparagraph (A) has been filed.

(2) A temporary restraining order under this subsection may be entered upon application of the United States without notice or opportunity for a hearing when an information or indictment has not yet been filed with respect to the property, if the United States demonstrates that there is probable cause to believe that the property with respect to which the order is sought would, in the event of conviction, be subject to forfeiture under this section and that provision of notice will jeopardize the availability of the property for forfeiture. Such a temporary order shall expire not more than fourteen days after the date on which it is entered, unless extended for good cause shown or unless the party against whom it is entered consents to an extension for a longer period. A hearing requested concerning an order entered under this paragraph shall be held at the earliest possible time, and prior to the expiration of the temporary order.

(3) The court may receive and consider, at a hearing held pursuant to this subsection, evidence and information that would be inadmissible under the Federal Rules of Evidence.

(e) Upon conviction of a person under this section, the court shall enter a judgment of forfeiture of the property to the United States and shall also authorize the Attorney General to seize all property ordered forfeited upon such terms and conditions as the court shall deem proper. Following the entry of an order declaring the property forfeited, the court may, upon application of the United States, enter such appropriate restraining orders or injunctions, require the execution of satisfactory performance bonds, appoint receivers, conservators, appraisers, accountants, or trustees, or take any other action to protect the interest of the United States in the property ordered forfeited. Any income accruing to, or derived from, an enterprise or an interest in an enterprise which has been ordered forfeited under this section may be used to offset ordinary and necessary expenses to the enterprise which are required by law, or which are necessary to protect the interests of the United States or third parties.

(f) Following the seizure of property ordered forfeited under this section, the Attorney General shall direct the disposition of the property by sale or any other commercially feasible means, making due provision for the rights of any innocent persons. Any property right or interest not exercisable by, or transferable for value to, the United States shall expire and shall not revert to the defendant, nor shall the defendant or any person acting in concert with or on behalf of the defendant be eligible to purchase forfeited property at any sale held by the United States. Upon application of a person, other than the defendant or a person acting in concert with or on behalf of the defendant, the court may restrain or stay the sale or disposition of the property pending the conclusion of any appeal of the criminal case giving rise to the forfeiture, if the applicant demonstrates that proceeding with the sale or disposition of the property will result in

irreparable injury, harm or loss to him. Notwithstanding *31 U.S.C. 3302(b)*, the proceeds of any sale or other disposition of property forfeited under this section and any moneys forfeited shall be used to pay all proper expenses for the forfeiture and the sale, including expenses of seizure, maintenance and custody of the property pending its disposition, advertising and court costs. The Attorney General shall deposit in the Treasury any amounts of such proceeds or moneys remaining after the payment of such expenses.

(g) With respect to property ordered forfeited under this section, the Attorney General is authorized to--

(1) grant petitions for mitigation or remission of forfeiture, restore forfeited property to victims of a violation of this chapter [*18 USCS §§ 1961 et seq.*], or take any other action to protect the rights of innocent persons which is in the interest of justice and which is not inconsistent with the provisions of this chapter [*18 USCS §§ 1961 et seq.*];

(2) compromise claims arising under this section;

(3) award compensation to persons providing information resulting in a forfeiture under this section;

(4) direct the disposition by the United States of all property ordered forfeited under this section by public sale or any other commercially feasible means, making due provision for the rights of innocent persons; and

(5) take appropriate measures necessary to safeguard and maintain property ordered forfeited under this section pending its disposition.

(h) The Attorney General may promulgate regulations with respect to--

(1) making reasonable efforts to provide notice to persons who may have an interest in property ordered forfeited under this section;

(2) granting petitions for remission or mitigation of forfeiture;

(3) the restitution of property to victims of an offense petitioning for remission or mitigation of forfeiture under this chapter [*18 USCS §§ 1961 et seq.*];

(4) the disposition by the United States of forfeited property by public sale or other commercially feasible means;

(5) the maintenance and safekeeping of any property forfeited under this section pending its disposition; and

(6) the compromise of claims arising under this chapter [*18 USCS §§ 1961 et seq.*].

Pending the promulgation of such regulations, all provisions of law relating to the disposition of property, or the proceeds from the sale thereof, or the remission or mitigation of forfeitures for violation of the customs laws, and the compromise of claims and the award of compensation to informers in respect of such forfeitures shall apply to forfeitures incurred, or alleged to have been incurred, under the provisions of this section, insofar as applicable and not inconsistent with the provisions hereof. Such duties as are imposed upon the Customs Service or any person with respect to the disposition of property under the customs law shall be performed under this chapter [*18 USCS §§ 1961 et seq.*] by the Attorney General.

(i) Except as provided in subsection (l), no party claiming an interest in property subject to forfeiture under this section may--

(1) intervene in a trial or appeal of a criminal case involving the forfeiture of such property under this section; or

(2) commence an action at law or equity against the United States concerning the validity of his alleged interest in the property subsequent to the filing of an indictment or information alleging that the property is subject to forfeiture under this section.

(j) The district courts of the United States shall have jurisdiction to enter orders as provided in this section without regard to the location of any property which may be subject to forfeiture under this section or which has been ordered forfeited under this section.

(k) In order to facilitate the identification or location of property declared forfeited and to facilitate the disposition of petitions for remission or mitigation of forfeiture, after the entry of an order declaring property forfeited to the United States the court may, upon application of the United States, order that the testimony of any witness relating to the property forfeited be taken by deposition and that any designated book, paper, document, record, recording, or other material not privileged be produced at the same time and place, in the same manner as provided for the taking of depositions under *Rule 15 of the Federal Rules of Criminal Procedure*.

(1)

(1) Following the entry of an order of forfeiture under this section, the United States shall publish notice of the order and of its intent to dispose of the property in such manner as the Attorney General may direct. The Government may also, to the extent practicable, provide direct written notice to any person known to have alleged an interest in the property that is the subject of the order of forfeiture as a substitute for published notice as to those persons so notified.

(2) Any person, other than the defendant, asserting a legal interest in property which has been ordered forfeited to the United States pursuant to this section may, within thirty days of the final publication of notice or his receipt of notice under paragraph (1), whichever is earlier, petition the court for a hearing to adjudicate the validity of his alleged interest in the property. The hearing shall be held before the court alone, without a jury.

(3) The petition shall be signed by the petitioner under penalty of perjury and shall set forth the nature and extent of the petitioner's right, title, or interest in the property, the time and circumstances of the petitioner's acquisition of the right, title, or interest in the property, any additional facts supporting the petitioner's claim, and the relief sought.

(4) The hearing on the petition shall, to the extent practicable and consistent with the interests of justice, be held within thirty days of the filing of the petition. The court may consolidate the hearing on the petition with a hearing on any other petition filed by a person other than the defendant under this subsection.

(5) At the hearing, the petitioner may testify and present evidence and witnesses on his own behalf, and cross examine witnesses who appear at the hearing. The United States may present evidence and witnesses in rebuttal and in defense of its claim to the property and cross examine witnesses who appear at the hearing. In addition to testimony and evidence presented at the hearing, the court shall consider the relevant portions of the record of the criminal case which resulted in the order of forfeiture.

(6) If, after the hearing, the court determines that the petitioner has established by a preponderance of the evidence that--

(A) the petitioner has a legal right, title, or interest in the property, and such right, title, or interest renders the order of forfeiture invalid in whole or in part because the right, title, or interest was vested in the petitioner rather than the defendant or was superior to any right, title, or interest of the defendant at the time of the commission of the acts which gave rise to the forfeiture of the property under this section; or

(B) the petitioner is a bona fide purchaser for value of the right, title, or interest in the property and was at the time of purchase reasonably without cause to believe that the property was subject to forfeiture under this section;

the court shall amend the order of forfeiture in accordance with its determination.

(7) Following the court's disposition of all petitions filed under this subsection, or if no such petitions are filed following the expiration of the period provided in paragraph (2) for the filing of such petitions, the United States shall have clear title to property that is the subject of the order of forfeiture and may warrant good title to any subsequent purchaser or transferee.

(m) If any of the property described in subsection (a), as a result of any act or omission of the defendant--

(1) cannot be located upon the exercise of due diligence;

(2) has been transferred or sold to, or deposited with, a third party;

(3) has been placed beyond the jurisdiction of the court;

(4) has been substantially diminished in value; or

(5) has been commingled with other property which cannot be divided without difficulty;

the court shall order the forfeiture of any other property of the defendant up to the value of any property described in paragraphs (1) through (5).



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APPENDIX E Selected Title 18 Provisions

2-E Securities Enforcement: Counseling and Defense § 1965

§ 1965 RICO Venue and process

(a) Any civil action or proceeding under this chapter [*18 USCS §§ 1961 et seq.*] against any person may be instituted in the district court of the United States for any district in which such person resides, is found, has an agent, or transacts his affairs.

(b) In any action under section 1964 of this chapter in any district court of the United States in which it is shown that the ends of justice require that other parties residing in any other district be brought before the court, the court may cause such parties to be summoned, and process for that purpose may be served in any judicial district of the United States by the marshal thereof.

(c) In any civil or criminal action or proceeding instituted by the United States under this chapter [*18 USCS §§ 1961 et seq.*] in the district court of the United States for any judicial district, subpoenas issued by such court to compel the attendance of witnesses may be served in any other judicial district, except that in any civil action or proceeding no such subpoena shall be issued for service upon any individual who resides in another district at a place more than one hundred miles from the place at which such court is held without approval given by a judge of such court upon a showing of good cause.

(d) All other process in any action or proceeding under this chapter [*18 USCS §§ 1961 et seq.*] may be served on any person in any judicial district in which such person resides, is found, has an agent, or transacts his affairs.



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APPENDIX E Selected Title 18 Provisions

CHAPTER 96. RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS 18 USCS § 1968

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APPENDIX E Selected Title 18 Provisions

2-E Securities Enforcement: Counseling and Defense § 1968

§ 1968 RICO Civil investigative demand

(a) Whenever the Attorney General has reason to believe that any person or enterprise may be in possession, custody, or control of any documentary materials relevant to a racketeering investigation, he may, prior to the institution of a civil or criminal proceeding thereon, issue in writing, and cause to be served upon such person, a civil investigative demand requiring such person to produce such material for examination.

(b) Each such demand shall--

(1) state the nature of the conduct constituting the alleged racketeering violation which is under investigation and the provision of law applicable thereto;

(2) describe the class or classes of documentary material produced thereunder with such definiteness and certainty as to permit such material to be fairly identified;

(3) state that the demand is returnable forthwith or prescribe a return date which will provide a reasonable period of time within which the material so demanded may be assembled and made available for inspection and copying or reproduction; and

(4) identify the custodian to whom such material shall be made available.

(c) No such demand shall--

(1) contain any requirement which would be held to be unreasonable if contained in a subpoena duces tecum issued by a court of the United States in aid of a grand jury investigation of such alleged racketeering violation; or

(2) require the production of any documentary evidence which would be privileged from disclosure if demanded by a subpoena duces tecum issued by a court of the United States in aid of a grand jury investigation of such alleged racketeering violation.

(d) Service of any such demand or any petition filed under this section may be made upon a person by--

(1) delivering a duly executed copy thereof to any partner, executive officer, managing agent, or general agent thereof, or to any agent thereof authorized by appointment or by law to receive service of process on behalf of such person, or upon any individual person;

(2) delivering a duly executed copy thereof to the principal office or place of business of the person to be served; or

(3) depositing such copy in the United States mail, by registered or certified mail duly addressed to such person at its principal office or place of business.

(e) A verified return by the individual serving any such demand or petition setting forth the manner of such service shall be prima facie proof of such service. In the case of service by registered or certified mail, such return shall be accompanied by the return post office receipt of delivery of such demand.

(f)

(1) The Attorney General shall designate a racketeering investigator to serve as racketeer document custodian, and such additional racketeering investigators as he shall determine from time to time to be necessary to serve as deputies to such officer.

(2) Any person upon whom any demand issued under this section has been duly served shall make such material available for inspection and copying or reproduction to the custodian designated therein at the principal place of business of such person, or at such other place as such custodian and such person thereafter may agree and prescribe in writing or as the court may direct, pursuant to this section on the return date specified in such demand, or on such later

date as such custodian may prescribe in writing. Such person may upon written agreement between such person and the custodian substitute for copies of all or any part of such material originals thereof.

(3) The custodian to whom any documentary material is so delivered shall take physical possession thereof, and shall be responsible for the use made thereof and for the return thereof pursuant to this chapter [*18 USCS §§ 1961 et seq.*]. The custodian may cause the preparation of such copies of such documentary material as may be required for official use under regulations which shall be promulgated by the Attorney General. While in the possession of the custodian, no material so produced shall be available for examination, without the consent of the person who produced such material, by any individual other than the Attorney General. Under such reasonable terms and conditions as the Attorney General shall prescribe, documentary material while in the possession of the custodian shall be available for examination by the person who produced such material or any duly authorized representatives of such person.

(4) Whenever any attorney has been designated to appear on behalf of the United States before any court or grand jury in any case or proceeding involving any alleged violation of this chapter [*18 USCS §§ 1961 et seq.*], the custodian may deliver to such attorney such documentary material in the possession of the custodian as such attorney determines to be required for use in the presentation of such case or proceeding on behalf of the United States. Upon the conclusion of any such case or proceeding, such attorney shall return to the custodian any documentary material so withdrawn which has not passed into the control of such court or grand jury through the introduction thereof into the record of such case or proceeding.

(5) Upon the completion of--

(i) the racketeering investigation for which any documentary material was produced under this chapter [*18 USCS §§ 1961 et seq.*], and

(ii) any case or proceeding arising from such investigation, the custodian shall return to the person who produced such material all such material other than copies thereof made by the Attorney General pursuant to this subsection which has not passed into the control of any court or grand jury through the introduction thereof into the record of such case or proceeding.

(6) When any documentary material has been produced by any person under this section for use in any racketeering investigation, and no such case or proceeding arising therefrom has been instituted within a reasonable time after completion of the examination and analysis of all evidence assembled in the course of such investigation, such person shall be entitled, upon written demand made upon the Attorney General, to the return of all documentary material other than copies thereof made pursuant to this subsection so produced by such person.

(7) In the event of the death, disability, or separation from service of the custodian of any documentary material produced under any demand issued under this section or the official relief of such custodian from responsibility for the custody and control of such material, the Attorney General shall promptly--

(i) designate another racketeering investigator to serve as custodian thereof, and

(ii) transmit notice in writing to the person who produced such material as to the identity and address of the successor so designated. Any successor so designated shall have with regard to such materials all duties and responsibilities imposed by this section upon his predecessor in office with regard thereto, except that he shall not be held responsible for any default or dereliction which occurred before his designation as custodian.

(g) Whenever any person fails to comply with any civil investigative demand duly served upon him under this section or whenever satisfactory copying or reproduction of any such material cannot be done and such person refuses to surrender such material, the Attorney General may file, in the district court of the United States for any judicial district in which such person resides, is found, or transacts business, and serve upon such person a petition for an order of such court for the enforcement of this section, except that if such person transacts business in more than one such district such petition shall be filed in the district in which such person maintains his principal place of business, or in such other district in which such person transacts business as may be agreed upon by the parties to such petition.

(h) Within twenty days after the service of any such demand upon any person, or at any time before the return date specified in the demand, whichever period is shorter, such person may file, in the district court of the United States for the judicial district within which such person resides, is found, or transacts business, and serve upon such custodian a petition for an order of such court modifying or setting aside such demand. The time allowed for compliance with the demand in whole or in part as deemed proper and ordered by the court shall not run during the pendency of such petition in the court. Such petition shall specify each ground upon which the petitioner relies in seeking such relief, and may be based upon any failure of such demand to comply with the provisions of this section or upon any constitutional or other legal right or privilege of such person.

(i) At any time during which any custodian is in custody or control of any documentary material delivered by any person in compliance with any such demand, such person may file, in the district court of the United States for the judicial district within which the office of such custodian is situated, and serve upon such custodian a petition for an order of such court requiring the performance by such custodian of any duty imposed upon him by this section.

(j) Whenever any petition is filed in any district court of the United States under this section, such court shall have jurisdiction to hear and determine the material so presented, and to enter such order or orders as may be required to carry into effect the provisions of this section.



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APPENDIX F SECURITIES ACT OF 1933 Selected Provisions

2-F Securities Enforcement: Counseling and Defense APPENDIX F.syn

§ F.syn Synopsis to Appendix F: SECURITIES ACT OF 1933 Selected Provisions

§ Section 2 [15 U.S.C. § 77b] Definitions

§ Section 4 [15 U.S.C. § 77d] Exempted transactions

§ Section 5 [15 U.S.C. § 77e] Prohibitions relating to interstate commerce and the mails

§ Section 8A [15 U.S.C. § 77h-1] Cease-and-desist proceedings

§ Section 9 [15 U.S.C. § 77i] Court review of orders

§ Section 11 [15 U.S.C. § 77k] Civil liabilities on account of false registration statement

§ Section 12 [15 U.S.C. § 77l] Civil liabilities arising in connection with prospectuses and communications

§ Section 15 [15 U.S.C. § 77o] Liability of controlling persons

§ Section 17 [15 U.S.C. § 77q] Fraudulent interstate transactions

§ Section 20 [15 U.S.C. § 77t] Injunctions and prosecutions of offenses

§ Section 24 [15 U.S.C. § 77x] Penalties



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APPENDIX F SECURITIES ACT OF 1933 Selected Provisions

2-F Securities Enforcement: Counseling and Defense § Section 2

§ Section 2 [15 U.S.C. § 77b] Definitions

(a) Definitions

When used in this subchapter, unless the context otherwise requires--

(1)

The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

(2)

The term "person" means an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof. As used in this paragraph the term "trust" shall include only a trust where the interest or interests of the beneficiary or beneficiaries are evidenced by a security.

(3)

The term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell", "offer for sale", or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. The terms defined in this paragraph and the term "offer to buy" as used in subsection (c) of section 77e of this title shall not include preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer). Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been offered and sold for value. The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be an offer or sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security. Any offer or sale of a security futures product by or on behalf of the issuer of the securities underlying the security futures product, an affiliate of the issuer, or an underwriter, shall constitute a contract for sale of, sale of, offer for sale, or offer to sell the underlying securities.

(4)

The term "issuer" means every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term "issuer" means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.

(5)

The term "Commission" means the Securities and Exchange Commission.

(6)

The term "Territory" means Puerto Rico, the Virgin Islands, and the insular possessions of the United States.

(7)

The term "interstate commerce" means trade or commerce in securities or any transportation or communication relating thereto among the several States or between the District of Columbia or any Territory of the United States and any State or other Territory, or between any foreign country and any State, Territory, or the District of Columbia, or within the District of Columbia.

(8)

The term "registration statement" means the statement provided for in section 77f of this title, and includes any amendment thereto and any report, document, or memorandum filed as part of such statement or incorporated therein by reference.

(9)

The term "write" or "written" shall include printed, lithographed, or any means of graphic communication.

(10)

The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 77j of this title) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 77j of this title at the time of n1 such communication was sent or given to the person to whom the communication was made, and (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 77j of this title may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

(11)

The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

(12)

The term "dealer" means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.

(13)

The term "insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner, or a similar official or agency, of a State or territory or the District of Columbia; or any receiver or similar official or any liquidating agent for such company, in his capacity as such.

(14)

The term "separate account" means an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, the District of Columbia, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

(15)

The term "accredited investor" shall mean--

(i)

a bank as defined in section 3(a)(2) whether acting in its individual or fiduciary capacity; an insurance company as defined in paragraph (13) of this subsection; an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.] or a business development company as defined in section 2(a)(48) of that Act [15 U.S.C. 80a-2(a)(48)]; a Small Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account, which is subject to the provisions of the Employee Retirement Income Security Act of 1974 [29 U.S.C. 1001 et seq.], if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act [29 U.S.C. 1002(21)], which is either a bank, insurance company, or registered investment adviser; or

(ii)

any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations

which the Commission shall prescribe.

(16)

The terms "security future", "narrow-based security index", and "security futures product" have the same meanings as provided in section 3(a)(55) of the Securities Exchange Act of 1934.

(b) Consideration of promotion of efficiency, competition and capital formation

Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

FOOTNOTES:

(n309)Footnote 1. So in original.



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APPENDIX F SECURITIES ACT OF 1933 Selected Provisions

2-F Securities Enforcement: Counseling and Defense § Section 4

§ Section 4 [15 U.S.C. § 77d] Exempted transactions

The provisions of section 77e of this title shall not apply to--

(1)

transactions by any person other than an issuer, underwriter, or dealer.

(2)

transactions by an issuer not involving any public offering.

(3)

transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except--

(A)

transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter,

(B)

transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 77h of this title is in effect as to the security), or such shorter period as the Commission may specify by rules and regulations or order, and

(C)

transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter. With respect to transactions referred to in clause (B), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of forty days, shall be ninety days, or such shorter period as the Commission may specify by rules and regulations or order.

(4)

brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders.

(5)

(A)

Transactions involving offers or sales of one or more promissory notes directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or other residential or commercial structure, and participation interests in such notes--

(i)

where such securities are originated by a savings and loan association, savings bank, commercial bank, or similar banking institution which is supervised and examined by a Federal or State authority, and are offered and sold subject to the following conditions:

(a)

the minimum aggregate sales price per purchaser shall not be less than \$250,000;

(b)

the purchaser shall pay cash either at the time of the sale or within sixty days thereof; and

(c)

each purchaser shall buy for his own account only; or

(ii)

where such securities are originated by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections 1709 and 1715b of title 12 and are offered or sold subject to the three conditions specified in subparagraph (A)(i) to any institution described in such subparagraph or to any insurance company subject to the supervision of the insurance commissioner, or any agency or officer performing like function, of any State or territory of the United States or the District of Columbia, or the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Government National Mortgage Association.

(B)

Transactions n3 between any of the entities described in subparagraph (A)(i) or (A)(ii) involving non-assignable contracts to buy or sell the foregoing securities which are to be completed within two years, where the seller of the foregoing securities pursuant to any such contract is one of the parties described in subparagraph (A)(i) or (A)(ii) who may originate such securities and the purchaser of such securities pursuant to any such contract is any institution described in subparagraph (A)(i) or any insurance company described in subparagraph (A)(ii), the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, or the Government National Mortgage Association and where the foregoing securities are subject to the three conditions for sale set forth in subparagraphs (A)(i)(a) through (c).

(C)

The n4 exemption provided by subparagraphs (A) and (B) shall not apply to resales of the securities acquired pursuant thereto, unless each of the conditions for sale contained in subparagraphs (A)(i)(a) through (c) are satisfied.

(6)

transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered in reliance on this paragraph does not exceed the amount allowed under section 77c(b) of this title, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf, and if the issuer files such notice with the Commission as the Commission shall prescribe.

FOOTNOTES:

(n310)Footnote 2. So in original. Probably should not be capitalized.

(n311)Footnote 3. So in original. Probably should not be capitalized.

(n312)Footnote 4. So in original. Probably should not be capitalized.



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APPENDIX F SECURITIES ACT OF 1933 Selected Provisions

2-F Securities Enforcement: Counseling and Defense § Section 5

§ Section 5 [15 U.S.C. § 77e] Prohibitions relating to interstate commerce and the mails

(a) Sale or delivery after sale of unregistered securities

Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly--

(1)

to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2)

to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) Necessity of prospectus meeting requirements of section 77j of this title

It shall be unlawful for any person, directly or indirectly--

(1)

to make use of any means or instruments of transportation or communication in interstate commerce or of the

mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2)

to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

(c) Necessity of filing registration statement

It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.



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APPENDIX F SECURITIES ACT OF 1933 Selected Provisions

2-F Securities Enforcement: Counseling and Defense § Section 8A

§ Section 8A [15 U.S.C. § 77h-1] Cease-and-desist proceedings

(a) Authority of the Commission

If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this subchapter, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule, or regulation with respect to any security, any issuer, or any other person.

(b) Hearing

The notice instituting proceedings pursuant to subsection (a) of this section shall fix a hearing date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served.

(c) Temporary order

(1)

In general

Whenever the Commission determines that the alleged violation or threatened violation specified in the notice instituting proceedings pursuant to subsection (a) of this section, or the continuation thereof, is likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest, including, but not limited to, losses to the Securities Investor Protection Corporation, prior to the completion of the proceedings, the Commission may enter a temporary order requiring the respondent to cease and desist from the violation or threatened violation and to take such action to prevent the violation or threatened violation and to prevent dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest as the Commission deems appropriate pending completion of such proceeding. Such an order shall be entered only after notice and opportunity for a hearing, unless the Commission determines that notice and hearing prior to entry would be impracticable or contrary to the public interest. A temporary order shall become effective upon service upon the respondent and, unless set aside, limited, or suspended by the Commission or a court of competent jurisdiction, shall remain effective and enforceable pending the completion of the proceedings.

(2)

Applicability

This subsection shall apply only to a respondent that acts, or, at the time of the alleged misconduct acted, as a broker, dealer, investment adviser, investment company, municipal securities dealer, government securities broker, government securities dealer, or transfer agent, or is, or was at the time of the alleged misconduct, an associated person of, or a person seeking to become associated with, any of the foregoing.

(d) Review of temporary orders

(1)

Commission review

At any time after the respondent has been served with a temporary cease-and-desist order pursuant to subsection (c) of this section, the respondent may apply to the Commission to have the order set aside, limited, or suspended. If the respondent has been served with a temporary cease-and-desist order entered without a prior Commission hearing, the respondent may, within 10 days after the date on which the order was served, request a hearing on such application and the Commission shall hold a hearing and render a decision on such application at the earliest possible time.

(2)

Judicial review

Within--

(A)

10 days after the date the respondent was served with a temporary cease-and-desist order entered with a prior Commission hearing, or

(B)

10 days after the Commission renders a decision on an application and hearing under paragraph (1), with respect to any temporary cease-and-desist order entered without a prior Commission hearing, the respondent may apply to the United States district court for the district in which the respondent resides or has its principal place of business, or for the District of Columbia, for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order, and the court shall have jurisdiction to enter such an order. A respondent served with a temporary cease-and-desist order entered without a prior Commission hearing may not apply to the court except after hearing and decision by the Commission on the respondent's application under paragraph (1) of this subsection.

(3)

No automatic stay of temporary order

The commencement of proceedings under paragraph (2) of this subsection shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

(4)

Exclusive review

Section 77i(a) of this title shall not apply to a temporary order entered pursuant to this section.

(e) Authority to enter an order requiring an accounting and disgorgement

In any cease-and-desist proceeding under subsection (a) of this section, the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

(f) Authority of the Commission to Prohibit Persons From Serving as Officers or Directors

In any cease-and-desist proceeding under subsection (a), the Commission may issue an order to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated section 17(a)(1) or the rules or regulations thereunder, from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934, or that is required to file reports pursuant to section 15(d) of that Act, if the conduct of that person demonstrates unfitness to serve as an

officer or director of any such issuer.



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2-F Securities Enforcement: Counseling and Defense § Section 9

§ Section 9 [15 U.S.C. § 77i] Court review of orders

(a)

Any person aggrieved by an order of the Commission may obtain a review of such order in the court of appeals of the United States, within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or be set aside in whole or in part. A copy of such petition shall be forthwith transmitted by the clerk of the court to the Commission, and thereupon the Commission shall file in the court the record upon which the order complained of was entered, as provided in section 2112 of title 28. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission. The finding of the Commission as to the facts, if supported by evidence, shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the hearing before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The jurisdiction of the court shall be exclusive and its judgment and decree, affirming, modifying, or setting aside, in whole or in part, any order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in section 1254 of title 28.

(b)

The commencement of proceedings under subsection (a) of this section shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.



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2-F Securities Enforcement: Counseling and Defense § Section 11

§ Section 11 [15 U.S.C. § 77k] Civil liabilities on account of false registration statement

(a) Persons possessing cause of action; persons liable

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue--

(1)

every person who signed the registration statement;

(2)

every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3)

every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4)

every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5)

every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Persons exempt from liability upon proof of issues

Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof--

(1)

that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2)

that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3)

that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to

believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) Standard of reasonableness

In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

(d) Effective date of registration statement with regard to underwriters

If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

(e) Measure of damages; undertaking for payment of costs

The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement,

with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) Joint and several liability

(1)

Except as provided in paragraph (2), all or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(2)

(A)

The liability of an outside director under subsection (e) shall be determined in accordance with section 21D(f) of the Securities Exchange Act of 1934.

(B)

For purposes of this paragraph, the term "outside director" shall have the meaning given such term by rule or regulation of the Commission.

(g) Offering price to public as maximum amount recoverable

In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.



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APPENDIX F SECURITIES ACT OF 1933 Selected Provisions

2-F Securities Enforcement: Counseling and Defense § Section 12

§ Section 12 [15 U.S.C. § 77I] Civil liabilities arising in connection with prospectuses and communications

(a) In General

Any person who--

(1)

offers or sells a security in violation of section 77e of this title, or

(2)

offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

(b) Loss causation

In an action described in subsection (a)(2), if the person who offered or sold such security proves that any person or

all of the amount recoverable under subsection (a)(2) represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.



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2-F Securities Enforcement: Counseling and Defense § Section 15

§ Section 15 [15 U.S.C. § 77o] Liability of controlling persons

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.



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2-F Securities Enforcement: Counseling and Defense § Section 17

§ Section 17 [15 U.S.C. § 77q] Fraudulent interstate transactions

(a) Use of interstate commerce for purpose of fraud or deceit

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly--

(1)

to employ any device, scheme, or artifice to defraud, or

(2)

to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(3)

to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) Use of interstate commerce for purpose of offering for sale

It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) Exemptions of section 77c not applicable to this section

The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

(d) The authority of the Commission under this section with respect to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) shall be subject to the restrictions and limitations of section 2A(b) of this title.



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2-F Securities Enforcement: Counseling and Defense § Section 20

§ Section 20 [15 U.S.C. § 77t] Injunctions and prosecutions of offenses

(a) Investigation of violations

Whenever it shall appear to the Commission, either upon complaint or otherwise, that the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, have been or are about to be violated, it may, in its discretion, either require or permit such person to file with it a statement in writing, under oath, or otherwise, as to all the facts and circumstances concerning the subject matter which it believes to be in the public interest to investigate, and may investigate such facts.

(b) Action for injunction or criminal prosecution in district court

Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation prescribed under authority thereof, the Commission may, in its discretion, bring an action in any district court of the United States or United States court of any Territory, to enjoin such acts or practices, and upon a proper showing, a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this subchapter. Any such criminal proceeding may be brought either in the district wherein the transmittal of the prospectus or security complained of begins, or in the district wherein such prospectus or security is received.

(c) Writ of mandamus

Upon application of the Commission, the district courts of the United States and the United States courts of any Territory shall have jurisdiction to issue writs of mandamus commanding any person to comply with the provisions of this title or any order of the Commission made in pursuance thereof.

(d) Money penalties in civil actions

(1)

Authority of commission

Whenever it shall appear to the Commission that any person has violated any provision of this subchapter, the rules or regulations thereunder, or a cease-and-desist order entered by the Commission pursuant to section 77h-1 of this title, other than by committing a violation subject to a penalty pursuant to section 78u-1 of this title, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

(2)

Amount of penalty

(A)

First tier

The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of

(i)

\$5,000 for a natural person or \$50,000 for any other person, or

(ii)

the gross amount of pecuniary gain to such defendant as a result of the violation.

(B)

Second tier

Notwithstanding subparagraph (A), the amount of penalty for each such violation shall not exceed the greater of

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(i)

\$50,000 for a natural person or \$250,000 for any other person, or

(ii)

the gross amount of pecuniary gain to such defendant as a result of the violation, if the violation described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(C)

Third tier

Notwithstanding subparagraphs (A) and (B), the amount of penalty for each such violation shall not exceed the greater of

(i)

\$100,000 for a natural person or \$500,000 for any other person, or

(ii)

the gross amount of pecuniary gain to such defendant as a result of the violation, if--

(I)

the violation described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(II)

such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.

(3)

Procedures for collection

(A)

Payment of penalty to treasury

A penalty imposed under this section shall be payable into the Treasury of the United States, except as otherwise provided in section 308 of the Sarbanes-Oxley Act of 2002.

(B)

Collection of penalties

If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

(C)

Remedy not exclusive

The actions authorized by this subsection may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring.

(D)

Jurisdiction and venue

For purposes of section 77v of this title, actions under this section shall be actions to enforce a liability or a duty created by this title.

(4)

Special provisions relating to a violation of a cease-and-desist order

In an action to enforce a cease-and-desist order entered by the Commission pursuant to section 77h-1 of this title, each separate violation of such order shall be a separate offense, except that in the case of a violation through a continuing failure to comply with such an order, each day of the failure to comply with the order shall be deemed a separate offense.

(e) Authority of a court to prohibit persons from serving as officers and directors

In any proceeding under subsection (b) of this section, the court may prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who violated section 77q(a)(1) of this title from

acting as an officer or director of any issuer that has a class of securities registered pursuant to section 781 of this title or that is required to file reports pursuant to section 780(d) of this title if the person's conduct demonstrates substantial unfitness to serve as an officer or director of any such issuer.

(f) Prohibition of attorneys' fees paid from Commission disgorgement funds

Except as otherwise ordered by the court upon motion by the Commission, or, in the case of an administrative action, as otherwise ordered by the Commission, funds disgorged as the result of an action brought by the Commission in Federal court, or as a result of any Commission administrative action, shall not be distributed as payment for attorneys' fees or expenses incurred by private parties seeking distribution of the disgorged funds.

(g) Authority of a Court To Prohibit Persons From Participating in an Offering of Penny Stock

(1)

In general

In any proceeding under subsection (a) against any person participating in, or, at the time of the alleged misconduct, who was participating in, an offering of penny stock, the court may prohibit that person from participating in an offering of penny stock, conditionally or unconditionally, and permanently or for such period of time as the court shall determine.

(2)

Definition

For purposes of this subsection, the term "person participating in an offering of penny stock" includes any person engaging in activities with a broker, dealer, or issuer for purposes of issuing, trading, or inducing or attempting to induce the purchase or sale of, any penny stock. The Commission may, by rule or regulation, define such term to include other activities, and may, by rule, regulation, or order, exempt any person or class of persons, in whole or in part, conditionally or unconditionally, from inclusion in such term.



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2-F Securities Enforcement: Counseling and Defense § Section 24

§ Section 24 [15 U.S.C. § 77x] Penalties

Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subchapter, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than \$10,000 or imprisoned not more than five years, or both.



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

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§ 3 [15 USC § 78c] Definitions and application

(a) Definitions. When used in this title, unless the context otherwise requires--

(1) The term "exchange" means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

(2) The term "facility" when used with respect to an exchange includes its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.

(3)

(A) The term "member" when used with respect to a national securities exchange means (i) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker, (ii) any registered broker or dealer with which such a natural person is associated, (iii) any registered broker or dealer permitted to designate as a representative such a natural person, and (iv) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of this title, the rules and regulations thereunder, and its own rules. For purposes of sections [6](b)(1), 6(b)(4), 6(b)(6), 6(b)(7), 6(d), 17(d), 19(d), 19(e), 19(g), 19(h), and 21 of this title [15 USCS §§ 78f(b)(1), (4), (6), (7), (d), 78q(d), 78s(d), (e), (g), (h), and 78u], the term "member" when used with respect to a national securities exchange also means, to the extent of the rules of the exchange specified by the Commission, any person required by the

Commission to comply with such rules pursuant to section 6(f) of this title [15 USCS § 78ff(f)].

(B) The term "member" when used with respect to a registered securities association means any broker or dealer who agrees to be regulated by such association and with respect to whom the association undertakes to enforce compliance with the provisions of this title, the rules and regulations thereunder, and its own rules.

(4) Broker.

(A) In general. The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others.

(B) Exception for certain bank activities. A bank shall not be considered to be a broker because the bank engages in any one or more of the following activities under the conditions described:

(i) Third party brokerage arrangements. The bank enters into a contractual or other written arrangement with a broker or dealer registered under this title under which the broker or dealer offers brokerage services on or off the premises of the bank if--

(I) such broker or dealer is clearly identified as the person performing the brokerage services;

(II) the broker or dealer performs brokerage services in an area that is clearly marked and, to the extent practicable, physically separate from the routine deposit-taking activities of the bank;

(III) any materials used by the bank to advertise or promote generally the availability of brokerage services under the arrangement clearly indicate that the brokerage services are being provided by the broker or dealer and not by the bank;

(IV) any materials used by the bank to advertise or promote generally the availability of brokerage services under the arrangement are in compliance with the Federal securities laws before distribution;

(V) bank employees (other than associated persons of a broker or dealer who are qualified pursuant to the rules of a self-regulatory organization) perform only clerical or ministerial functions in connection with brokerage

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transactions including scheduling appointments with the associated persons of a broker or dealer, except that bank employees may forward customer funds or securities and may describe in general terms the types of investment vehicles available from the bank and the broker or dealer under the arrangement;

(VI) bank employees do not receive incentive compensation for any brokerage transaction unless such employees are associated persons of a broker or dealer and are qualified pursuant to the rules of a self-regulatory organization, except that the bank employees may receive compensation for the referral of any customer if the compensation is a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction;

(VII) such services are provided by the broker or dealer on a basis in which all customers that receive any services are fully disclosed to the broker or dealer;

(VIII) the bank does not carry a securities account of the customer except as permitted under clause (ii) or (viii) of this subparagraph; and

(IX) the bank, broker, or dealer informs each customer that the brokerage services are provided by the broker or dealer and not by the bank and that the securities are not deposits or other obligations of the bank, are not guaranteed by the bank, and are not insured by the Federal Deposit Insurance Corporation.

(ii) Trust activities. The bank effects transactions in a trustee capacity, or effects transactions in a fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards, and--

(I) is chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee (payable on a monthly, quarterly, or other basis), a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers, or any combination of such fees; and

(II) does not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities.

(iii) Permissible securities transactions. The bank effects transactions in--

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(I) commercial paper, bankers acceptances, or commercial bills;

(II) exempted securities;

(III) qualified Canadian government obligations as defined in section 5136 of the Revised Statutes [12 USCS § 24], in conformity with section 15C of this title [15 USCS § 78o-5] and the rules and regulations thereunder, or obligations of the North American Development Bank; or

(IV) any standardized, credit enhanced debt security issued by a foreign government pursuant to the March 1989 plan of then Secretary of the Treasury Brady, used by such foreign government to retire outstanding commercial bank loans.

(iv) Certain stock purchase plans.

(I) Employee benefit plans. The bank effects transactions, as part of its transfer agency activities, in the securities of an issuer as part of any pension, retirement, profit-sharing, bonus, thrift, savings, incentive, or other similar benefit plan for the employees of that issuer or its affiliates (as defined in section 2 of the Bank Holding Company Act of 1956 [12 USCS § 1841]), if the bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan.

(II) Dividend reinvestment plans. The bank effects transactions, as part of its transfer agency activities, in the securities of an issuer as part of that issuer's dividend reinvestment plan, if--

(aa) the bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan; and

(bb) the bank does not net shareholders' buy and sell orders, other than for programs for odd-lot holders or plans registered with the Commission.

(III) Issuer plans. The bank effects transactions, as part of its transfer agency activities, in the securities of an issuer as part of a plan or program for the purchase or sale of that issuer's shares, if--

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(aa) the bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan or program; and

(bb) the bank does not net shareholders' buy and sell orders, other than for programs for odd-lot holders or plans registered with the Commission.

(IV) Permissible delivery of materials. The exception to being considered a broker for a bank engaged in activities described in subclauses (I), (II), and (III) will not be affected by delivery of written or electronic plan materials by a bank to employees of the issuer, shareholders of the issuer, or members of affinity groups of the issuer, so long as such materials are--

(aa) comparable in scope or nature to that permitted by the Commission as of the date of the enactment of the Gramm-Leach-Bliley Act [enacted Nov. 12, 1999]; or

(bb) otherwise permitted by the Commission.

(v) Sweep accounts. The bank effects transactions as part of a program for the investment or reinvestment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act of 1940 that holds itself out as a money market fund.

(vi) Affiliate transactions. The bank effects transactions for the account of any affiliate of the bank (as defined in section 2 of the Bank Holding Company Act of 1956 [12 USCS § 1841]) other than--

(I) a registered broker or dealer; or

(II) an affiliate that is engaged in merchant banking, as described in section 4(k)(4)(H) of the Bank Holding Company Act of 1956 [12 USCS § 1843(k)(4)(H)].

(vii) Private securities offerings. The bank--

(I) effects sales as part of a primary offering of securities not involving a public offering, pursuant to section

3(b), 4(2), or 4(6) of the Securities Act of 1933 [15 USCS § 77c(b), 77d(2), or 77d(6)] or the rules and regulations issued thereunder;

(II) at any time after the date that is 1 year after the date of the enactment of the Gramm-Leach-Bliley Act [enacted Nov. 12, 1999], is not affiliated with a broker or dealer that has been registered for more than 1 year in accordance with this Act, and engages in dealing, market making, or underwriting activities, other than with respect to exempted securities; and

(III) if the bank is not affiliated with a broker or dealer, does not effect any primary offering described in subclause (I) the aggregate amount of which exceeds 25 percent of the capital of the bank, except that the limitation of this subclause shall not apply with respect to any sale of government securities or municipal securities.

(viii) Safekeeping and custody activities.

(I) In general. The bank, as part of customary banking activities--

(aa) provides safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers;

(bb) facilitates the transfer of funds or securities, as a custodian or a clearing agency, in connection with the clearance and settlement of its customers' transactions in securities;

(cc) effects securities lending or borrowing transactions with or on behalf of customers as part of services provided to customers pursuant to division (aa) or (bb) or invests cash collateral pledged in connection with such transactions;

(dd) holds securities pledged by a customer to another person or securities subject to purchase or resale agreements involving a customer, or facilitates the pledging or transfer of such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; or

(ee) serves as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.

(II) Exception for carrying broker activities. The exception to being considered a broker for a bank engaged in activities described in subclause (I) shall not apply if the bank, in connection with such activities, acts in the United States as a carrying broker (as such term, and different formulations thereof, are used in section 15(c)(3) of this title [15 USCS § 78o(c)(3)] and the rules and regulations thereunder) for any broker or dealer, unless such carrying broker activities are engaged in with respect to government securities (as defined in paragraph (42) of this subsection).

(ix) Identified banking products. The bank effects transactions in identified banking products as defined in section 206 of the Gramm-Leach-Bliley Act [note to this section].

(x) Municipal securities. The bank effects transactions in municipal securities.

(xi) De minimis exception. The bank effects, other than in transactions referred to in clauses (i) through (x), not more than 500 transactions in securities in any calendar year, and such transactions are not effected by an employee of the bank who is also an employee of a broker or dealer.

(C) Execution by broker or dealer. The exception to being considered a broker for a bank engaged in activities described in clauses (ii), (iv), and (viii) of subparagraph (B) shall not apply if the activities described in such provisions result in the trade in the United States of any security that is a publicly traded security in the United States, unless--

(i) the bank directs such trade to a registered broker or dealer for execution;

(ii) the trade is a cross trade or other substantially similar trade of a security that--

(I) is made by the bank or between the bank and an affiliated fiduciary; and

(II) is not in contravention of fiduciary principles established under applicable Federal or State law; or

(iii) the trade is conducted in some other manner permitted under rules, regulations, or orders as the Commission may prescribe or issue.

(D) Fiduciary capacity. For purposes of subparagraph (B)(ii), the term "fiduciary capacity" means--

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(i) in the capacity as trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minor act, or as an investment adviser if the bank receives a fee for its investment advice;

(ii) in any capacity in which the bank possesses investment discretion on behalf of another; or

(iii) in any other similar capacity.

(E) Exception for entities subject to section 15(e) [*15 USCS § 77o(e)*]. The term "broker" does not include a bank that--

(i) was, on the day before the date of enactment of the Gramm-Leach-Bliley Act [enacted Nov. 12, 1999], subject to section 15(e) [*15 USCS § 77o(e)*]; and

(ii) is subject to such restrictions and requirements as the Commission considers appropriate.

(F) Joint rulemaking required. The Commission and the Board of Governors of the Federal Reserve System shall jointly adopt a single set of rules or regulations to implement the exceptions in subparagraph (B).

(5) Dealer.

(A) In general. The term "dealer" means any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise.

(B) Exception for person not engaged in the business of dealing. The term "dealer" does not include a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

(C) Exception for certain bank activities. A bank shall not be considered to be a dealer because the bank engages in any of the following activities under the conditions described:

(i) Permissible securities transactions. The bank buys or sells--

(I) commercial paper, bankers acceptances, or commercial bills;

(II) exempted securities;

(III) qualified Canadian government obligations as defined in section 5136 of the Revised Statutes of the United States, in conformity with section 15C of this title [15 USCS § 78o-5] and the rules and regulations thereunder, or obligations of the North American Development Bank; or

(IV) any standardized, credit enhanced debt security issued by a foreign government pursuant to the March 1989 plan of then Secretary of the Treasury Brady, used by such foreign government to retire outstanding commercial bank loans.

(ii) Investment, trustee, and fiduciary transactions. The bank buys or sells securities for investment purposes--

(I) for the bank; or

(II) for accounts for which the bank acts as a trustee or fiduciary.

(iii) Asset-backed transactions. The bank engages in the issuance or sale to qualified investors, through a grantor trust or other separate entity, of securities backed by or representing an interest in notes, drafts, acceptances, loans, leases, receivables, other obligations (other than securities of which the bank is not the issuer), or pools of any such obligations predominantly originated by--

(I) the bank;

(II) an affiliate of any such bank other than a broker or dealer; or

(III) a syndicate of banks of which the bank is a member, if the obligations or pool of obligations consists of mortgage obligations or consumer-related receivables.

(iv) Identified banking products. The bank buys or sells identified banking products, as defined in section 206 of the Gramm-Leach-Bliley Act [note to this section].

(6) The term "bank" means (A) a banking institution organized under the laws of the United States or a Federal savings association, as defined in section 2(5) of the Home Owners' Loan Act [*12 USCS § 1462(5)*], (B) a member bank of the Federal Reserve System, (C) any other banking institution or savings association, as defined in section 2(4) of the Home Owners' Loan Act [*12 USCS § 1462(4)*], whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency pursuant to the first section of Public Law 87-722 (*12 U.S.C. 92a*), and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

(7) The term "director" means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.

(8) The term "issuer" means any person who issues or proposes to issue any security; except that with respect to certificates of deposit for securities, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is, or is to be, used.

(9) The term "person" means a natural person, company, government, or political subdivision, agency, or instrumentality of a government.

(10) The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim

certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

(11) The term "equity security" means any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

(12)

(A) The term "exempted security" or "exempted securities" includes--

(i) government securities, as defined in paragraph (42) of this subsection;

(ii) municipal securities, as defined in paragraph (29) of this subsection;

(iii) any interest or participation in any common trust fund or similar fund that is excluded from the definition of the term 'investment company' under section 3(c)(3) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(3)];

(iv) any interest or participation in a single trust fund, or a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation, or security is issued in connection with a qualified plan as defined in subparagraph (C) of this paragraph;

(v) any security issued by or any interest or participation in any pooled income fund, collective trust fund, collective investment fund, or similar fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(10)(B)];

(vi) solely for purposes of sections 12, 13, 14, and 16 of this title [15 USCS §§ 78l, 78m, 78n, and 78p], any security issued by or any interest or participation in any church plan, company, or account that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(14)]; and

(vii) such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this title which by their terms do not apply to an "exempted security" or to "exempted securities".

(B)

(i) Notwithstanding subparagraph (A)(i) of this paragraph, government securities shall not be deemed to be "exempted securities" for the purposes of section 17A of this title [15 USCS § 78q-1].

(ii) Notwithstanding subparagraph (A)(ii) of this paragraph, municipal securities shall not be deemed to be "exempted securities" for the purposes of sections 15 and 17A of this title [15 USCS §§ 78o, 78q-1].

(C) For purposes of subparagraph (A)(iv) of this paragraph, the term "qualified plan" means (i) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under *section 401 of the Internal Revenue Code of 1954* [Internal Revenue Code of 1986], (ii) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code, (iii) a governmental plan as defined in section 414(d) of such Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, or (iv) a church plan, company, or account that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(14)], other than any plan described in clause (i), (ii), or (iii) of this subparagraph which (I) covers employees some or all of whom are employees within the meaning of section 401(c) of such Code, or (II) is a plan funded by an annuity contract described in section 403(b) of such Code.

(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire. For security futures products, such term includes any contract, agreement, or transaction for future delivery.

(14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of. For security futures products, such term includes any contract, agreement, or transaction for future delivery.

(15) The term "Commission" means the Securities and Exchange Commission established by section 4 of this title [15 USCS § 78d].

(16) The term "State" means any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

(17) The term "interstate commerce" means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof. The term also includes intrastate use of (A) any facility of a national securities exchange or of a telephone or other interstate means of communication, or (B) any other interstate instrumentality.

(18) The term "person associated with a broker or dealer" or "associated person of a broker or dealer" means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of this title [15 USCS § 78o(b)] (other than paragraph (6) thereof).

(19) The terms "investment company", "affiliated person", "insurance company", "separate account", and "company" have the same meanings as in the Investment Company Act of 1940 [15 USCS §§ 80a-1 et seq.].

(20) The terms "investment adviser" and "underwriter" have the same meanings as in the Investment Advisers Act of 1940 [15 USCS §§ 80b-1 et seq.].

(21) The term "person associated with a member" or "associated person of a member" when used with respect to a member of a national securities exchange or registered securities association means any partner, officer, director, or branch manager of such member (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such member, or any employee of such member.

(22)

(A) The term "securities information processor" means any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security (other than an exempted security) or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis, information with respect to such transactions or quotations. The term "securities information processor" does not include any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation, any self-regulatory organization, any bank, broker, dealer, building and loan, savings and loan, or homestead association, or cooperative bank, if such bank, broker, dealer, association, or cooperative bank would be deemed to be a securities information processor solely by reason of functions performed by such institutions as part of customary banking, brokerage, dealing, association, or cooperative bank

activities, or any common carrier, as defined in section 3 of the Communications Act of 1934 [47 USCS § 153], subject to the jurisdiction of the Federal Communications Commission or a State commission, as defined in section 3 of that Act [47 USCS § 153], unless the Commission determines that such carrier is engaged in the business of collecting, processing, or preparing for distribution or publication, information with respect to transactions in or quotations for any security.

(B) The term "exclusive processor" means any securities information processor or self-regulatory organization which, directly or indirectly, engages on an exclusive basis on behalf of any national securities exchange or registered securities association, or any national securities exchange or registered securities association which engages on an exclusive basis on its own behalf, in collecting, processing, or preparing for distribution or publication any information with respect to (i) transactions or quotations on or effected or made by means of any facility of such exchange or (ii) quotations distributed or published by means of any electronic system operated or controlled by such association.

(23)

(A) The term "clearing agency" means any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities. Such term also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.

(B) The term "clearing agency" does not include (i) any Federal Reserve bank, Federal home loan bank, or Federal land bank; (ii) any national securities exchange or registered securities association solely by reason of its providing facilities for comparison of data respecting the terms of settlement of securities transactions effected on such exchange or by means of any electronic system operated or controlled by such association; (iii) any bank, broker, dealer, building and loan, savings and loan, or homestead association, or cooperative bank if such bank, broker, dealer, association, or cooperative bank would be deemed to be a clearing agency solely by reason of functions performed by such institution as part of customary banking, brokerage, dealing, association, or cooperative banking activities, or solely by reason of acting on behalf of a clearing agency or a participant therein in connection with the furnishing by the clearing agency of services to its participants or the use of services of the clearing agency by its participants, unless the Commission, by rule, otherwise provides as necessary or appropriate to assure the prompt and accurate clearance and settlement of securities transactions or to prevent evasion of this title; (iv) any life insurance company, its registered separate accounts, or a subsidiary of such insurance company solely by reason of functions commonly performed by such entities in connection with variable annuity contracts or variable life policies issued by such insurance company or its separate accounts; (v) any registered open-end investment company or unit investment trust solely by reason of functions commonly performed by it in connection with shares in such registered open-end investment company or unit investment trust, or (vi) any person solely by reason of its performing functions described in paragraph 25(E) of this subsection.

(24) The term "participant" when used with respect to a clearing agency means any person who uses a clearing agency to clear or settle securities transactions or to transfer, pledge, lend, or hypothecate securities. Such term does not include a person whose only use of a clearing agency is (A) through another person who is a participant or (B) as a pledgee of securities.

(25) The term "transfer agent" means any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (C) registering the transfer of such securities; (D) exchanging or converting such securities; or (E) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates. The term "transfer agent" does not include any insurance company or separate account which performs such functions solely with respect to variable annuity contracts or variable life policies which it issues or any registered clearing agency which performs such functions solely with respect to options contracts which it issues.

(26) The term "self-regulatory organization" means any national securities exchange, registered securities association, or registered clearing agency, or (solely for purposes of sections 19(b), 19(c), and 23(b) of this title [*15 USCS §§ 78s(b), (c), 78w(b)*]) the Municipal Securities Rulemaking Board established by section 15B of this title [*15 USCS § 78o-4*].

(27) The term "rules of an exchange", "rules of an association", or "rules of a clearing agency" means the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing, of an exchange, association of brokers and dealers, or clearing agency, respectively, and such of the stated policies, practices, and interpretations of such exchange, association, or clearing agency as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange, association, or clearing agency.

(28) The term "rules of a self-regulatory organization" means the rules of an exchange which is a national securities exchange, the rules of an association of brokers and dealers which is a registered securities association, the rules of a clearing agency which is a registered clearing agency, or the rules of the Municipal Securities Rulemaking Board.

(29) The term "municipal securities" means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in *section 103(c)(2) of the Internal Revenue Code of 1954*) the interest on which is excludable from gross income under section 103(a)(1) of such Code [*26 USCS § 103(a)(1)*] if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security.

(30) The term "municipal securities dealer" means any person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling municipal securities for his own account, through a

broker or otherwise, but does not include--

(A) any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business; or

(B) a bank, unless the bank is engaged in the business of buying and selling municipal securities for its own account other than in a fiduciary capacity, through a broker or otherwise: Provided, however, That if the bank is engaged in such business through a separately identifiable department or division (as defined by the Municipal Securities Rulemaking Board in accordance with section 15B(b)(2)(H) of this title [*15 USCS § 78o-4(b)(2)(H)*]), the department or division and not the bank itself shall be deemed to be the municipal securities dealer.

(31) The term "municipal securities broker" means a broker engaged in the business of effecting transactions in municipal securities for the account of others.

(32) The term "person associated with a municipal securities dealer" when used with respect to a municipal securities dealer which is a bank or a division or department of a bank means any person directly engaged in the management, direction, supervision, or performance of any of the municipal securities dealer's activities with respect to municipal securities, and any person directly or indirectly controlling such activities or controlled by the municipal securities dealer in connection with such activities.

(33) The term "municipal securities investment portfolio" means all municipal securities held for investment and not for sale as part of a regular business by a municipal securities dealer or by a person, directly or indirectly, controlling, controlled by, or under common control with a municipal securities dealer.

(34) The term "appropriate regulatory agency" means--

(A) When used with respect to a municipal securities dealer:

(i) the Comptroller of the Currency, in the case of a national bank, or a subsidiary or a department or division of any such bank;

(ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a subsidiary or a department or division thereof, a bank holding company, a subsidiary of a bank holding company which is a bank other than a bank specified in clause (i), (iii), or (iv) of this subparagraph, or a

subsidiary or a department or division of such subsidiary;

(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System), or a subsidiary or department or division thereof;

(iv) the Director of the Office of Thrift Supervision, in the case of a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act (*12 U.S.C. 1813(b)*)), the deposits of which are insured by the Federal Deposit Insurance Corporation, a subsidiary or a department or division of any such savings association, or a savings and loan holding company; and

(v) the Commission in the case of all other municipal securities dealers.

(B) When used with respect to a clearing agency or transfer agent:

(i) the Comptroller of the Currency, in the case of a national bank, or a subsidiary of any such bank;

(ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a subsidiary thereof, a bank holding company, or a subsidiary of a bank holding company which is a bank other than a bank specified in clause (i), (iii), or (iv) of this subparagraph;

(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System), or a subsidiary thereof;

(iv) the Director of the Office of Thrift Supervision, in the case of a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act (*12 U.S.C. 1813(b)*)), the deposits of which are insured by the Federal Deposit Insurance Corporation, or a subsidiary of any such savings association, or a savings and loan holding company; and

(v) the Commission in the case of all other clearing agencies and transfer agents.

(C) When used with respect to a participant or applicant to become a participant in a clearing agency or a person requesting or having access to services offered by a clearing agency:

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(i) the Comptroller of the Currency, in the case of a national bank when the appropriate regulatory agency for such clearing agency is not the Commission;

(ii) the Board of Governors of the Federal Reserve System in the case of a state member bank of the Federal Reserve System, a bank holding company, [or a subsidiary of a bank holding company,] or a subsidiary of a bank holding company which is a bank other than a bank specified in clause (i), (iii), or (iv) of this subparagraph when the appropriate regulatory agency for such clearing agency is not the Commission;

(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System) when the appropriate regulatory agency for such clearing agency is not the Commission;

(iv) the Director of the Office of Thrift Supervision, in the case of a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act (*12 U.S.C. 1813(b)*)), the deposits of which are insured by the Federal Deposit Insurance Corporation, a savings and loan holding company, or a subsidiary of a savings and loan holding company when the appropriate regulatory agency for such clearing agency is not the Commission; and

(v) the Commission in all other cases.

(D) When used with respect to an institutional investment manager which is a bank the deposits of which are insured in accordance with the Federal Deposit Insurance Act [*12 USCS §§ 1811 et seq.*]:

(i) the Comptroller of the Currency, in the case of a national bank;

(ii) the Board of Governors of the Federal Reserve System, in the case of any other member bank of the Federal Reserve System;

(iii) the Director of the Office of Thrift Supervision, in the case of a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act (*12 U.S.C. 1813(b)*)) the deposits of which are insured by the Federal Deposit Insurance Corporation; and

(iv) the Federal Deposit Insurance Corporation, in the case of any other insured bank.

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(E) When used with respect to a national securities exchange or registered securities association, member thereof, person associated with a member thereof, applicant to become a member thereof or to become associated with a member thereof, or person requesting or having access to services offered by such exchange or association or member thereof, or the Municipal Securities Rulemaking Board, the Commission.

(F) When used with respect to a person exercising investment discretion with respect to an account;[:]

(i) the Comptroller of the Currency, in the case of a national bank;

(ii) the Director of the Office of Thrift Supervision, in the case of a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act (*12 U.S.C. 1813(b)*)), the deposits of which are insured by the Federal Deposit Insurance Corporation; and

(iii) The Board of Governors of the Federal Reserve System in the case of any other member bank of the Federal Reserve System;

(iv) the Federal Deposit Insurance Corporation, in the case of any other bank the deposits of which are insured in accordance with the Federal Deposit Insurance Act [*12 USCS §§ 1811 et seq.*]; and

(v) the Commission in the case of all other such persons.

(G) When used with respect to a government securities broker or government securities dealer, or person associated with a government securities broker or government securities dealer:

(i) the Comptroller of the Currency, in the case of a national bank or a Federal branch or Federal agency of a foreign bank (as such terms are used in the International Banking Act of 1978);

(ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a foreign bank, an uninsured State branch or State agency of a foreign bank, a commercial lending company owned or controlled by a foreign bank (as such terms are used in the International Banking Act of 1978), or a corporation organized or having an agreement with the Board of Governors of the Federal Reserve System pursuant to section 25 or section 25A of the Federal Reserve Act [*12 USCS §§ 601 et seq.* or *§ 611*];

(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System or a Federal savings bank) or an insured State branch of a foreign bank (as such terms are used in the International Banking Act of 1978);

(iv) the Director of the Office of Thrift Supervision, in the case of a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act [*12 USCS § 1813(b)*]) the deposits of which are insured by the Federal Deposit Insurance Corporation; [and]

(v) the Commission, in the case of all other government securities brokers and government securities dealers.

(H) When used with respect to an institution described in subparagraph (D), (F), or (G) of section 2(c)(2) [*15 USCS § 78b(c)(2)*], or held under section 4(f) [*12 USCS § 1843(f)*], of the Bank Holding Company Act of 1956--

(i) the Comptroller of the Currency, in the case of a national bank;

(ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System or any corporation chartered under section 25A of the Federal Reserve Act [*12 USCS §§ 611 et seq.*];

(iii) the Federal Deposit Insurance Corporation, in the case of any other bank the deposits of which are insured in accordance with the Federal Deposit Insurance Act; or

(iv) the Commission in the case of all other such institutions.

As used in this paragraph, the terms "bank holding company" and "subsidiary of a bank holding company" have the meanings given them in section 2 of the Bank Holding Company Act of 1956 [*12 USCS § 1841*], and the term "District of Columbia savings and loan association" means any association subject to examination and supervision by the Office of Thrift Supervision under section 8 of the Home Owners' Loan Act of 1933 [*12 USCS § 1466a*]. As used in this paragraph, the term "savings and loan holding company" has the same meaning as in section 10(a) of the Home Owners' Loan Act (*12 U.S.C. 1467a(a)*).

(35) A person exercises "investment discretion" with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to

the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.

(36) A class of persons or markets is subject to "equal regulation" if no member of the class has a competitive advantage over any other member thereof resulting from a disparity in their regulation under this title which the Commission determines is unfair and not necessary or appropriate in furtherance of the purposes of this title.

(37) The term "records" means accounts, correspondence, memorandums, tapes, discs, papers, books, and other documents or transcribed information of any type, whether expressed in ordinary or machine language.

(38) The term "market maker" means any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.

(39) A person is subject to a "statutory disqualification" with respect to membership or participation in, or association with a member of, a self-regulatory organization, if such person--

(A) has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization, foreign equivalent of a self-regulatory organization, foreign or international securities exchange, contract market designated pursuant to section 5 of the Commodity Exchange Act (7 U.S.C. 7), or any substantially equivalent foreign statute or regulation, or futures association registered under section 17 of such Act (7 U.S.C. 21), or any substantially equivalent foreign statute or regulation, or has been and is denied trading privileges on any such contract market or foreign equivalent;

(B) is subject to--

(i) an order of the Commission, other appropriate regulatory agency, or foreign financial regulatory authority--

(I) denying, suspending for a period not exceeding 12 months, or revoking his registration as a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer or limiting his activities as a foreign person performing a function substantially equivalent to any of the above; or

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(II) barring or suspending for a period not exceeding 12 months his being associated with a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or foreign person performing a function substantially equivalent to any of the above;

(ii) an order of the Commodity Futures Trading Commission denying, suspending, or revoking his registration under the Commodity Exchange Act (7 *U.S.C. 1 et seq.*); or

(iii) an order by a foreign financial regulatory authority denying, suspending, or revoking the person's authority to engage in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof;

(C) by his conduct while associated with a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer, or while associated with an entity or person required to be registered under the Commodity Exchange Act [7 *USCS §§ 1 et seq.*], has been found to be a cause of any effective suspension, expulsion, or order of the character described in subparagraph (A) or (B) of this paragraph, and in entering such a suspension, expulsion, or order, the Commission, an appropriate regulatory agency, or any such self-regulatory organization shall have jurisdiction to find whether or not any person was a cause thereof;

(D) by his conduct while associated with any broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or any other entity engaged in transactions in securities, or while associated with an entity engaged in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof, has been found to be a cause of any effective suspension, expulsion, or order by a foreign or international securities exchange or foreign financial regulatory authority empowered by a foreign government to administer or enforce its laws relating to financial transactions as described in subparagraph (A) or (B) of this paragraph;

(E) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person described by subparagraph (A), (B), (C), or (D) of this paragraph; or

(F) has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (D), (E), (H), or (G) of paragraph (4) of section 15(b) of this title [15 *USCS § 78o(b)(4)(D), (E), (H), or (G)*], has been convicted of any offense specified in subparagraph (B) of such paragraph (4) [15 *USCS § 78o(b)(4)(B)*] or any other felony within ten years of the date of the filing of an application for membership or participation in, or to become associated with a member of, such self-regulatory organization, is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4) [15 *USCS § 78o(b)(4)(C)*], has willfully made or caused to be made in any application for membership or participation in, or to become associated with a member of, a self-regulatory organization, report required to be filed with a self-regulatory organization, or proceeding before a self-regulatory organization, any statement which was at the time, and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application, report, or proceeding any

material fact which is required to be stated therein.

(40) The term "financial responsibility rules" means the rules and regulations of the Commission or the rules and regulations prescribed by any self-regulatory organization relating to financial responsibility and related practices which are designated by the Commission, by rule or regulation, to be financial responsibility rules.

(41) The term "mortgage related security" means a security that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization, and either:

(A) represents ownership of one or more promissory notes or certificates of interest or participation in such notes (including any rights designed to assure servicing of, or the receipt or timeliness of receipt by the holders of such notes, certificates, or participations of amounts payable under, such notes, certificates, or participations), which notes:

(i) are directly secured by a first lien on a single parcel of real estate, including stock allocated to a dwelling unit in a residential cooperative housing corporation, upon which is located a dwelling or mixed residential and commercial structure, on a residential manufactured home as defined in section 603(6) of the National Manufactured Housing Construction and Safety Standards Act of 1974 [42 USCS § 5402(6)], whether such manufactured home is considered real or personal property under the laws of the State in which it is to be located, or on one or more parcels of real estate upon which is located one or more commercial structures; and

(ii) were originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections 203 and 211 of the National Housing Act [12 USCS §§ 1709, 1715b], or, where such notes involve a lien on the manufactured home, by any such institution or by any financial institution approved for insurance by the Secretary of Housing and Urban Development pursuant to section 2 of the National Housing Act [12 USCS § 1703]; or

(B) is secured by one or more promissory notes or certificates of interest or participations in such notes (with or without recourse to the issuer thereof) and, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, on notes meeting the requirements of subparagraphs (A)(i) and (ii) or certificates of interest or participations in promissory notes meeting such requirements.

For the purpose of this paragraph, the term "promissory note", when used in connection with a manufactured home, shall also include a loan, advance, or credit sale as evidence [evidenced] by a retail installment sales contract or other instrument.

(42) The term "government securities" means--

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(A) securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States;

(B) securities which are issued or guaranteed by the Tennessee Valley Authority or by corporations in which the United States has a direct or indirect interest and which are designated by the Secretary of the Treasury for exemption as necessary or appropriate in the public interest or for the protection of investors;

(C) securities issued or guaranteed as to principal or interest by any corporation the securities of which are designated, by statute specifically naming such corporation, to constitute exempt securities within the meaning of the laws administered by the Commission;

(D) for purposes of sections 15C and 17A [*15 USCS §§ 78o-5, 78q-1*], any put, call, straddle, option, or privilege on a security described in subparagraph (A), (B), or (C) other than a put, call, straddle, option, or privilege--

(i) that is traded on one or more national securities exchanges; or

(ii) for which quotations are disseminated through an automated quotation system operated by a registered securities association; or

(E) for purposes of sections 15, 15C, and 17A [*15 USCS §§ 78o, 78o-5, 78q-1*] as applied to a bank, a qualified Canadian government obligation as defined in section 5136 of the Revised Statutes of the United States [*12 USCS § 24*].

(43) The term "government securities broker" means any person regularly engaged in the business of effecting transactions in government securities for the account of others, but does not include--

(A) any corporation the securities of which are government securities under subparagraph (B) or (C) of paragraph (42) of this subsection; or

(B) any person registered with the Commodity Futures Trading Commission, any contract market designated by the Commodity Futures Trading Commission, such contract market's affiliated clearing organization, or any floor trader on such contract market, solely because such person effects transactions in government securities that the Commission, after consultation with the Commodity Futures Trading Commission, has determined by rule or order to be incidental to

such person's futures-related business.

(44) The term "government securities dealer" means any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise, but does not include--

(A) any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business;

(B) any corporation the securities of which are government securities under subparagraph (B) or (C) of paragraph (42) of this subsection;

(C) any bank, unless the bank is engaged in the business of buying and selling government securities for its own account other than in a fiduciary capacity, through a broker or otherwise; or

(D) any person registered with the Commodity Futures Trading Commission, any contract market designated by the Commodity Futures Trading Commission, such contract market's affiliated clearing organization, or any floor trader on such contract market, solely because such person effects transactions in government securities that the Commission, after consultation with the Commodity Futures Trading Commission, has determined by rule or order to be incidental to such person's futures-related business.

(45) The term "person associated with a government securities broker or government securities dealer" means any partner, officer, director, or branch manager of such government securities broker or government securities dealer (or any person occupying a similar status or performing similar functions), and any other employee of such government securities broker or government securities dealer who is engaged in the management, direction, supervision, or performance of any activities relating to government securities, and any person directly or indirectly controlling, controlled by, or under common control with such government securities broker or government securities dealer.

(46) The term "financial institution" means--

(A) a bank (as defined in paragraph (6) of this subsection);

(B) a foreign bank (as such term is used in the International Banking Act of 1978); and

(C) a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act [*12 USCS § 1813(b)*]) the deposits of which are insured by the Federal Deposit Insurance Corporation.

(47) The term "securities laws" means the Securities Act of 1933 (*15 U.S.C. 77a et seq.*), the Securities Exchange Act of 1934 (*15 U.S.C. 78a et seq.*), the Sarbanes-Oxley Act of 2002, the Public Utility Holding Company Act of 1935 (*15 U.S.C. 79a et seq.*), the Trust Indenture Act of 1939 (*15 U.S.C. 77aaa et seq.*), the Investment Company Act of 1940 (*15 U.S.C. 80a-1 et seq.*), the Investment Advisers Act of 1940 (*15 U.S.C. 80b et seq.*), and the Securities Investor Protection Act of 1970 (*15 U.S.C. 78aaa et seq.*).

(48) The term "registered broker or dealer" means a broker or dealer registered or required to register pursuant to section 15 or 15B of this title [*15 USCS § 78o or 78o-4*], except that in paragraph (3) of this subsection and sections 6 and 15A [*15 USCS §§ 78f, 78o-3*] the term means such a broker or dealer and a government securities broker or government securities dealer registered or required to register pursuant to section 15C(a)(1)(A) of this title [*15 USCS § 78o-5(a)(1)(A)*].

(49) The term "person associated with a transfer agent" and "associated person of a transfer agent" mean any person (except an employee whose functions are solely clerical or ministerial) directly engaged in the management, direction, supervision, or performance of any of the transfer agent's activities with respect to transfer agent functions, and any person directly or indirectly controlling such activities or controlled by the transfer agent in connection with such activities.

(50) The term "foreign securities authority" means any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

(51)

(A) The term "penny stock" means any equity security other than a security that is--

(i) registered or approved for registration and traded on a national securities exchange that meets such criteria as the Commission shall prescribe by rule or regulation for purposes of this paragraph;

(ii) authorized for quotation on an automated quotation system sponsored by a registered securities association, if such system (I) was established and in operation before January 1, 1990, and (II) meets such criteria as the Commission shall prescribe by rule or regulation for purposes of this paragraph;

(iii) issued by an investment company registered under the Investment Company Act of 1940 [15 USCS §§ 80b-1 *et seq.*];

(iv) excluded, on the basis of exceeding a minimum price, net tangible assets of the issuer, or other relevant criteria, from the definition of such term by rule or regulation which the Commission shall prescribe for purposes of this paragraph; or

(v) exempted, in whole or in part, conditionally or unconditionally, from the definition of such term by rule, regulation, or order prescribed by the Commission.

(B) The Commission may, by rule, regulation, or order, designate any equity security or class of equity securities described in clause (i) or (ii) of subparagraph (A) as within the meaning of the term "penny stock" if such security or class of securities is traded other than on a national securities exchange or through an automated quotation system described in clause (ii) of subparagraph (A).

(C) In exercising its authority under this paragraph to prescribe rules, regulations, and orders, the Commission shall determine that such rule, regulation, or order is consistent with the public interest and the protection of investors.

(52) The term "foreign financial regulatory authority" means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate participation of its members in activities listed above.

(53)

(A) The term "small business related security" means a security that is rated in 1 of the 4 highest rating categories by at least 1 nationally recognized statistical rating organization, and either--

(i) represents an interest in 1 or more promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution, insured credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or a finance company or leasing company; or

(ii) is secured by an interest in 1 or more promissory notes or leases of personal property (with or without recourse to the issuer or lessee) and provides for payments of principal in relation to payments, or reasonable projections of payments, on notes or leases described in clause (i).

(B) For purposes of this paragraph--

(i) an "interest in a promissory note or a lease of personal property" includes ownership rights, certificates of interest or participation in such notes or leases, and rights designed to assure servicing of such notes or leases, or the receipt or timely receipt of amounts payable under such notes or leases;

(ii) the term "small business concern" means a business that meets the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act [15 USCS § 632(a)];

(iii) the term "insured depository institution" has the same meaning as in section 3 of the Federal Deposit Insurance Act [12 USCS § 1813]; and

(iv) the term "insured credit union" has the same meaning as in section 101 of the Federal Credit Union Act [12 USCS § 1752].

(54) Qualified investor.

(A) Definition. Except as provided in subparagraph (B), for purposes of this title, the term "qualified investor" means--

(i) any investment company registered with the Commission under section 8 of the Investment Company Act of 1940 [15 USCS § 80a-8];

(ii) any issuer eligible for an exclusion from the definition of investment company pursuant to section 3(c)(7) of the Investment Company Act of 1940 [15 USCS § 80a-3];

(iii) any bank (as defined in paragraph (6) of this subsection), savings association (as defined in section 3(b) of the

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Federal Deposit Insurance Act [12 USCS § 1813(b)], broker, dealer, insurance company (as defined in section 2(a)(13) of the Securities Act of 1933 [15 USCS § 77b(a)(13)], or business development company (as defined in section 2(a)(48) of the Investment Company Act of 1940 [15 USCS § 80a-2(a)(48)]);

(iv) any small business investment company licensed by the United States Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958 [15 USCS § 681(c) or (d)];

(v) any State sponsored employee benefit plan, or any other employee benefit plan, within the meaning of the Employee Retirement Income Security Act of 1974, other than an individual retirement account, if the investment decisions are made by a plan fiduciary, as defined in section 3(21) of that Act [29 USCS § 1002(21)], which is either a bank, savings and loan association, insurance company, or registered investment adviser;

(vi) any trust whose purchases of securities are directed by a person described in clauses (i) through (v) of this subparagraph;

(vii) any market intermediary exempt under section 3(c)(2) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(2)];

(viii) any associated person of a broker or dealer other than a natural person;

(ix) any foreign bank (as defined in section 1(b)(7) of the International Banking Act of 1978 [12 USCS § 3101(7)]);

(x) the government of any foreign country;

(xi) any corporation, company, or partnership that owns and invests on a discretionary basis, not less than \$ 25,000,000 in investments;

(xii) any natural person who owns and invests on a discretionary basis, not less than \$ 25,000,000 in investments;

(xiii) any government or political subdivision, agency, or instrumentality of a government who owns and invests on a discretionary basis not less than \$ 50,000,000 in investments; or

(xiv) any multinational or supranational entity or any agency or instrumentality thereof.

(B) Altered thresholds for asset-backed securities and loan participations. For purposes of section 3(a)(5)(C)(iii) of this title [subsec. (a)(5)(C)(iii) of this section] and section 206(a)(5) of the Gramm-Leach-Bliley Act [note to this section], the term "qualified investor" has the meaning given such term by subparagraph (A) of this paragraph except that clauses (xi) and (xii) shall be applied by substituting "\$ 10,000,000" for "\$ 25,000,000".

(C) Additional authority. The Commission may, by rule or order, define a "qualified investor" as any other person, taking into consideration such factors as the financial sophistication of the person, net worth, and knowledge and experience in financial matters.

(55)

(A) The term "security future" means a contract of sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof, except an exempted security under section 3(a)(12) of the Securities Exchange Act of 1934 [subsec. (a)(12) of this section] as in effect on the date of enactment of the Futures Trading Act of 1982 [enacted Jan. 11, 1983] (other than any municipal security as defined in section 3(a)(29) [subsec. (a)(29) of this section] as in effect on the date of enactment of the Futures Trading Act of 1982 [enacted Jan. 11, 1983]). The term "security future" does not include any agreement, contract, or transaction excluded from the Commodity Exchange Act under section 2(c), 2(d), 2(f) or 2(g) of the Commodity Exchange Act [7 USCS § 2(c), (d), (f), or (g)] (as in effect on the date of enactment of the Commodity Futures Modernization Act of 2000 [enacted Dec. 21, 2000]) or title IV of the Commodity Futures Modernization Act of 2000 [7 USCS §§ 27 *et seq.*].

(B) The term "narrow-based security index" means an index--

(i) that has 9 or fewer component securities;

(ii) in which a component security comprises more than 30 percent of the index's weighting;

(iii) in which the 5 highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or

(iv) in which the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's

weighting have an aggregate dollar value of average daily trading volume of less than \$ 50,000,000 (or in the case of an index with 15 or more component securities, \$ 30,000,000), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security.

(C) Notwithstanding subparagraph (B), an index is not a narrow-based security index if--

(i)

(I) it has at least 9 component securities;

(II) no component security comprises more than 30 percent of the index's weighting; and

(III) each component security is--

(aa) registered pursuant to section 12 of the Securities Exchange Act of 1934 [*15 USCS § 78l*];

(bb) 1 of 750 securities with the largest market capitalization; and

(cc) 1 of 675 securities with the largest dollar value of average daily trading volume;

(ii) a board of trade was designated as a contract market by the Commodity Futures Trading Commission with respect to a contract of sale for future delivery on the index, before the date of enactment of the Commodity Futures Modernization Act of 2000 [enacted Dec. 21, 2000];

(iii)

(I) a contract of sale for future delivery on the index traded on a designated contract market or registered derivatives transaction execution facility for at least 30 days as a contract of sale for future delivery on an index that was not a narrow-based security index; and

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(II) it has been a narrow-based security index for no more than 45 business days over 3 consecutive calendar months;

(iv) a contract of sale for future delivery on the index is traded on or subject to the rules of a foreign board of trade and meets such requirements as are jointly established by rule or regulation by the Commission and the Commodity Futures Trading Commission;

(v) no more than 18 months have passed since the date of enactment of the Commodity Futures Modernization Act of 2000 [enacted Dec. 21, 2000] and--

(I) it is traded on or subject to the rules of a foreign board of trade;

(II) the offer and sale in the United States of a contract of sale for future delivery on the index was authorized before the date of the enactment of the Commodity Futures Modernization Act of 2000 [enacted Dec. 21, 2000]; and

(III) the conditions of such authorization continue to be met; or

(vi) a contract of sale for future delivery on the index is traded on or subject to the rules of a board of trade and meets such requirements as are jointly established by rule, regulation, or order by the Commission and the Commodity Futures Trading Commission.

(D) Within 1 year after the enactment of the Commodity Futures Modernization Act of 2000 [enacted Dec. 21, 2000], the Commission and the Commodity Futures Trading Commission jointly shall adopt rules or regulations that set forth the requirements under clause (iv) of subparagraph (C).

(E) An index that is a narrow-based security index solely because it was a narrow-based security index for more than 45 business days over 3 consecutive calendar months pursuant to clause (iii) of subparagraph (C) shall not be a narrow-based security index for the 3 following calendar months.

(F) For purposes of subparagraphs (B) and (C) of this paragraph--

(i) the dollar value of average daily trading volume and the market capitalization shall be calculated as of the preceding 6 full calendar months; and

(ii) the Commission and the Commodity Futures Trading Commission shall, by rule or regulation, jointly specify the method to be used to determine market capitalization and dollar value of average daily trading volume.

(56) The term "security futures product" means a security future or any put, call, straddle, option, or privilege on any security future.

(57)

(A) The term "margin", when used with respect to a security futures product, means the amount, type, and form of collateral required to secure any extension or maintenance of credit, or the amount, type, and form of collateral required as a performance bond related to the purchase, sale, or carrying of a security futures product.

(B) The terms "margin level" and "level of margin", when used with respect to a security futures product, mean the amount of margin required to secure any extension or maintenance of credit, or the amount of margin required as a performance bond related to the purchase, sale, or carrying of a security futures product.

(C) The terms "higher margin level" and "higher level of margin", when used with respect to a security futures product, mean a margin level established by a national securities exchange registered pursuant to section 6(g) [15 USCS § 78f(g)] that is higher than the minimum amount established and in effect pursuant to section 7(c)(2)(B) [15 USCS § 78g(c)(2)(B)].

(58) Audit committee. The term "audit committee" means--

(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and

(B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

(59) Registered public accounting firm. The term "registered public accounting firm" has the same meaning as in section 2 of the Sarbanes-Oxley Act of 2002 [15 USCS § 7201].

(60) Credit rating. The term "credit rating" means an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.

(61) Credit rating agency. The term "credit rating agency" means any person--

(A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company;

(B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and

(C) receiving fees from either issuers, investors, or other market participants, or a combination thereof.

(62) Nationally recognized statistical rating organization. The term "nationally recognized statistical rating organization" means a credit rating agency that--

(A) has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under section 15E [*15 USCS § 78o-7*];

(B) issues credit ratings certified by qualified institutional buyers, in accordance with section 15E(a)(1)(B)(ix) [*15 USCS § 78o-7(a)(1)(B)(ix)*], with respect to--

(i) financial institutions, brokers, or dealers;

(ii) insurance companies;

(iii) corporate issuers;

(iv) issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title 17, Code of

Federal Regulations, as in effect on the date of enactment of this paragraph);

(v) issuers of government securities, municipal securities, or securities issued by a foreign government; or

(vi) a combination of one or more categories of obligors described in any of clauses (i) through (v); and

(C) is registered under section 15E [*15 USCS § 78o-7*].

(63) Person associated with a nationally recognized statistical rating organization. The term "person associated with" a nationally recognized statistical rating organization means any partner, officer, director, or branch manager of a nationally recognized statistical rating organization (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with a nationally recognized statistical rating organization, or any employee of a nationally recognized statistical rating organization.

(64) Qualified institutional buyer. The term "qualified institutional buyer" has the meaning given such term in *section 230.144A(a) of title 17, Code of Federal Regulations*, or any successor thereto.

(b) Power to define technical, trade, accounting, and other terms. The Commission and the Board of Governors of the Federal Reserve System, as to matters within their respective jurisdictions, shall have power by rules and regulations to define technical, trade, accounting, and other terms used in this title, consistently with the provisions and purposes of this title.

(c) Application to governmental departments or agencies. No provision of this title shall apply to, or be deemed to include, any executive department or independent establishment of the United States, or any lending agency which is wholly owned, directly or indirectly, by the United States, or any officer, agent, or employee of any such department, establishment, or agency, acting in the course of his official duty as such, unless such provision makes specific reference to such department, establishment, or agency.

(d) Issuers of municipal securities. No issuer of municipal securities or officer or employee thereof acting in the course of his official duties as such shall be deemed to be a "broker", "dealer", or "municipal securities dealer" solely by reason of buying, selling, or effecting transactions in the issuer's securities.

(e) Charitable organizations.

(1) Exemption. Notwithstanding any other provision of this title, but subject to paragraph (2) of this subsection, a charitable organization, as defined in section 3(c)(10)(D) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(10)(D)], or any trustee, director, officer, employee, or volunteer of such a charitable organization acting within the scope of such person's employment or duties with such organization, shall not be deemed to be a "broker", "dealer", "municipal securities broker", "municipal securities dealer", "government securities broker", or "government securities dealer" for purposes of this title solely because such organization or person buys, holds, sells, or trades in securities for its own account in its capacity as trustee or administrator of, or otherwise on behalf of or for the account of--

(A) such a charitable organization;

(B) a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(10)(B)]; or

(C) a trust or other donative instrument described in section 3(c)(10)(B) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(10)(B)], or the settlors (or potential settlors) or beneficiaries of any such trust or other instrument.

(2) Limitation on compensation. The exemption provided under paragraph (1) shall not be available to any charitable organization, or any trustee, director, officer, employee, or volunteer of such a charitable organization, unless each person who, on or after 90 days after the date of enactment of this subsection [enacted Dec. 8, 1995], solicits donations on behalf of such charitable organization from any donor to a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(10)(B)], is either a volunteer or is engaged in the overall fund raising activities of a charitable organization and receives no commission or other special compensation based on the number or the value of donations collected for the fund.

(f) Consideration of promotion of efficiency, competition, and capital formation. Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

(g) Church plans. No church plan described in *section 414(e) of the Internal Revenue Code of 1986* [26 USCS § 414(e)], no person or entity eligible to establish and maintain such a plan under the Internal Revenue Code of 1986, no company or account that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(14)], and no trustee, director, officer or employee of or volunteer for such plan, company, account person, or entity, acting within the scope of that person's employment or activities with respect to such plan, shall be deemed to be a "broker", "dealer", "municipal securities broker", "municipal securities dealer", "government securities broker", "government securities dealer", "clearing agency", or "transfer agent" for purposes of

this title--

(1) solely because such plan, company, person, or entity buys, holds, sells, trades in, or transfers securities or acts as an intermediary in making payments in connection with transactions in securities for its own account in its capacity as trustee or administrator of, or otherwise on behalf of, or for the account of, any church plan, company, or account that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940 [*15 USCS § 80a-3(c)(14)*]; and

(2) if no such person or entity receives a commission or other transaction-related sales compensation in connection with any activities conducted in reliance on the exemption provided by this subsection.



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 4

§ 4 [15 USC § 78d] Securities and Exchange Commission

(a) Establishment; composition; limitations on commissioners; terms of office

There is hereby established a Securities and Exchange Commission (hereinafter referred to as the "Commission") to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate. Not more than three of such commissioners shall be members of the same political party, and in making appointments members of different political parties shall be appointed alternately as nearly as may be practicable. No commissioner shall engage in any other business, vocation, or employment than that of serving as commissioner, nor shall any commissioner participate, directly or indirectly, in any stock-market operations or transactions of a character subject to regulation by the Commission pursuant to this chapter. Each commissioner shall hold office for a term of five years and until his successor is appointed and has qualified, except that he shall not so continue to serve beyond the expiration of the next session of Congress subsequent to the expiration of said fixed term of office, and except (1) any commissioner appointed to fill a vacancy occurring prior to the expiration of the term for which his predecessor was appointed shall be appointed for the remainder of such term, and (2) the terms of office of the commissioners first taking office after June 6, 1934, shall expire as designated by the President at the time of nomination, one at the end of one year, one at the end of two years, one at the end of three years, one at the end of four years, and one at the end of five years, after June 6, 1934.

(b) Appointment and compensation of staff and leasing authority

(1) Appointment and compensation.--The Commission shall appoint and compensate officers, attorneys, economists, examiners, and other employees in accordance with *section 4802 of title 5, United States Code*.

(2) Reporting of information.--In establishing and adjusting schedules of compensation and benefits for officers, attorneys, economists, examiners, and other employees of the Commission under applicable provisions of law, the Commission shall inform the heads of the agencies referred to under section 1206 of the Financial Institutions Reform,

Recovery, and Enforcement Act of 1989 (*12 U.S.C. 1833b*) and Congress of such compensation and benefits and shall seek to maintain comparability with such agencies regarding compensation and benefits."

(3) Leasing authority.--Notwithstanding n1 any other provision of law, the Commission is authorized to enter directly into leases for real property for office, meeting, storage, and such other space as is necessary to carry out its functions, and shall be exempt from any General Services Administration space management regulations or directives.

(c) Acceptance of travel support for Commission activities from non-Federal sources; regulations

Notwithstanding any other provision of law, in accordance with regulations which the Commission shall prescribe to prevent conflicts of interest, the Commission may accept payment and reimbursement, in cash or in kind, from non-Federal agencies, organizations, and individuals for travel, subsistence, and other necessary expenses incurred by Commission members and employees in attending meetings and conferences concerning the functions or activities of the Commission. Any payment or reimbursement accepted shall be credited to the appropriated funds of the Commission. The amount of travel, subsistence, and other necessary expenses for members and employees paid or reimbursed under this subsection may exceed per diem amounts established in official travel regulations, but the Commission may include in its regulations under this subsection a limitation on such amounts.

(d) Acceptance of relocation expenses from former employers by professional fellows program participants

Notwithstanding any other provision of law, former employers of participants in the Commission's professional fellows programs may pay such participants their actual expenses for relocation to Washington, District of Columbia, to facilitate their participation in such programs, and program participants may accept such payments.

(e) Fee payments

Notwithstanding any other provision of law, whenever any fee is required to be paid to the Commission pursuant to any provision of the securities laws or any other law, the Commission may provide by rule that such fee shall be paid in a manner other than in cash.

(f) Reimbursement of expenses for assisting foreign securities authorities

Notwithstanding any other provision of law, the Commission may accept payment and reimbursement, in cash or in kind, from a foreign securities authority, or made on behalf of such authority, for necessary expenses incurred by the Commission, its members, and employees in carrying out any investigation pursuant to section 78u(a)(2) of this title or in providing any other assistance to a foreign securities authority. Any payment or reimbursement accepted shall be considered a reimbursement to the appropriated funds of the Commission.

FOOTNOTES:

(n313)Footnote 1. So in original. Probably should be "Notwithstanding".



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 9

§ 9 [15 USC § 78i] Manipulation of security prices

(a) Transactions relating to purchase or sale of security

It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange--

(1)

For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security, (A) to effect any transaction in such security which involves no change in the beneficial ownership thereof, or (B) to enter an order or orders for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (C) to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties.

(2)

To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange or in connection with any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

(3)

If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security, to induce the purchase or sale of any security registered on a national securities exchange or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security by the circulation or dissemination in the ordinary course of business of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(4)

If a dealer or broker, or the person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security, to make, regarding any security registered on a national securities exchange or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security, for the purpose of inducing the purchase or sale of such security or such security-based swap agreement, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.

(5)

For a consideration, received directly or indirectly from a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security, to induce the purchase of any security registered on a national securities exchange or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security by the circulation or dissemination of information to the effect that the price of any such security will or is likely to rise or fall because of the market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(6)

To effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) Transactions relating to puts, calls, straddles, or options

It shall be unlawful for any person to effect, by use of any facility of a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors--

(1)

any transaction in connection with any security whereby any party to such transaction acquires (A) any put, call, straddle, or other option or privilege of buying the security from or selling the security to another without being bound to do so; or (B) any security futures product on the security; or

(2)

any transaction in connection with any security with relation to which he has, directly or indirectly, any interest in any (A) such put, call, straddle, option, or privilege; or (B) such security futures product; or

(3)

any transaction in any security for the account of any person who he has reason to believe has, and who actually has, directly or indirectly, any interest in any (A) such put, call, straddle, option, or privilege; or (B) such security futures product with relation to such security.

(c) Endorsement or guarantee of puts, calls, straddles, or options

It shall be unlawful for any member of a national securities exchange directly or indirectly to endorse or guarantee the performance of any put, call, straddle, option, or privilege in relation to any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(d) Registered warrant, right, or convertible security not included in "put", "call", "straddle", or "option"

The terms "put", "call", "straddle", "option", or "privilege" as used in this section shall not include any registered warrant, right, or convertible security.

(e) Persons liable; suits at law or in equity

Any person who willfully participates in any act or transaction in violation of subsections (a), (b), or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of any such act or transaction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant. Every person who becomes liable to make any payment under this subsection may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment. No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.

(f) Subsection (a) not applicable to exempted securities

The provisions of subsection (a) of this section shall not apply to an exempted security.

(g) Foreign currencies

(1)

Notwithstanding any other provision of law, the Commission shall have the authority to regulate the trading of any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency (but not, with respect to any of the foregoing, an option on a contract for future delivery other than a security futures product).

(2)

Notwithstanding the Commodity Exchange Act, the Commission shall have the authority to regulate the trading of any security futures product to the extent provided in the securities laws.

(h) Limitations on practices that affect market volatility

It shall be unlawful for any person, by the use of the mails or any means or instrumentality of interstate commerce or of any facility of any national securities exchange, to use or employ any act or practice in connection with the purchase or sale of any equity security in contravention of such rules or regulations as the Commission may adopt, consistent with the public interest, the protection of investors, and the maintenance of fair and orderly markets--

(1)

to prescribe means reasonably designed to prevent manipulation of price levels of the equity securities market or a substantial segment thereof; and

(2)

to prohibit or constrain, during periods of extraordinary market volatility, any trading practice in connection with the purchase or sale of equity securities that the Commission determines (A) has previously contributed significantly to extraordinary levels of volatility that have threatened the maintenance of fair and orderly markets; and (B) is reasonably certain to engender such levels of volatility if not prohibited or constrained. In adopting rules under paragraph (2), the Commission shall, consistent with the purposes of this subsection, minimize the impact on the normal operations of the

market and a natural person's freedom to buy or sell any equity security.

(i) The authority of the Commission under this section with respect to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) shall be subject to the restrictions and limitations of section 3A(b) of this title.



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002-G Securities Enforcement: Counseling and Defense Section 10

§ 10 [15 USC § 78j] Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--

(a)

(1)

To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(2)

Paragraph (1) of this subsection shall not apply to security futures products.

(b)

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rules promulgated under subsection (b) that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading), and judicial precedents decided under subsection (b) and rules promulgated thereunder

that prohibit fraud, manipulation, or insider trading, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities. Judicial precedents decided under section 17(a) of the Securities Act of 1933 and sections 9, 15, 16, 20, and 21A of this title, and judicial precedents decided under applicable rules promulgated under such sections, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities.



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002-G Securities Enforcement: Counseling and Defense Section 10A

§ 10A [15 USC 78j-1] Audit requirements

(a) In General

Each audit required pursuant to this chapter of the financial statements of an issuer by a registered public accounting firm shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission--

(1)

procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

(2)

procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and

(3)

an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

(b) Required response to audit discoveries

(1)

Investigation and report to management

If, in the course of conducting an audit pursuant to this chapter to which subsection (a) of this section applies, the registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred, the firm shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission--

(A)

(i)

determine whether it is likely that an illegal act has occurred; and

(ii)

if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and

(B)

as soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential.

(2)

Response to failure to take remedial action

If, after determining that the audit committee of the board of directors of the issuer, or the board of directors of the issuer in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the firm in the course of the audit of such firm, the registered public accounting firm concludes that--

(A)

the illegal act has a material effect on the financial statements of the issuer;

(B)

the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and

(C)

the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement; the registered public accounting firm shall, as soon as practicable, directly report its conclusions to the Board of directors.

(3)

Notice to commission; response to failure to notify An issuer whose board of directors receives a report under paragraph (2) shall inform the Commission by notice not later than 1 business day after the receipt of such report and shall furnish the registered public accounting firm making such report with a copy of the notice furnished to the Commission. If the registered public accounting firm fails to receive a copy of the notice before the expiration of the required 1-business-day period, the registered public accounting firm shall--

(A)

resign from the engagement; or

(B)

furnish to the Commission a copy of its report (or the documentation of any oral report given) not later than 1 business day following such failure to receive notice.

(4)

Report after resignation

If a registered public accounting firm resigns from an engagement under paragraph (3)(A), the firm shall, not later than 1 business day following the failure by the issuer to notify the Commission under paragraph (3), furnish to the Commission a copy of the report of the firm (or the documentation of any oral report given).

(c) Auditor Liability Limitation

No registered public accounting firm shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b), including any rule promulgated pursuant

thereto.

(d) Civil Penalties in Cease-and-Desist Proceedings

If the Commission finds, after notice and opportunity for hearing in a proceeding instituted pursuant to section 21C, that a registered public accounting firm has willfully violated paragraph (3) or (4) of subsection (b), the Commission may, in addition to entering an order under section 21C, impose a civil penalty against the registered public accounting firm and any other person that the Commission finds was a cause of such violation. The determination to impose a civil penalty and the amount of the penalty shall be governed by the standards set forth in section 21B.

(e) Preservation of Existing Authority

Except as provided in subsection (d), nothing in this section shall be held to limit or otherwise affect the authority of the Commission under this title.

(f) Definitions

As used in this section, the term "illegal act" means an act or omission that violates any law, or any rule or regulation having the force of law. As used in this section, the term "issuer" means an issuer (as defined in section 3), the securities of which are registered under section 12, or that is required to file reports pursuant to section 15(d), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (*15 U.S.C. 77a et seq.*), and that it has not withdrawn.

(g) Prohibited Activities

Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the 'Board'), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including--

(1)

bookkeeping or other services related to the accounting records or financial statements of the audit client;

(2)

financial information systems design and implementation;

(3)

appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

(4)

actuarial services;

(5)

internal audit outsourcing services;

(6)

management functions or human resources;

(7)

broker or dealer, investment adviser, or investment banking services;

(8)

legal services and expert services unrelated to the audit; and

(9)

any other service that the Board determines, by regulation, is impermissible.

(h) Preapproval Required for Non-Audit Services

A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i).

(i) Preapproval Requirements

(1)

In general--

(A)

Audit committee action--All auditing services (which may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of State law) and non-audit services, other than as provided in subparagraph (B), provided to an issuer by the auditor of the issuer shall be preapproved by the audit committee of the issuer.

(B)

De minimus exception--The preapproval requirement under subparagraph (A) is waived with respect to the provision of non-audit services for an issuer, if--

(i)

the aggregate amount of all such non-audit services provided to the issuer constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the nonaudit services are provided;

(ii)

such services were not recognized by the issuer at the time of the engagement to be non-audit services; and

(iii)

such services are promptly brought to the attention of the audit committee of the issuer and approved prior to the completion of the audit by the audit committee or by 1 or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

(2)

Disclosure to investors--Approval by an audit committee of an issuer under this subsection of a non-audit service to be performed by the auditor of the issuer shall be disclosed to investors in periodic reports required by section 13(a).

(3)

Delegation authority--The audit committee of an issuer may delegate to 1 or more designated members of the audit committee who are independent directors of the board of directors, the authority to grant preapprovals required by this subsection. The decisions of any member to whom authority is delegated under this paragraph to preapprove an activity under this subsection shall be presented to the full audit committee at each of its scheduled meetings.

(4)

Approval of audit services for other purposes--In carrying out its duties under subsection (m)(2), if the audit committee of an issuer approves an audit service within the scope of the engagement of the auditor, such audit service shall be deemed to have been preapproved for purposes of this subsection.

(j) Audit Partner Rotation

It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.

(k) Reports to Audit Committees

Each registered public accounting firm that performs for any issuer any audit required by this title shall timely report to the audit committee of the issuer--

(1)

all critical accounting policies and practices to be used;

(2)

all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

(3)

other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

(l) Conflicts of Interest

It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.

(m) Standards Relating to Audit Committees

(1)

Commission rules.

(A)

In general--Effective not later than 270 days after the date of enactment of this subsection, the Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraphs (2) through (6).

(B)

Opportunity to cure defects--The rules of the Commission under subparagraph (A) shall provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for a prohibition under subparagraph (A), before the imposition of such prohibition.

(2)

Responsibilities relating to registered public accounting firms--The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.

(3)

Independence.

(A)

In general--Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

(B)

Criteria--In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee--

(i)

accept any consulting, advisory, or other compensatory fee from the issuer; or

(ii)

be an affiliated person of the issuer or any subsidiary thereof.

(C)

Exemption authority--The Commission may exempt from the requirements of subparagraph (B) a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.

(4)

Complaints--Each audit committee shall establish procedures for--

(A)

the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

(B)

the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

(5)

Authority to engage advisers--Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

(6)

Funding--Each issuer shall provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation--

(A) to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report; and

(B) to any advisers employed by the audit committee under paragraph (5).



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Securities Enforcement: Counseling and Defense

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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 12

§ 12 [15 USC § 78I] Registration requirements for securities

(a) General requirement of registration. It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of this title and the rules and regulations thereunder. The provisions of this subsection shall not apply in respect of a security futures product traded on a national securities exchange.

(b) Procedure for registration; information. A security may be registered on a national securities exchange by the issuer filing an application with the exchange (and filing with the Commission such duplicate originals thereof as the Commission may require), which application shall contain--

(1) Such information, in such detail, as to the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer, and any guarantor of the security as to principal or interest or both, as the Commission may by rules and regulations require, as necessary or appropriate in the public interest or for the protection of investors, in respect of the following:

(A) the organization, financial structure and nature of the business;

(B) the terms, position, rights, and privileges of the different classes of securities outstanding;

(C) the terms on which their securities are to be, and during the preceding three years have been, offered to the public or otherwise;

(D) the directors, officers, and underwriters, and each security holder of record holding more than 10 per centum of any class of any equity security of the issuer (other than an exempted security), their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer;

(E) remuneration to others than directors and officers exceeding \$ 20,000 per annum;

(F) bonus and profit-sharing arrangements;

(G) management and service contracts;

(H) options existing or to be created in respect of their securities;

(I) material contracts, not made in the ordinary course of business, which are to be executed in whole or in part at or after the filing of the application or which were made not more than two years before such filing, and every material patent or contract for a material patent right shall be deemed a material contract;

(J) balance sheets for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by a registered public accounting firm;

(K) profit and loss statements for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by a registered public accounting firm; and

(L) any further financial statement which the Commission may deem necessary or appropriate for the protection of investors.

(2) Such copies of articles of incorporation, bylaws, trust indentures, or corresponding documents by whatever name known, underwriting arrangements, and other similar documents of, and voting trust agreements with respect to, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer as the Commission may require as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security.

(3) Such copies of material contracts, referred to in paragraph (1)(I) above, as the Commission may require as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security.

(c) Additional or alternative information. If in the judgment of the Commission any information required under subsection (b) is inapplicable to any specified class or classes of issuers, the Commission shall require in lieu thereof the submission of such other information of comparable character as it may deem applicable to such class of issuers.

(d) Effective date of registration; withdrawal of registration. If the exchange authorities certify to the Commission that the security has been approved by the exchange for listing and registration, the registration shall become effective thirty days after the receipt of such certification by the Commission or within such shorter period of time as the Commission may determine. A security registered with a national securities exchange may be withdrawn or stricken from listing and registration in accordance with the rules of the exchange and, upon such terms as the Commission may deem necessary to impose for the protection of investors, upon application by the issuer or the exchange to the Commission; whereupon the issuer shall be relieved from further compliance with the provisions of this section and section 13 of this title [*15 USCS § 78m*] and any rules or regulations under such sections as to the securities so withdrawn or stricken. An unissued security may be registered only in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(e) Exemption from provisions of section for period ending not later than July 1, 1935. Notwithstanding the foregoing provisions of this section, the Commission may by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors permit securities listed on any exchange at the time the registration of such exchange as a national securities exchange becomes effective, to be registered for a period ending not later than July 1, 1935, without complying with the provisions of this section.

(f) Unlisted trading privileges for security originally listed on another national exchange.

(1)

(A) Notwithstanding the preceding subsections of this section, any national securities exchange, in accordance with the requirements of this subsection and the rules hereunder, may extend unlisted trading privileges to--

(i) any security that is listed and registered on a national securities exchange, subject to subparagraph (B); and

(ii) any security that is otherwise registered pursuant to this section, or that would be required to be so registered except for the exemption from registration provided in subparagraph (B) or (G) of subsection (g)(2), subject to

subparagraph (E) of this paragraph.

(B) A national securities exchange may not extend unlisted trading privileges to a security described in subparagraph (A)(i) during such interval, if any, after the commencement of an initial public offering of such security, as is or may be required pursuant to subparagraph (C).

(C) Not later than 180 days after the date of enactment of the Unlisted Trading Privileges Act of 1994 [enacted Oct. 22, 1994], the Commission shall prescribe, by rule or regulation, the duration of the interval referred to in subparagraph (B), if any, as the Commission determines to be necessary or appropriate for the maintenance of fair and orderly markets, the protection of investors and the public interest, or otherwise in furtherance of the purposes of this title. Until the earlier of the effective date of such rule or regulation or 240 days after such date of enactment, such interval shall begin at the opening of trading on the day on which such security commences trading on the national securities exchange with which such security is registered and end at the conclusion of the next day of trading.

(D) The Commission may prescribe, by rule or regulation such additional procedures or requirements for extending unlisted trading privileges to any security as the Commission deems necessary or appropriate for the maintenance of fair and orderly markets, the protection of investors and the public interest, or otherwise in furtherance of the purposes of this title.

(E) No extension of unlisted trading privileges to securities described in subparagraph (A)(ii) may occur except pursuant to a rule, regulation, or order of the Commission approving such extension or extensions. In promulgating such rule or regulation or in issuing such order, the Commission--

(i) shall find that such extension or extensions of unlisted trading privileges is consistent with the maintenance of fair and orderly markets, the protection of investors and the public interest, and otherwise in furtherance of the purposes of this title;

(ii) shall take account of the public trading activity in such securities, the character of such trading, the impact of such extension on the existing markets for such securities, and the desirability of removing impediments to and the progress that has been made toward the development of a national market system; and

(iii) shall not permit a national securities exchange to extend unlisted trading privileges to such securities if any rule of such national securities exchange would unreasonably impair the ability of a dealer to solicit or effect transactions in such securities for its own account, or would unreasonably restrict competition among dealers in such securities or between such dealers acting in the capacity of market makers who are specialists and such dealers who are not specialists.

(F) An exchange may continue to extend unlisted trading privileges in accordance with this paragraph only if the exchange and the subject security continue to satisfy the requirements for eligibility under this paragraph, including any rules and regulations issued by the Commission pursuant to this paragraph, except that unlisted trading privileges may continue with regard to securities which had been admitted on such exchange prior to July 1, 1964, notwithstanding the failure to satisfy such requirements. If unlisted trading privileges in a security are discontinued pursuant to this subparagraph, the exchange shall cease trading in that security, unless the exchange and the subject security thereafter satisfy the requirements of this paragraph and the rules issued hereunder.

(G) For purposes of this paragraph--

(i) a security is the subject of an initial public offering if--

(I) the offering of the subject security is registered under the Securities Act of 1933 [*15 USCS §§ 77a et seq.*]; and

(II) the issuer of the security, immediately prior to filing the registration statement with respect to the offering, was not subject to the reporting requirements of section 13 or 15(d) of this title [*15 USCS § 78m or 78o(d)*]; and

(ii) an initial public offering of such security commences at the opening of trading on the day on which such security commences trading on the national securities exchange with which such security is registered.

(2)

(A) At any time within 60 days of commencement of trading on an exchange of a security pursuant to unlisted trading privileges, the Commission may summarily suspend such unlisted trading privileges on the exchange. Such suspension shall not be reviewable under section 25 of this title [*15 USCS § 78y*] and shall not be deemed to be a final agency action for purposes of *section 704 of title 5, United States Code*. Upon such suspension--

(i) the exchange shall cease trading in the security by the close of business on the date of such suspension, or at such time as the Commission may prescribe by rule or order for the maintenance of fair and orderly markets, the protection of investors and the public interest, or otherwise in furtherance of the purposes of this title; and

(ii) if the exchange seeks to extend unlisted trading privileges to the security, the exchange shall file an

application to reinstate its ability to do so with the Commission pursuant to such procedures as the Commission may prescribe by rule or order for the maintenance of fair and orderly markets, the protection of investors and the public interest, or otherwise in furtherance of the purposes of this title.

(B) A suspension under subparagraph (A) shall remain in effect until the Commission, by order, grants approval of an application to reinstate, as described in subparagraph (A)(ii).

(C) A suspension under subparagraph (A) shall not affect the validity or force of an extension of unlisted trading privileges in effect prior to such suspension.

(D) The Commission shall not approve an application by a national securities exchange to reinstate its ability to extend unlisted trading privileges to a security unless the Commission finds, after notice and opportunity for hearing, that the extension of unlisted trading privileges pursuant to such application is consistent with the maintenance of fair and orderly markets, the protection of investors and the public interest, and otherwise in furtherance of the purposes of this title. If the application is made to reinstate unlisted trading privileges to a security described in paragraph (1)(A)(ii), the Commission--

(i) shall take account of the public trading activity in such security, the character of such trading, the impact of such extension on the existing markets for such a security, and the desirability of removing impediments to and the progress that has been made toward the development of a national market system; and

(ii) shall not grant any such application if any rule of the national securities exchange making application under this subsection would unreasonably impair the ability of a dealer to solicit or effect transactions in such security for its own account, or would unreasonably restrict competition among dealers in such security or between such dealers acting in the capacity of marketmakers who are specialists and such dealers who are not specialists.

(3) Notwithstanding paragraph (2), the Commission shall by rules and regulations suspend unlisted trading privileges in whole or in part for any or all classes of securities for a period not exceeding twelve months, if it deems such suspension necessary or appropriate in the public interest or for the protection of investors or to prevent evasion of the purposes of this title.

(4) On the application of the issuer of any security for which unlisted trading privileges on any exchange have been continued or extended pursuant to this subsection, or of any broker or dealer who makes or creates a market for such security, or of any other person having a bona fide interest in the question of termination or suspension of such unlisted trading privileges, or on its own motion, the Commission shall by order terminate, or suspend for a period not exceeding twelve months, such unlisted trading privileges for such security if the Commission finds, after appropriate notice and opportunity for hearing, that such termination or suspension is necessary or appropriate in the public interest

or for the protection of investors.

(5) In any proceeding under this subsection in which appropriate notice and opportunity for hearing are required, notice of not less than ten days to the applicant in such proceeding, to the issuer of the security involved, to the exchange which is seeking to continue or extend or has continued or extended unlisted trading privileges for such security, and to the exchange, if any, on which such security is listed and registered, shall be deemed adequate notice, and any broker or dealer who makes or creates a market for such security, and any other person having a bona fide interest in such proceeding, shall upon application be entitled to be heard.

(6) Any security for which unlisted trading privileges are continued or extended pursuant to this subsection shall be deemed to be registered on a national securities exchange within the meaning of this title. The powers and duties of the Commission under this title shall be applicable to the rules of an exchange in respect of any such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions, or for stated periods, exempt such securities from the operation of any provision of section 13, 14, or 16 of this title [*15 USCS §§ 78m, 78n, 78p*].

(g) Registration of securities by issuer; exemptions.

(1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall--

(A) within one hundred and twenty days after the last day of its first fiscal year ended after the effective date of this subsection on which the issuer has total assets exceeding \$ 1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and

(B) within one hundred and twenty days after the last day of its first fiscal year ended after two years from the effective date of this subsection on which the issuer has total assets exceeding \$ 1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons, register such security by filing with the Commission a registration statement (and such copies thereof as the Commission may require) with respect to such security containing such information and documents as the Commission may specify comparable to that which is required in an application to register a security pursuant to subsection (b) of this section. Each such registration statement shall become effective sixty days after filing with the Commission or within such shorter period as the Commission may direct. Until such registration statement becomes effective it shall not be deemed filed for the purposes of section 18 of this title [*15 USCS § 78r*]. Any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. The Commission is authorized to extend the date upon which any issuer or class of issuers is required to register a security pursuant to the provisions of this paragraph.

(2) The provisions of this subsection shall not apply in respect of--

(A) any security listed and registered on a national securities exchange.

(B) any security issued by an investment company registered pursuant to section 8 of the Investment Company Act of 1940 [15 USCS § 80a-8].

(C) any security, other than permanent stock, guaranty stock, permanent reserve stock, or any similar certificate evidencing nonwithdrawable capital, issued by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution.

(D) any security of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any private shareholder or individual; or any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(10)(B)].

(E) any security of an issuer which is a "cooperative association" as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended [12 USCS §§ 1141 *et seq.*], or a federation of such cooperative associations, if such federation possesses no greater powers or purposes than cooperative associations so defined.

(F) any security issued by a mutual or cooperative organization which supplies a commodity or service primarily for the benefit of its members and operates not for pecuniary profit, but only if the security is part of a class issuable only to persons who purchase commodities or services from the issuer, the security is transferable only to a successor in interest or occupancy of premises serviced or to be served by the issuer, and no dividends are payable to the holder of the security.

(G) any security issued by an insurance company if all of the following conditions are met:

(i) Such insurance company is required to and does file an annual statement with the Commissioner of Insurance (or other officer or agency performing a similar function) of its domiciliary State, and such annual statement conforms to that prescribed by the National Association of Insurance Commissioners or in the determination of such State commissioner, officer or agency substantially conforms to that so prescribed.

(ii) Such insurance company is subject to regulation by its domiciliary State of proxies, consents, or authorizations in respect of securities issued by such company and such regulation conforms to that prescribed by the National Association of Insurance Commissioners.

(iii) After July 1, 1966, the purchase and sales of securities issued by such insurance company by beneficial owners, directors, or officers of such company are subject to regulation (including reporting) by its domiciliary State substantially in the manner provided in section 16 of this title [15 USCS § 78p].

(H) any interest or participation in any collective trust funds maintained by a bank or in a separate account maintained by an insurance company which interest or participation is issued in connection with (i) a stock-bonus, pension, or profit-sharing plan which meets the requirements for qualification under *section 401 of the Internal Revenue Code of 1954* [26 USCS § 401], (ii) an annuity plan which meets the requirements for deduction of the employer's contribution under section 404(a)(2) of such Code [26 USCS § 404(a)(2)], or (iii) a church plan, company, or account that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(14)].

(3) The Commission may by rules or regulations or, on its own motion, after notice and opportunity for hearing, by order, exempt from this subsection any security of a foreign issuer, including any certificate of deposit for such a security, if the Commission finds that such exemption is in the public interest and is consistent with the protection of investors.

(4) Registration of any class of security pursuant to this subsection shall be terminated ninety days, or such shorter period as the Commission may determine, after the issuer files a certification with the Commission that the number of holders of record of such class of security is reduced to less than three hundred persons. The Commission shall after notice and opportunity for hearing deny termination of registration if it finds that the certification is untrue. Termination of registration shall be deferred pending final determination on the question of denial.

(5) For the purposes of this subsection the term "class" shall include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. The Commission may for the purpose of this subsection define by rules and regulations the terms "total assets" and "held of record" as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection. For purposes of this subsection, a security futures product shall not be considered a class of equity security of the issuer of the securities underlying the security futures product.

(h) Exemption by rules and regulations from certain provisions of section. The Commission may by rules and regulations, or upon application of an interested person, by order, after notice and opportunity for hearing, exempt in whole or in part any issuer or class of issuers from the provisions of subsection (g) of this section or from section 13, 14, or 15(d) [15 USCS § 78m, 78n, or 78o(d)] or may exempt from section 16 [15 USCS § 78p] any officer, director, or

beneficial owner of securities of any issuer, any security of which is required to be registered pursuant to subsection (g) hereof, upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors. The Commission may, for the purposes of any of the above-mentioned sections or subsections of this title, classify issuers and prescribe requirements appropriate for each such class.

(i) Securities issued by banks. In respect of any securities issued by banks and savings associations and deposits of which are insured in accordance with the Federal Deposit Insurance Act [12 USCS §§ 1811 *et seq.*], the powers, functions, and duties vested in the Commission to administer and enforce sections 10A(m), 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of this Act [15 USCS §§ 78j-1(m), 78l, 78m, 78n(a), (c), (d), (f), and 78p], and sections 302, 303, 304, 306, 401(b), 404, 406, and 407 of the Sarbanes-Oxley Act of 2002 [15 USCS §§ 7241, 7242, 7243, 7244, 7261(b), 7262, 7264, and 7265], (1) with respect to national banks are vested in the Comptroller of the Currency, (2) with respect to all other member banks of the Federal Reserve System are vested in the Board of Governors of the Federal Reserve System, (3) with respect to all other insured banks are vested in the Federal Deposit Insurance Corporation, and (4) with respect to savings associations the accounts of which are insured by the Federal Deposit Insurance Corporation are vested in the Office of Thrift Supervision. The Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision shall have the power to make such rules and regulations as may be necessary for the execution of the functions vested in them as provided in this subsection. In carrying out their responsibilities under this subsection, the agencies named in the first sentence of this subsection shall issue substantially similar regulations to regulations and rules issued by the Commission under sections 10A(m), 12, 13, 14(a), 14(c), 14(d), 14(f) and 16 of this Act [15 USCS §§ 78j-1(m), 78l, 78m, 78n(a), (c), (d), (f), and 78p], and sections 302, 303, 304, 306, 401(b), 404, 406, and 407 of the Sarbanes-Oxley Act of 2002 [15 USCS §§ 7241, 7242, 7243, 7244, 7261(b), 7262, 7264, and 7265], unless they find that implementation of substantially similar regulations with respect to insured banks and insured institutions are not necessary or appropriate in the public interest or for protection of investors, and publish such findings, and the detailed reasons therefor, in the Federal Register. Such regulations of the above-named agencies, or the reasons for failure to publish such substantially similar regulations to those of the Commission, shall be published in the Federal Register within 120 days of the date of enactment of this subsection, and, thereafter, within 60 days of any changes made by the Commission in its relevant regulations and rules.

(j) Denial, suspension, or revocation of registration; notice and hearing. The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

(k) Trading suspensions; emergency authority.

(1) Trading suspensions. If in its opinion the public interest and the protection of investors so require, the Commission

is authorized by order--

(A) summarily to suspend trading in any security (other than an exempted security) for a period not exceeding 10 business days, and

(B) summarily to suspend all trading on any national securities exchange or otherwise, in securities other than exempted securities, for a period not exceeding 90 calendar days.

The action described in subparagraph (B) shall not take effect unless the Commission notifies the President of its decision and the President notifies the Commission that the President does not disapprove of such decision. If the actions described in subparagraph (A) or (B) involve a security futures product, the Commission shall consult with and consider the views of the Commodity Futures Trading Commission.

(2) Emergency orders.

(A) In general. The Commission, in an emergency, may by order summarily take such action to alter, supplement, suspend, or impose requirements or restrictions with respect to any matter or action subject to regulation by the Commission or a self-regulatory organization under the securities laws, as the Commission determines is necessary in the public interest and for the protection of investors--

(i) to maintain or restore fair and orderly securities markets (other than markets in exempted securities);

(ii) to ensure prompt, accurate, and safe clearance and settlement of transactions in securities (other than exempted securities); or

(iii) to reduce, eliminate, or prevent the substantial disruption by the emergency of--

(I) securities markets (other than markets in exempted securities), investment companies, or any other significant portion or segment of such markets; or

(II) the transmission or processing of securities transactions (other than transactions in exempted securities).

(B) Effective period. An order of the Commission under this paragraph shall continue in effect for the period specified by the Commission, and may be extended. Except as provided in subparagraph (C), an order of the Commission under this paragraph may not continue in effect for more than 10 business days, including extensions.

(C) Extension. An order of the Commission under this paragraph may be extended to continue in effect for more than 10 business days if, at the time of the extension, the Commission finds that the emergency still exists and determines that the continuation of the order beyond 10 business days is necessary in the public interest and for the protection of investors to attain an objective described in clause (i), (ii), or (iii) of subparagraph (A). In no event shall an order of the Commission under this paragraph continue in effect for more than 30 calendar days.

(D) Security futures. If the actions described in subparagraph (A) involve a security futures product, the Commission shall consult with and consider the views of the Commodity Futures Trading Commission.

(E) Exemption. In exercising its authority under this paragraph, the Commission shall not be required to comply with the provisions of--

(i) section 19(c) [*15 USCS § 78s(c)*]; or

(ii) *section 553 of title 5, United States Code.*

(3) Termination of emergency actions by President. The President may direct that action taken by the Commission under paragraph (1)(B) or paragraph (2) of this subsection shall not continue in effect.

(4) Compliance with orders. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security in contravention of an order of the Commission under this subsection unless such order has been stayed, modified, or set aside as provided in paragraph (5) of this subsection or has ceased to be effective upon direction of the President as provided in paragraph (3).

(5) Limitations on review of orders. An order of the Commission pursuant to this subsection shall be subject to review only as provided in section 25(a) of this title [*15 USCS § 78y(a)*]. Review shall be based on an examination of all the information before the Commission at the time such order was issued. The reviewing court shall not enter a stay, writ of mandamus, or similar relief unless the court finds, after notice and hearing before a panel of the court, that the Commission's action is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.

(6) Consultation. Prior to taking any action described in paragraph (1)(B), the Commission shall consult with and consider the views of the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, and the Commodity Futures Trading Commission, unless such consultation is impracticable in light of the emergency.

(7) Definitions. For purposes of this subsection--

(A) the term "emergency" means--

(i) a major market disturbance characterized by or constituting--

(I) sudden and excessive fluctuations of securities prices generally, or a substantial threat thereof, that threaten fair and orderly markets; or

(II) a substantial disruption of the safe or efficient operation of the national system for clearance and settlement of transactions in securities, or a substantial threat thereof; or

(ii) a major disturbance that substantially disrupts, or threatens to substantially disrupt--

(I) the functioning of securities markets, investment companies, or any other significant portion or segment of the securities markets; or

(II) the transmission or processing of securities transactions; and

(B) notwithstanding section 3(a)(47) [*15 USCS § 78c(a)(47)*], the term "securities laws" does not include the Public Utility Holding Company Act of 1935 [*15 USCS §§ 79 et seq.*].

(I) Issuance of any security in contravention of rules and regulations; application to annuity contracts and variable life policies. It shall be unlawful for an issuer, any class of whose securities is registered pursuant to this section or would be required to be so registered except for the exemption from registration provided by subsection (g)(2)(B) or (g)(2)(G) of this section, by the use of any means or instrumentality of interstate commerce, or of the mails, to issue, either originally or upon transfer, any of such securities in a form or with a format which contravenes such rules and

regulations as the Commission may prescribe as necessary or appropriate for the prompt and accurate clearance and settlement of transactions in securities. The provisions of this subsection shall not apply to variable annuity contracts or variable life policies issued by an insurance company or its separate accounts.



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Securities Enforcement: Counseling and Defense

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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 13

§ 13 [15 USC § 78m] Periodical and other reports

(a) Reports by issuer of security; contents

Every issuer of a security registered pursuant to section 781 of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security--

(1) such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 781 of this title, except that the Commission may not require the filing of any material contract wholly executed before July 1, 1962.

(2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe. Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange.

(b) Form of report; books, records, and internal accounting; directives

(1) The Commission may prescribe, in regard to reports made pursuant to this chapter, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or

desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; but in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter (except that such rules and regulations of the Commission may be inconsistent with such requirements to the extent that the Commission determines that the public interest or the protection of investors so requires).

(2) Every issuer which has a class of securities registered pursuant to section 78l of this title and every issuer which is required to file reports pursuant to section 78o(d) of this title shall--

(A)

make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(B)

devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that--

(i)

transactions are executed in accordance with management's general or specific authorization;

(ii)

transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii)

access to assets is permitted only in accordance with management's general or specific authorization; and

(iv)

the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences; and

(C)

notwithstanding any other provision of law, pay the allocable share of such issuer of a reasonable annual accounting support fee or fees, determined in accordance with section 109 of the Sarbanes-Oxley Act of 2002.

(3)

(A)

With respect to matters concerning the national security of the United States, no duty or liability under paragraph (2) of this subsection shall be imposed upon any person acting in cooperation with the head of any Federal department or agency responsible for such matters if such act in cooperation with such head of a department or agency was done upon the specific, written directive of the head of such department or agency pursuant to Presidential authority to issue such directives. Each directive issued under this paragraph shall set forth the specific facts and circumstances with respect to which the provisions of this paragraph are to be invoked. Each such directive shall, unless renewed in writing, expire one year after the date of issuance.

(B)

Each head of a Federal department or agency of the United States who issues a directive pursuant to this paragraph shall maintain a complete file of all such directives and shall, on October 1 of each year, transmit a summary of matters covered by such directives in force at any time during the previous year to the Permanent Select Committee on Intelligence of the House of Representatives and the Select Committee on Intelligence of the Senate.

(4)

No criminal liability shall be imposed for failing to comply with the requirements of paragraph (2) of this subsection except as provided in paragraph (5) of this subsection.

(5)

No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in paragraph (2).

(6)

Where an issuer which has a class of securities registered pursuant to section 78l of this title or an issuer which is required to file reports pursuant to section 78o(d) of this title holds 50 per centum or less of the voting power with respect to domestic or foreign firm, the provisions of paragraph (2) require only that the issuer proceed in good faith to use its influence, to the extent reasonable under the issuer's circumstances, to cause such domestic or foreign firm to

devise and maintain a system of internal accounting controls consistent with paragraph (2). Such circumstances include the relative degree of the issuer's ownership of the domestic or foreign firm and the laws and practices governing the business operations of the country in which such firm is located. An issuer which demonstrates good faith efforts to use such influence shall be conclusively presumed to have complied with the requirements of paragraph (2).

(7)

For the purpose of paragraph (2) of this subsection, the terms "reasonable assurances" and "reasonable detail" mean such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.

(c) Alternative reports

If in the judgment of the Commission any report required under subsection (a) of this section is inapplicable to any specified class or classes of issuers, the Commission shall require in lieu thereof the submission of such reports of comparable character as it may deem applicable to such class or classes of issuers.

(d) Reports by persons acquiring more than five per centum of certain classes of securities

(1)

Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 781 of this title, or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in section 781(g)(2)(G) of this title, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.] or any equity security issued by a Native Corporation pursuant to section 1629c(d)(6) of title 43, is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement containing such of the following information, and such additional information, as the Commission may by rules and regulations, prescribe as necessary or appropriate in the public interest or for the protection of investors--

(A)

the background, and identity, residence, and citizenship of, and the nature of such beneficial ownership by, such person and all other persons by whom or on whose behalf the purchases have been or are to be effected;

(B)

the source and amount of the funds or other consideration used or to be used in making the purchases, and if any part of the purchase price is represented or is to be represented by funds or other consideration borrowed or otherwise

obtained for the purpose of acquiring, holding, or trading such security, a description of the transaction and the names of the parties thereto, except that where a source of funds is a loan made in the ordinary course of business by a bank, as defined in section 78c(a)(6) of this title, if the person filing such statement so requests, the name of the bank shall not be made available to the public;

(C)

if the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities, any plans or proposals which such persons may have to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure;

(D)

the number of shares of such security which are beneficially owned, and the number of shares concerning which there is a right to acquire, directly or indirectly, by (i) such person, and (ii) by each associate of such person, giving the background, identity, residence, and citizenship of each such associate; and

(E)

information as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer, including but not limited to transfer of any of the securities, joint ventures, loan or option arrangements, puts or calls, guaranties of loans, guaranties against loss or guaranties of profits, division of losses or profits, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, or understandings have been entered into, and giving the details thereof.

(2)

If any material change occurs in the facts set forth in the statements to the issuer and the exchange, and in the statement filed with the Commission, an amendment shall be transmitted to the issuer and the exchange and shall be filed with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(3)

When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a "person" for the purposes of this subsection.

(4)

In determining, for purposes of this subsection, any percentage of a class of any security, such class shall be deemed to consist of the amount of the outstanding securities of such class, exclusive of any securities of such class held by or for the account of the issuer or a subsidiary of the issuer.

(5)

The Commission, by rule or regulation or by order, may permit any person to file in lieu of the statement required by paragraph (1) of this subsection or the rules and regulations thereunder, a notice stating the name of such person, the number of shares of any equity securities subject to paragraph (1) which are owned by him, the date of their acquisition and such other information as the Commission may specify, if it appears to the Commission that such securities were acquired by such person in the ordinary course of his business and were not acquired for the purpose of and do not have the effect of changing or influencing the control of the issuer nor in connection with or as a participant in any transaction having such purpose or effect.

(6)

The provisions of this subsection shall not apply to--

(A)

any acquisition or offer to acquire securities made or proposed to be made by means of a registration statement under the Securities Act of 1933 [*15 U.S.C. 77a et seq.*];

(B)

any acquisition of the beneficial ownership of a security which, together with all other acquisitions by the same person of securities of the same class during the preceding twelve months, does not exceed 2 per centum of that class;

(C)

any acquisition of an equity security by the issuer of such security;

(D)

any acquisition or proposed acquisition of a security which the Commission, by rules or regulations or by order, shall exempt from the provisions of this subsection as not entered into for the purpose of, and not having the effect of, changing or influencing the control of the issuer or otherwise as not comprehended within the purposes of this subsection.

(e) Purchase of securities by issuer

(1)

It shall be unlawful for an issuer which has a class of equity securities registered pursuant to section 781 of this title, or which is a closed-end investment company registered under the Investment Company Act of 1940 [*15 U.S.C. 80a-1 et seq.*], to purchase any equity security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices. Such rules and regulations may require such issuer to provide holders of equity securities of such class with such information relating to the reasons for such purchase, the source of funds, the number of shares to be purchased, the price to be paid for such securities, the method of purchase, and such additional information, as the Commission deems necessary or appropriate in the public interest or for the protection of investors, or which the Commission deems to be material to a determination whether such security should be sold.

(2)

For the purpose of this subsection, a purchase by or for the issuer or any person controlling, controlled by, or under common control with the issuer, or a purchase subject to control of the issuer or any such person, shall be deemed to be a purchase by the issuer. The Commission shall have power to make rules and regulations implementing this paragraph in the public interest and for the protection of investors, including exemptive rules and regulations covering situations in which the Commission deems it unnecessary or inappropriate that a purchase of the type described in this paragraph shall be deemed to be a purchase by the issuer for purposes of some or all of the provisions of paragraph (1) of this subsection.

(3)

At the time of filing such statement as the Commission may require by rule pursuant to paragraph (1) of this subsection, the person making the filing shall pay to the Commission a fee at a rate that, subject to paragraphs (5) and (6), is equal to \$92 per \$1,000,000 of the value of securities proposed to be purchased. The fee shall be reduced with respect to securities in an amount equal to any fee paid with respect to any securities issued in connection with the proposed transaction under section 6(b) of the Securities Act of 1933 [*15 U.S.C. 77f(b)*], or the fee paid under that section shall be reduced in an amount equal to the fee paid to the Commission in connection with such transaction under this paragraph.

(4)

Offsetting collections--Fees collected pursuant to this subsection for any fiscal year shall be deposited and credited as offsetting collections to the account providing appropriations to the Commission, and, except as provided in paragraph (9), shall not be collected for any fiscal year except to the extent provided in advance in appropriation Acts. No fees collected pursuant to this subsection for fiscal year 2002 or any succeeding fiscal year shall be deposited and credited as general revenue of the Treasury.

(5)

Annual adjustment--For each of the fiscal years 2003 through 2011, the Commission shall by order adjust the rate required by paragraph (3) for such fiscal year to a rate that is equal to the rate (expressed in dollars per million) that is applicable under section 6(b) of the Securities Act of 1933 for such fiscal year.

(6)

Final rate adjustment--For fiscal year 2012 and all of the succeeding fiscal years, the Commission shall by order adjust the rate required by paragraph (3) for all of such fiscal years to a rate that is equal to the rate (expressed in dollars per million) that is applicable under section 6(b) of the Securities Act of 1933 for all of such fiscal years.

(7)

Pro rata application--The rates per \$1,000,000 required by this subsection shall be applied pro rata to amounts and balances of less than \$1,000,000.

(8)

Review and effective date--In exercising its authority under this subsection, the Commission shall not be required to comply with the provisions of *section 553 of title 5, United States Code*. An adjusted rate prescribed under paragraph (5) or (6) and published under paragraph (10) shall not be subject to judicial review. Subject to paragraphs (4) and (9)--

(A)

an adjusted rate prescribed under paragraph (5) shall take effect on the later of--

(i)

the first day of the fiscal year to which such rate applies; or

(ii)

five days after the date on which a regular appropriation to the Commission for such fiscal year is enacted; and

(B)

an adjusted rate prescribed under paragraph (6) shall take effect on the later of--

(i)

the first day of fiscal year 2012; or

(ii)

five days after the date on which a regular appropriation to the Commission for fiscal year 2012 is enacted.

(9)

Lapse of appropriation--If on the first day of a fiscal year a regular appropriation to the Commission has not been enacted, the Commission shall continue to collect fees (as offsetting collections) under this subsection at the rate in effect during the preceding fiscal year, until 5 days after the date such a regular appropriation is enacted.

(10)

Publication--The rate applicable under this subsection for each fiscal year is published pursuant to section 6(b)(10) of the Securities Act of 1933.

(f) Reports by institutional investment managers

(1)

Every institutional investment manager which uses the mails, or any means or instrumentality of interstate commerce in the course of its business as an institutional investment manager and which exercises investment discretion with respect to accounts holding equity securities of a class described in subsection (d)(1) of this section having an aggregate fair market value on the last trading day in any of the preceding twelve months of at least \$100,000,000 or such lesser amount (but in no case less than \$10,000,000) as the Commission, by rule, may determine, shall file reports with the Commission in such form, for such periods, and at such times after the end of such periods as the Commission, by rule, may prescribe, but in no event shall such reports be filed for periods longer than one year or shorter than one quarter. Such reports shall include for each such equity security held on the last day of the reporting period by accounts (in aggregate or by type as the Commission, by rule, may prescribe) with respect to which the institutional investment manager exercises investment discretion (other than securities held in amounts which the Commission, by rule, determines to be insignificant for purposes of this subsection), the name of the issuer and the title, class, CUSIP number, number of shares or principal amount, and aggregate fair market value of each such security. Such reports may also include for accounts (in aggregate or by type) with respect to which the institutional investment manager exercises investment discretion such of the following information as the Commission, by rule, prescribes--

(A)

the name of the issuer and the title, class, CUSIP number, number of shares or principal amount, and aggregate fair market value or cost or amortized cost of each other security (other than an exempted security) held on the last day of the reporting period by such accounts;

(B)

the aggregate fair market value or cost or amortized cost of exempted securities (in aggregate or by class) held on the last day of the reporting period by such accounts;

(C)

the number of shares of each equity security of a class described in subsection (d)(1) of this section held on the last day of the reporting period by such accounts with respect to which the institutional investment manager possesses sole or shared authority to exercise the voting rights evidenced by such securities;

(D)

the aggregate purchases and aggregate sales during the reporting period of each security (other than an exempted security) effected by or for such accounts; and

(E)

with respect to any transaction or series of transactions having a market value of at least \$500,000 or such other amount as the Commission, by rule, may determine, effected during the reporting period by or for such accounts in any equity security of a class described in subsection (d)(1) of this section--

(i)

the name of the issuer and the title, class, and CUSIP number of the security;

(ii)

the number of shares or principal amount of the security involved in the transaction;

(iii)

whether the transaction was a purchase or sale;

(iv)

the per share price or prices at which the transaction was effected;

(v)

the date or dates of the transaction;

(vi)

the date or dates of the settlement of the transaction;

(vii)

the broker or dealer through whom the transaction was effected;

(viii)

the market or markets in which the transaction was effected; and

(ix)

such other related information as the Commission, by rule, may prescribe.

(2)

The Commission, by rule, or order, may exempt, conditionally or unconditionally, any institutional investment manager or security or any class of institutional investment managers or securities from any or all of the provisions of this subsection or the rules thereunder.

(3)

The Commission shall make available to the public for a reasonable fee a list of all equity securities of a class described in subsection (d)(1) of this section, updated no less frequently than reports are required to be filed pursuant to paragraph (1) of this subsection. The Commission shall tabulate the information contained in any report filed pursuant

to this subsection in a manner which will, in the view of the Commission, maximize the usefulness of the information to other Federal and State authorities and the public. Promptly after the filing of any such report, the Commission shall make the information contained therein conveniently available to the public for a reasonable fee in such form as the Commission, by rule, may prescribe, except that the Commission, as it determines to be necessary or appropriate in the public interest or for the protection of investors, may delay or prevent public disclosure of any such information in accordance with section 552 of title 5. Notwithstanding the preceding sentence, any such information identifying the securities held by the account of a natural person or an estate or trust (other than a business trust or investment company) shall not be disclosed to the public.

(4)

In exercising its authority under this subsection, the Commission shall determine (and so state) that its action is necessary or appropriate in the public interest and for the protection of investors or to maintain fair and orderly markets or, in granting an exemption, that its action is consistent with the protection of investors and the purposes of this subsection. In exercising such authority the Commission shall take such steps as are within its power, including consulting with the Comptroller General of the United States, the Director of the Office of Management and Budget, the appropriate regulatory agencies, Federal and State authorities which, directly or indirectly, require reports from institutional investment managers of information substantially similar to that called for by this subsection, national securities exchanges, and registered securities associations, (A) to achieve uniform, centralized reporting of information concerning the securities holdings of and transactions by or for accounts with respect to which institutional investment managers exercise investment discretion, and (B) consistently with the objective set forth in the preceding subparagraph, to avoid unnecessarily duplicative reporting by, and minimize the compliance burden on, institutional investment managers. Federal authorities which, directly or indirectly, require reports from institutional investment managers of information substantially similar to that called for by this subsection shall cooperate with the Commission in the performance of its responsibilities under the preceding sentence. An institutional investment manager which is a bank, the deposits of which are insured in accordance with the Federal Deposit Insurance Act [*12 U.S.C. 1811 et seq.*], shall file with the appropriate regulatory agency a copy of every report filed with the Commission pursuant to this subsection.

(5)

(A)

For purposes of this subsection the term "institutional investment manager" includes any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.

(B)

The Commission shall adopt such rules as it deems necessary or appropriate to prevent duplicative reporting pursuant to this subsection by two or more institutional investment managers exercising investment discretion with respect to the same amount. n6

(g) Statement of equity security ownership

(1)

Any person who is directly or indirectly the beneficial owner of more than 5 per centum of any security of a class described in subsection (d)(1) of this section shall send to the issuer of the security and shall file with the Commission a statement setting forth, in such form and at such time as the Commission may, by rule, prescribe--

(A)

such person's identity, residence, and citizenship; and

(B)

the number and description of the shares in which such person has an interest and the nature of such interest.

(2)

If any material change occurs in the facts set forth in the statement sent to the issuer and filed with the Commission, an amendment shall be transmitted to the issuer and shall be filed with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(3)

When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a "person" for the purposes of this subsection.

(4)

In determining, for purposes of this subsection, any percentage of a class of any security, such class shall be deemed to consist of the amount of the outstanding securities of such class, exclusive of any securities of such class held by or for the account of the issuer or a subsidiary of the issuer.

(5)

In exercising its authority under this subsection, the Commission shall take such steps as it deems necessary or appropriate in the public interest or for the protection of investors (A) to achieve centralized reporting of information

regarding ownership, (B) to avoid unnecessarily duplicative reporting by and minimize the compliance burden on persons required to report, and (C) to tabulate and promptly make available the information contained in any report filed pursuant to this subsection in a manner which will, in the view of the Commission, maximize the usefulness of the information to other Federal and State agencies and the public.

(6)

The Commission may, by rule or order, exempt, in whole or in part, any person or class of persons from any or all of the reporting requirements of this subsection as it deems necessary or appropriate in the public interest or for the protection of investors.

(h) Large trader reporting

(1)

Identification requirements for large traders

For the purpose of monitoring the impact on the securities markets of securities transactions involving a substantial volume or a large fair market value or exercise value and for the purpose of otherwise assisting the Commission in the enforcement of this chapter, each large trader shall--

(A)

provide such information to the Commission as the Commission may by rule or regulation prescribe as necessary or appropriate, identifying such large trader and all accounts in or through which such large trader effects such transactions; and

(B)

identify, in accordance with such rules or regulations as the Commission may prescribe as necessary or appropriate, to any registered broker or dealer by or through whom such large trader directly or indirectly effects securities transactions, such large trader and all accounts directly or indirectly maintained with such broker or dealer by such large trader in or through which such transactions are effected.

(2)

Recordkeeping and reporting requirements for brokers and dealers

Every registered broker or dealer shall make and keep for prescribed periods such records as the Commission by rule or regulation prescribes as necessary or appropriate in the public interest, for the protection of investors, or

otherwise in furtherance of the purposes of this chapter, with respect to securities transactions that equal or exceed the reporting activity level effected directly or indirectly by or through such registered broker or dealer of or for any person that such broker or dealer knows is a large trader, or any person that such broker or dealer has reason to know is a large trader on the basis of transactions in securities effected by or through such broker or dealer. Such records shall be available for reporting to the Commission, or any self-regulatory organization that the Commission shall designate to receive such reports, on the morning of the day following the day the transactions were effected, and shall be reported to the Commission or a self-regulatory organization designated by the Commission immediately upon request by the Commission or such a self-regulatory organization. Such records and reports shall be in a format and transmitted in a manner prescribed by the Commission (including, but not limited to, machine readable form).

(3)

Aggregation rules

The Commission may prescribe rules or regulations governing the manner in which transactions and accounts shall be aggregated for the purpose of this subsection, including aggregation on the basis of common ownership or control.

(4)

Examination of broker and dealer records

All records required to be made and kept by registered brokers and dealers pursuant to this subsection with respect to transactions effected by large traders are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission as the Commission deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this chapter.

(5)

Factors to be considered in commission actions

In exercising its authority under this subsection, the Commission shall take into account--

(A)

existing reporting systems;

(B)

the costs associated with maintaining information with respect to transactions effected by large traders and reporting such information to the Commission or self-regulatory organizations; and

(C)

the relationship between the United States and international securities markets.

(6)

Exemptions

The Commission, by rule, regulation, or order, consistent with the purposes of this chapter, may exempt any person or class of persons or any transaction or class of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection, and the rules and regulations thereunder.

(7)

Authority of commission to limit disclosure of information

Notwithstanding any other provision of law, the Commission shall not be compelled to disclose any information required to be kept or reported under this subsection. Nothing in this subsection shall authorize the Commission to withhold information from Congress, or prevent the Commission from complying with a request for information from any other Federal department or agency requesting information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action brought by the United States or the Commission. For purposes of section 552 of title 5, this subsection shall be considered a statute described in subsection (b)(3)(B) of such section 552.

(8)

Definitions

For purposes of this subsection--

(A)

the term "large trader" means every person who, for his own account or an account for which he exercises investment discretion, effects transactions for the purchase or sale of any publicly traded security or securities by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of a national securities exchange, directly or indirectly by or through a registered broker or dealer in an aggregate amount equal to or in excess of the identifying activity level;

(B)

the term "publicly traded security" means any equity security (including an option on individual equity securities, and an option on a group or index of such securities) listed, or admitted to unlisted trading privileges, on a national securities exchange, or quoted in an automated interdealer quotation system;

(C)

the term "identifying activity level" means transactions in publicly traded securities at or above a level of volume, fair market value, or exercise value as shall be fixed from time to time by the Commission by rule or regulation, specifying the time interval during which such transactions shall be aggregated;

(D)

the term "reporting activity level" means transactions in publicly traded securities at or above a level of volume, fair market value, or exercise value as shall be fixed from time to time by the Commission by rule, regulation, or order, specifying the time interval during which such transactions shall be aggregated; and

(E)

the term "person" has the meaning given in section 78c(a)(9) of this title and also includes two or more persons acting as a partnership, limited partnership, syndicate, or other group, but does not include a foreign central bank.

(i) Accuracy of Financial Reports

Each financial report that contains financial statements, and that is required to be prepared in accordance with (or reconciled to) generally accepted accounting principles under this title and filed with the Commission shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission.

(j) Off-Balance Sheet Transactions

Not later than 180 days after the date of enactment of the Sarbanes-Oxley Act of 2002, the Commission shall issue final rules providing that each annual and quarterly financial report required to be filed with the Commission shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.

(k) Prohibition on Personal Loans to Executives

(1)

In general--It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002), directly

or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment.

(2)

Limitation--Paragraph (1) does not preclude any home improvement and manufactured home loans (as that term is defined in section 5 of the Home Owners' Loan Act (*12 U.S.C. 1464*)), consumer credit (as defined in section 103 of the Truth in Lending Act (*15 U.S.C. 1602*)), or any extension of credit under an open end credit plan (as defined in section 103 of the Truth in Lending Act (*15 U.S.C. 1602*)), or a charge card (as defined in section 127(c)(4)(e) of the Truth in Lending Act (*15 U.S.C. 1637(c)(4)(e)*)), or any extension of credit by a broker or dealer registered under section 15 of this title to an employee of that broker or dealer to buy, trade, or carry securities, that is permitted under rules or regulations of the Board of Governors of the Federal Reserve System pursuant to section 7 of this title (other than an extension of credit that would be used to purchase the stock of that issuer), that is--

(A)

made or provided in the ordinary course of the consumer credit business of such issuer;

(B)

of a type that is generally made available by such issuer to the public; and

(C)

made by such issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit.

(3)

Rule of construction for certain loans--Paragraph (1) does not apply to any loan made or maintained by an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (*12 U.S.C. 1813*)), if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (*12 U.S.C. 375b*).

(l) Real Time Issuer Disclosures

Each issuer reporting under section 13(a) or 15(d) shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain

English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest.

FOOTNOTES:

(n314)Footnote 6. So in original. Probably should be "account".



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Securities Enforcement: Counseling and Defense

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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 14

§ 14 [15 USC § 78n] Proxies

(a) Solicitation of proxies in violation of rules and regulations

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78l of this title.

(b) Giving or refraining from giving proxy in respect of any security carried for account of customer

(1)

It shall be unlawful for any member of a national securities exchange, or any broker or dealer registered under this chapter, or any bank, association, or other entity that exercises fiduciary powers, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to give, or to refrain from giving a proxy, consent, authorization, or information statement in respect of any security registered pursuant to section 78l of this title, or any security issued by an investment company registered under the Investment Company Act of 1940, and carried for the account of a customer.

(2)

With respect to banks, the rules and regulations prescribed by the Commission under paragraph (1) shall not require the disclosure of the names of beneficial owners of securities in an account held by the bank on December 28, 1985, unless the beneficial owner consents to the disclosure. The provisions of this paragraph shall not apply in the case of a bank which the Commission finds has not made a good faith effort to obtain such consent from such beneficial owners.

(c) Information to holders of record prior to annual or other meeting

Unless proxies, consents, or authorizations in respect of a security registered pursuant to section 78l of this title, or a security issued by an investment company registered under the Investment Company Act of 1940, are solicited by or on behalf of the management of the issuer from the holders of record of such security in accordance with the rules and regulations prescribed under subsection (a) of this section, prior to any annual or other meeting of the holders of such security, such issuer shall, in accordance with rules and regulations prescribed by the Commission, file with the Commission and transmit to all holders of record of such security information substantially equivalent to the information which would be required to be transmitted if a solicitation were made, but no information shall be required to be filed or transmitted pursuant to this subsection before July 1, 1964.

(d) Tender offer by owner of more than five per centum of class of securities; exceptions

(1)

It shall be unlawful for any person, directly or indirectly, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, to make a tender offer for, or a request or invitation for tenders of, any class of any equity security which is registered pursuant to section 78l of this title, or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in section 78l(g)(2)(G) of this title, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940 [*15 U.S.C. 80a-1 et seq.*], if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of more than 5 per centum of such class, unless at the time copies of the offer or request or invitation are first published or sent or given to security holders such person has filed with the Commission a statement containing such of the information specified in section 78m(d) of this title, and such additional information as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors. All requests or invitations for tenders or advertisements making a tender offer or requesting or inviting tenders of such a security shall be filed as a part of such statement and shall contain such of the information contained in such statement as the Commission may by rules and regulations prescribe. Copies of any additional material soliciting or requesting such tender offers subsequent to the initial solicitation or request shall contain such information as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors, and shall be filed with the Commission not later than the time copies of such material are first published or sent or given to security holders. Copies of all statements, in the form in which such material is furnished to security holders and the Commission, shall be sent to the issuer not later than the date such material is first published or sent or given to any security holders.

(2)

When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a "person" for purposes of this subsection.

(3)

In determining, for purposes of this subsection, any percentage of a class of any security, such class shall be deemed to consist of the amount of the outstanding securities of such class, exclusive of any securities of such class held by or for the account of the issuer or a subsidiary of the issuer.

(4)

Any solicitation or recommendation to the holders of such a security to accept or reject a tender offer or request or invitation for tenders shall be made in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(5)

Securities deposited pursuant to a tender offer or request or invitation for tenders may be withdrawn by or on behalf of the depositor at any time until the expiration of seven days after the time definitive copies of the offer or request or invitation are first published or sent or given to security holders, and at any time after sixty days from the date of the original tender offer or request or invitation, except as the Commission may otherwise prescribe by rules, regulations, or order as necessary or appropriate in the public interest or for the protection of investors.

(6)

Where any person makes a tender offer, or request or invitation for tenders, for less than all the outstanding equity securities of a class, and where a greater number of securities is deposited pursuant thereto within ten days after copies of the offer or request or invitation are first published or sent or given to security holders than such person is bound or willing to take up and pay for, the securities taken up shall be taken up as nearly as may be pro rata, disregarding fractions, according to the number of securities deposited by each depositor. The provisions of this subsection shall also apply to securities deposited within ten days after notice of an increase in the consideration offered to security holders, as described in paragraph (7), is first published or sent or given to security holders.

(7)

Where any person varies the terms of a tender offer or request or invitation for tenders before the expiration thereof by increasing the consideration offered to holders of such securities, such person shall pay the increased consideration to each security holder whose securities are taken up and paid for pursuant to the tender offer or request or invitation for tenders whether or not such securities have been taken up by such person before the variation of the tender offer or request or invitation.

(8)

The provisions of this subsection shall not apply to any offer for, or request or invitation for tenders of, any security--

(A)

if the acquisition of such security, together with all other acquisitions by the same person of securities of the same class during the preceding twelve months, would not exceed 2 per centum of that class;

(B)

by the issuer of such security; or

(C)

which the Commission, by rules or regulations or by order, shall exempt from the provisions of this subsection as not entered into for the purpose of, and not having the effect of, changing or influencing the control of the issuer or otherwise as not comprehended within the purposes of this subsection.

(e) Untrue statement of material fact or omission of fact with respect to tender offer

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

(f) Election or designation of majority of directors of issuer by owner of more than five per centum of class of securities at other than meeting of security holders

If, pursuant to any arrangement or understanding with the person or persons acquiring securities in a transaction subject to subsection (d) of this section or subsection (d) of section 78m of this title, any persons are to be elected or designated as directors of the issuer, otherwise than at a meeting of security holders, and the persons so elected or designated will constitute a majority of the directors of the issuer, then, prior to the time any such person takes office as a director, and in accordance with rules and regulations prescribed by the Commission, the issuer shall file with the Commission, and transmit to all holders of record of securities of the issuer who would be entitled to vote at a meeting for election of directors, information substantially equivalent to the information which would be required by subsection (a) or (c) of this section to be transmitted if such person or persons were nominees for election as directors at a meeting of such security holders.

(g) Filing fees

(1)

(A)

At the time of filing such preliminary proxy solicitation material as the Commission may require by rule pursuant to subsection (a) of this section that concerns an acquisition, merger, consolidation, or proposed sale or other disposition of substantially all the assets of a company, the person making such filing, other than a company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.], shall pay to the Commission the following fees:

(i)

for preliminary proxy solicitation material involving an acquisition, merger, or consolidation, if there is a proposed payment of cash or transfer of securities or property to shareholders, a fee at a rate that, subject to paragraphs (5) and (6), is equal to \$92 per \$1,000,000 of such proposed payment, or of the value of such securities or other property proposed to be transferred; and

(ii)

for preliminary proxy solicitation material involving a proposed sale or other disposition of substantially all of the assets of a company, a fee at a rate that, subject to paragraphs (5) and (6), is equal to \$92 per \$1,000,000 of the cash or of the value of any securities or other property proposed to be received upon such sale or disposition.

(B)

The fee imposed under subparagraph (A) shall be reduced with respect to securities in an amount equal to any fee paid to the Commission with respect to such securities in connection with the proposed transaction under section 77f(b) of this title, or the fee paid under that section shall be reduced in an amount equal to the fee paid to the Commission in connection with such transaction under this subsection. Where two or more companies involved in an acquisition, merger, consolidation, sale, or other disposition of substantially all the assets of a company must file such proxy material with the Commission, each shall pay a proportionate share of such fee.

(2)

At the time of filing such preliminary information statement as the Commission may require by rule pursuant to subsection (c) of this section, the issuer shall pay to the Commission the same fee as required for preliminary proxy solicitation material under paragraph (1) of this subsection.

(3)

At the time of filing such statement as the Commission may require by rule pursuant to subsection (d)(1) of this

section, the person making the filing shall pay to the Commission a fee at a rate that, subject to paragraphs (5) and (6), is equal to \$92 per \$1,000,000 of the aggregate amount of cash or of the value of securities or other property proposed to be offered. The fee shall be reduced with respect to securities in an amount equal to any fee paid with respect to such securities in connection with the proposed transaction under section 77f(b) of this title, or the fee paid under that section shall be reduced in an amount equal to the fee paid to the Commission in connection with such transaction under this subsection.

(4)

Offsetting collections--Fees collected pursuant to this subsection for any fiscal year shall be deposited and credited as offsetting collections to the account providing appropriations to the Commission, and, except as provided in paragraph (9), shall not be collected for any fiscal year except to the extent provided in advance in appropriation Acts. No fees collected pursuant to this subsection for fiscal year 2002 or any succeeding fiscal year shall be deposited and credited as general revenue of the Treasury.

(5)

Annual adjustment--For each of the fiscal years 2003 through 2011, the Commission shall by order adjust each of the rates required by paragraphs (1) and (3) for such fiscal year to a rate that is equal to the rate (expressed in dollars per million) that is applicable under section 6(b) of the Securities Act of 1933 for such fiscal year.

(6)

Final rate adjustment--For fiscal year 2012 and all of the succeeding fiscal years, the Commission shall by order adjust each of the rates required by paragraphs (1) and (3) for all of such fiscal years to a rate that is equal to the rate (expressed in dollars per million) that is applicable under section 6(b) of the Securities Act of 1933 for all of such fiscal years.

(7)

Pro rata application--The rates per \$1,000,000 required by this subsection shall be applied pro rata to amounts and balances of less than \$1,000,000.

(8)

Review and effective date--In exercising its authority under this subsection, the Commission shall not be required to comply with the provisions of *section 553 of title 5, United States Code*. An adjusted rate prescribed under paragraph (5) or (6) and published under paragraph (10) shall not be subject to judicial review. Subject to paragraphs (4) and (9)--

(A)

an adjusted rate prescribed under paragraph (5) shall take effect on the later of--

(i)

the first day of the fiscal year to which such rate applies; or

(ii)

five days after the date on which a regular appropriation to the Commission for such fiscal year is enacted; and

(B)

an adjusted rate prescribed under paragraph (6) shall take effect on the later of--

(i)

the first day of fiscal year 2012; or

(ii)

five days after the date on which a regular appropriation to the Commission for fiscal year 2012 is enacted.

(9)

Lapse of appropriation--If on the first day of a fiscal year a regular appropriation to the Commission has not been enacted, the Commission shall continue to collect fees (as offsetting collections) under this subsection at the rate in effect during the preceding fiscal year, until 5 days after the date such a regular appropriation is enacted.

(10)

Publication--The rate applicable under this subsection for each fiscal year is published pursuant to section 6(b)(10) of the Securities Act of 1933."

(11)

Notwithstanding any other provision of law, the Commission may impose fees, charges, or prices for matters not involving any acquisition, merger, consolidation, sale, or other disposition of assets described in this subsection, as

authorized by section 9701 of title 31, or otherwise.

(h) Proxy solicitations and tender offers in connection with limited partnership rollup transactions

(1)

Proxy rules to contain special provisions

It shall be unlawful for any person to solicit any proxy, consent, or authorization concerning a limited partnership rollup transaction, or to make any tender offer in furtherance of a limited partnership rollup transaction, unless such transaction is conducted in accordance with rules prescribed by the Commission under subsections (a) and (d) of this section as required by this subsection. Such rules shall--

(A)

permit any holder of a security that is the subject of the proposed limited partnership rollup transaction to engage in preliminary communications for the purpose of determining whether to solicit proxies, consents, or authorizations in opposition to the proposed limited partnership rollup transaction, without regard to whether any such communication would otherwise be considered a solicitation of proxies, and without being required to file soliciting material with the Commission prior to making that determination, except that--

(i)

nothing in this subparagraph shall be construed to limit the application of any provision of this chapter prohibiting, or reasonably designed to prevent, fraudulent, deceptive, or manipulative acts or practices under this chapter; and

(ii)

any holder of not less than 5 percent of the outstanding securities that are the subject of the proposed limited partnership rollup transaction who engages in the business of buying and selling limited partnership interests in the secondary market shall be required to disclose such ownership interests and any potential conflicts of interests in such preliminary communications;

(B)

require the issuer to provide to holders of the securities that are the subject of the limited partnership rollup transaction such list of the holders of the issuer's securities as the Commission may determine in such form and subject to such terms and conditions as the Commission may specify;

(C)

prohibit compensating any person soliciting proxies, consents, or authorizations directly from security holders concerning such a limited partnership rollup transaction--

(i)

on the basis of whether the solicited proxy, consent, or authorization either approves or disapproves the proposed limited partnership rollup transaction; or

(ii)

contingent on the approval, disapproval, or completion of the limited partnership rollup transaction;

(D)

set forth disclosure requirements for soliciting material distributed in connection with a limited partnership rollup transaction, including requirements for clear, concise, and comprehensible disclosure with respect to--

(i)

any changes in the business plan, voting rights, form of ownership interest, or the compensation of the general partner in the proposed limited partnership rollup transaction from each of the original limited partnerships;

(ii)

the conflicts of interest, if any, of the general partner;

(iii)

whether it is expected that there will be a significant difference between the exchange values of the limited partnerships and the trading price of the securities to be issued in the limited partnership rollup transaction;

(iv)

the valuation of the limited partnerships and the method used to determine the value of the interests of the limited partners to be exchanged for the securities in the limited partnership rollup transaction;

(v)

the differing risks and effects of the limited partnership rollup transaction for investors in different limited partnerships proposed to be included, and the risks and effects of completing the limited partnership rollup transaction with less than all limited partnerships;

(vi)

the statement by the general partner required under subparagraph (E);

(vii)

such other matters deemed necessary or appropriate by the Commission;

(E)

require a statement by the general partner as to whether the proposed limited partnership rollup transaction is fair or unfair to investors in each limited partnership, a discussion of the basis for that conclusion, and an evaluation and a description by the general partner of alternatives to the limited partnership rollup transaction, such as liquidation;

(F)

provide that, if the general partner or sponsor has obtained any opinion (other than an opinion of counsel), appraisal, or report that is prepared by an outside party and that is materially related to the limited partnership rollup transaction, such soliciting materials shall contain or be accompanied by clear, concise, and comprehensible disclosure with respect to--

(i)

the analysis of the transaction, scope of review, preparation of the opinion, and basis for and methods of arriving at conclusions, and any representations and undertakings with respect thereto;

(ii)

the identity and qualifications of the person who prepared the opinion, the method of selection of such person, and any material past, existing, or contemplated relationships between the person or any of its affiliates and the general partner, sponsor, successor, or any other affiliate;

(iii)

any compensation of the preparer of such opinion, appraisal, or report that is contingent on the transaction's approval or completion; and

(iv)

any limitations imposed by the issuer on the access afforded to such preparer to the issuer's personnel, premises, and relevant books and records;

(G)

provide that, if the general partner or sponsor has obtained any opinion, appraisal, or report as described in subparagraph;

(F)

from any person whose compensation is contingent on the transaction's approval or completion or who has not been given access by the issuer to its personnel and premises and relevant books and records, the general partner or sponsor shall state the reasons therefor;

(H)

provide that, if the general partner or sponsor has not obtained any opinion on the fairness of the proposed limited partnership rollup transaction to investors in each of the affected partnerships, such soliciting materials shall contain or be accompanied by a statement of such partner's or sponsor's reasons for concluding that such an opinion is not necessary in order to permit the limited partners to make an informed decision on the proposed transaction;

(I)

require that the soliciting material include a clear, concise, and comprehensible summary of the limited partnership rollup transaction (including a summary of the matters referred to in clauses (i) through (vii) of subparagraph (D) and a summary of the matter referred to in subparagraphs (F), (G), and (H)), with the risks of the limited partnership rollup transaction set forth prominently in the fore part thereof;

(J)

provide that any solicitation or offering period with respect to any proxy solicitation, tender offer, or information statement in a limited partnership rollup transaction shall be for not less than the lesser of 60 calendar days or the

maximum number of days permitted under applicable State law; and

(K)

contain such other provisions as the Commission determines to be necessary or appropriate for the protection of investors in limited partnership rollup transactions.

(2)

Exemptions

The Commission may, consistent with the public interest, the protection of investors, and the purposes of this chapter, exempt by rule or order any security or class of securities, any transaction or class of transactions, or any person or class of persons, in whole or in part, conditionally or unconditionally, from the requirements imposed pursuant to paragraph (1) or from the definition contained in paragraph (4).

(3)

Effect on Commission authority

Nothing in this subsection limits the authority of the Commission under subsection (a) or (d) of this section or any other provision of this chapter or precludes the Commission from imposing, under subsection (a) or (d) of this section or any other provision of this chapter, a remedy or procedure required to be imposed under this subsection.

(4)

Definition of limited partnership rollup transaction

Except as provided in paragraph (5), as used in this subsection, the term "limited partnership rollup transaction" means a transaction involving the combination or reorganization of one or more limited partnerships, directly or indirectly, in which--

(A)

some or all of the investors in any of such limited partnerships will receive new securities, or securities in another entity, that will be reported under a transaction reporting plan declared effective before December 17, 1993 by the Commission under section 78k of this title;

(B)

any of the investors' limited partnership securities are not, as of the date of filing, reported under a transaction

reporting plan declared effective before December 17, 1993 by the Commission under section 78k of this title;

(C)

investors in any of the limited partnerships involved in the transaction are subject to a significant adverse change with respect to voting rights, the term of existence of the entity, management compensation, or investment objectives; and

(D)

any of such investors are not provided an option to receive or retain a security under substantially the same terms and conditions as the original issue.

(5)

Exclusions from definition

Notwithstanding paragraph (4), the term "limited partnership rollup transaction" does not include--

(A)

a transaction that involves only a limited partnership or partnerships having an operating policy or practice of retaining cash available for distribution and reinvesting proceeds from the sale, financing, or refinancing of assets in accordance with such criteria as the Commission determines appropriate;

(B)

a transaction involving only limited partnerships wherein the interests of the limited partners are repurchased, recalled, or exchanged in accordance with the terms of the preexisting limited partnership agreements for securities in an operating company specifically identified at the time of the formation of the original limited partnership;

(C)

a transaction in which the securities to be issued or exchanged are not required to be and are not registered under the Securities Act of 1933;

(D)

a transaction that involves only issuers that are not required to register or report under section 78l of this title, both

before and after the transaction;

(E)

a transaction, except as the Commission may otherwise provide by rule for the protection of investors, involving the combination or reorganization of one or more limited partnerships in which a non-affiliated party succeeds to the interests of a general partner or sponsor, if--

(i) such action is approved by not less than 66 $\frac{2}{3}$ percent of the outstanding units of each of the participating limited partnerships; and

(ii) as a result of the transaction, the existing general partners will receive only compensation to which they are entitled as expressly provided for in the preexisting limited partnership agreements; or

(F) a transaction, except as the Commission may otherwise provide by rule for the protection of investors, in which the securities offered to investors are securities of another entity that are reported under a transaction reporting plan declared effective before December 17, 1993 by the Commission under section 78k-1 of this title, if--

(i) such other entity was formed, and such class of securities was reported and regularly traded, not less than 12 months before the date on which soliciting material is mailed to investors; and

(ii) the securities of that entity issued to investors in the transaction do not exceed 20 percent of the total outstanding securities of the entity, exclusive of any securities of such class held by or for the account of the entity or a subsidiary of the entity.



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Securities Enforcement: Counseling and Defense

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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 15

§ 15 [15 USC § 78o] Registration and regulation of brokers and dealers

(a) Registration of all persons utilizing exchange facilities to effect transactions; exemptions.

(1) It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

(2) The Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraph (1) of this subsection any broker or dealer or class of brokers or dealers specified in such rule or order.

(b) Manner of registration of brokers and dealers.

(1) A broker or dealer may be registered by filing with the Commission an application for registration in such form and containing such information and documents concerning such broker or dealer and any persons associated with such broker or dealer as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Within forty-five days of the date of the filing of such application (or within such longer period as to which the applicant consents), the Commission shall--

(A) by order grant registration, or

(B) institute proceedings to determine whether registration should be denied. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within one hundred twenty days of the date of the filing of the application for registration. At the conclusion of such proceedings, the Commission, by order, shall grant or deny such registration. The order granting registration shall not be effective until such broker or dealer has become a member of a registered securities association, or until such broker or dealer has become a member of a national securities exchange if such broker or dealer effects transactions solely on that exchange, unless the Commission has exempted such broker or dealer, by rule or order, from such membership. The Commission may extend the time for conclusion of such proceedings for up to ninety days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

The Commission shall grant such registration if the Commission finds that the requirements of this section are satisfied. The Commission shall deny such registration if it does not make such a finding or if it finds that if the applicant were so registered, its registration would be subject to suspension or revocation under paragraph (4) of this subsection.

(2)

(A) An application for registration of a broker or dealer to be formed or organized may be made by a broker or dealer to which the broker or dealer to be formed or organized is to be the successor. Such application, in such form as the Commission, by rule, may prescribe, shall contain such information and documents concerning the applicant, the successor, and any persons associated with the applicant or the successor, as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. The grant or denial of registration to such an applicant shall be in accordance with the procedures set forth in paragraph (1) of this subsection. If the Commission grants such registration, the registration shall terminate on the forty-fifth day after the effective date thereof, unless prior thereto the successor shall, in accordance with such rules and regulations as the Commission may prescribe, adopt the application for registration as its own.

(B) Any person who is a broker or dealer solely by reason of acting as a municipal securities dealer or municipal securities broker, who so acts through a separately identifiable department or division, and who so acted in such a manner on the date of enactment of the Securities Acts Amendments of 1975 [enacted June 4, 1975], may, in accordance with such terms and conditions as the Commission, by rule, prescribes as necessary and appropriate in the public interest and for the protection of investors, register such separately identifiable department or division in accordance with this subsection. If any such department or division is so registered, the department or division and not such person himself shall be the broker or dealer for purposes of this title [15 USCS §§ 78a et seq.].

(C) Within six months of the date of the granting of registration to a broker or dealer, the Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange of which such broker or dealer is a member, shall conduct an inspection of the broker or dealer to determine whether it is operating in conformity with the provisions of this title [15 USCS §§ 78a et seq.] and the rules and regulations thereunder: Provided, however, That the Commission may delay such inspection of any class of brokers or dealers for a

period not to exceed six months.

(3) Any provision of this title [15 USCS §§ 78a et seq.] (other than section 5 [15 USCS § 78e] and subsection (a) of this section) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce is used in connection therewith shall also prohibit any such act, practice, or course of business by any registered broker or dealer or any person acting on behalf of such a broker or dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated--

(A) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission or with any other appropriate regulatory agency under this title [15 USCS §§ 78a et seq.], or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.

(B) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor or of a substantially equivalent crime by a foreign court of competent jurisdiction which the Commission finds--

(i) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, any substantially equivalent activity however denominated by the laws of the relevant foreign government, or conspiracy to commit any such offense;

(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, investment adviser, bank, insurance company, fiduciary, transfer agent, nationally recognized statistical rating organization, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act (7 U.S.C. 1 et seq.) or any substantially equivalent foreign statute or regulation;

(iii) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities, or substantially equivalent activity however denominated by the laws of the relevant foreign government or;

(iv) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of title 18, *United States Code* [18 USCS §§ 152, 1341, 1342, or 1343 or 471 *et seq.* or 1001 *et seq.*], or a violation of a substantially equivalent foreign statute.;

(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, nationally recognized statistical rating organization, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act [7 USCS §§ 1 *et seq.*] or any substantially equivalent foreign statute or regulation, or as an affiliated person or employee of any investment company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act [7 USCS §§ 1 *et seq.*] or any substantially equivalent foreign statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(D) has willfully violated any provision of the Securities Act of 1933 [15 USCS §§ 77a *et seq.*], the Investment Advisers Act of 1940 [15 USCS §§ 80b-1 *et seq.*], the Investment Company Act of 1940 [15 USCS §§ 80a-1 *et seq.*], the Commodity Exchange Act [7 USCS §§ 1 *et seq.*], this title [15 USCS §§ 78a *et seq.*], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933 [15 USCS §§ 77a *et seq.*], the Investment Advisers Act of 1940 [15 USCS §§ 80b-1 *et seq.*], the Investment Company Act of 1940 [15 USCS §§ 80a-1 *et seq.*], the Commodity Exchange Act [7 USCS §§ 1 *et seq.*], this title [15 USCS §§ 78a *et seq.*], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if--

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

(F) is subject to any order of the Commission barring or suspending the right of the person to be associated with a

broker or dealer;

(G) has been found by a foreign financial regulatory authority to have--

(i) made or caused to be made in any application for registration or report required to be filed with a foreign financial regulatory authority, or in any proceeding before a foreign financial regulatory authority with respect to registration, any statement that was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to the foreign financial regulatory authority any material fact that is required to be stated therein;

(ii) violated any foreign statute or regulation regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade;

(iii) aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of any statutory provisions enacted by a foreign government, or rules or regulations thereunder, empowering a foreign financial regulatory authority regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade, or has been found, by a foreign financial regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of such statutory provisions, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision; or

(H) is subject to any final order of a State securities commission (or any agency or officer performing like functions), State authority that supervises or examines banks, savings associations, or credit unions, State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act (*12 U.S.C. 1813(q)*)), or the National Credit Union Administration, that--

(i) bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or

(ii) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.

(5) Pending final determination whether any registration under this subsection shall be revoked, the Commission, by order, may suspend such registration, if such suspension appears to the Commission, after notice and opportunity for

hearing, to be necessary or appropriate in the public interest or for the protection of investors. Any registered broker or dealer may, upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered broker or dealer is no longer in existence or has ceased to do business as a broker or dealer, the Commission, by order, shall cancel the registration of such broker or dealer.

(6)

(A) With respect to any person who is associated, who is seeking to become associated, or, at the time of the alleged misconduct, who was associated or was seeking to become associated with a broker or dealer, or any person participating, or, at the time of the alleged misconduct, who was participating, in an offering of any penny stock, the Commission, by order, shall censure, place limitations on the activities or functions of such person, or suspend for a period not exceeding 12 months, or bar such person from being associated with a broker or dealer, or from participating in an offering of penny stock, if the Commission finds, on the record after notice and opportunity for a hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person--

(i) has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (A), (D), or (E) of paragraph (4) of this subsection;

(ii) has been convicted of any offense specified in subparagraph (B) of such paragraph (4) within 10 years of the commencement of the proceedings under this paragraph; or

(iii) is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4).

(B) It shall be unlawful--

(i) for any person as to whom an order under subparagraph (A) is in effect, without the consent of the Commission, willfully to become, or to be, associated with a broker or dealer in contravention of such order, or to participate in an offering of penny stock in contravention of such order;

(ii) for any broker or dealer to permit such a person, without the consent of the Commission, to become or remain, a person associated with the broker or dealer in contravention of such order, if such broker or dealer knew, or in the exercise of reasonable care should have known, of such order; or

(iii) for any broker or dealer to permit such a person, without the consent of the Commission, to participate in an

offering of penny stock in contravention of such order, if such broker or dealer knew, or in the exercise of reasonable care should have known, of such order and of such participation.

(C) For purposes of this paragraph, the term "person participating in an offering of penny stock" includes any person acting as any promoter, finder, consultant, agent, or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock. The Commission may, by rule or regulation, define such term to include other activities, and may, by rule, regulation, or order, exempt any person or class of persons, in whole or in part, conditionally or unconditionally, from such term.

(7) No registered broker or dealer or government securities broker or government securities dealer registered (or required to register) under section 15C(a)(1)(A) [15 USCS § 78o-5(a)(1)(A)] shall effect any transaction in, or induce the purchase or sale of, any security unless such broker or dealer meets such standards of operational capability and such broker or dealer and all natural persons associated with such broker or dealer meet such standards of training, experience, competence, and such other qualifications as the Commission finds necessary or appropriate in the public interest or for the protection of investors. The Commission shall establish such standards by rules and regulations, which may--

(A) specify that all or any portion of such standards shall be applicable to any class of brokers and dealers and persons associated with brokers and dealers;

(B) require persons in any such class to pass tests prescribed in accordance with such rules and regulations, which tests shall, with respect to any class of partners, officers, or supervisory employees (which latter term may be defined by the Commission's rules and regulations and as so defined shall include branch managers of brokers or dealers) engaged in the management of the broker or dealer, include questions relating to bookkeeping, accounting, internal control over cash and securities, supervision of employees, maintenance of records, and other appropriate matters; and

(C) provide that persons in any such class other than brokers and dealers and partners, officers, and supervisory employees of brokers or dealers, may be qualified solely on the basis of compliance with such standards of training and such other qualifications as the Commission finds appropriate.

The Commission, by rule, may prescribe reasonable fees and charges to defray its costs in carrying out this paragraph, including, but not limited to, fees for any test administered by it or under its direction. The Commission may cooperate with registered securities associations and national securities exchanges in devising and administering tests and may require registered brokers and dealers and persons associated with such brokers and dealers to pass tests administered by or on behalf of any such association or exchange and to pay such association or exchange reasonable fees or charges to defray the costs incurred by such association or exchange in administering such tests.

(8) It shall be unlawful for any registered broker or dealer to effect any transaction in, or induce or attempt to induce

the purchase or sale of, any security (other than [or] commercial paper, bankers' acceptances, or commercial bills), unless such broker or dealer is a member of a securities association registered pursuant to section 15A of this title [15 USCS § 78o-3] or effects transactions in securities solely on a national securities exchange of which it is a member.

(9) The Commission by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraph (8) of this subsection any broker or dealer or class of brokers or dealers specified in such rule or order.

(10) For the purposes of determining whether a person is subject to a statutory disqualification under section 6(c)(2), 15A(g)(2), or 17A(b)(4)(A) of this title [15 USCS § 78f(c)(2), 78o-3(g)(2), or 78q-1(b)(4)(A)], the term "Commission" in paragraph (4)(B) of this subsection shall mean "exchange", "association", or "clearing agency", respectively.

(11) Broker/dealer registration with respect to transactions in security futures products.

(A) Notice registration.

(i) Contents of notice. Notwithstanding paragraphs (1) and (2), a broker or dealer required to register only because it effects transactions in security futures products on an exchange registered pursuant to section 6(g) [15 USCS § 78f(g)] may register for purposes of this section by filing with the Commission a written notice in such form and containing such information concerning such broker or dealer and any persons associated with such broker or dealer as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. A broker or dealer may not register under this paragraph unless that broker or dealer is a member of a national securities association registered under section 15A(k) [15 USCS § 78o-3].

(ii) Immediate effectiveness. Such registration shall be effective contemporaneously with the submission of notice, in written or electronic form, to the Commission, except that such registration shall not be effective if the registration would be subject to suspension or revocation under paragraph (4).

(iii) Suspension. Such registration shall be suspended immediately if a national securities association registered pursuant to section 15A(k) of this title [15 USCS § 78o-3(k)] suspends the membership of that broker or dealer.

(iv) Termination. Such registration shall be terminated immediately if any of the above stated conditions for registration set forth in this paragraph are no longer satisfied.

(B) Exemptions for registered brokers and dealers. A broker or dealer registered pursuant to the requirements of subparagraph (A) shall be exempt from the following provisions of this title [15 USCS §§ 78a et seq.] and the rules thereunder with respect to transactions in security futures products:

(i) Section 8 [15 USCS § 78h].

(ii) Section 11 [15 USCS § 78k].

(iii) Subsections (c)(3) and (c)(5) of this section.

(iv) Section 15B [15 USCS § 78o-4].

(v) Section 15C [15 USCS § 78o-5].

(vi) Subsections (d), (e), (f), (g), (h), and (i) of section 17 [15 USCS § 78q].

(12) Exemption for security futures product exchange members.

(A) Registration exemption. A natural person shall be exempt from the registration requirements of this section if such person--

(i) is a member of a designated contract market registered with the Commission as an exchange pursuant to section 6(g) [15 USCS § 78f(g)];

(ii) effects transactions only in securities on the exchange of which such person is a member; and

(iii) does not directly accept or solicit orders from public customers or provide advice to public customers in connection with the trading of security futures products.

(B) Other exemptions. A natural person exempt from registration pursuant to subparagraph (A) shall also be exempt from the following provisions of this title [15 USCS §§ 78a et seq.] and the rules thereunder:

- (i) Section 8 [15 USCS § 78h].
 - (ii) Section 11 [15 USCS § 78k].
 - (iii) Subsections (c)(3), (c)(5), and (e) of this section.
 - (iv) Section 15B [15 USCS § 78o-4].
 - (v) Section 15C [15 USCS § 78o-5].
 - (vi) Subsections (d), (e), (f), (g), (h), and (i) of section 17 [15 USCS § 78q].
- (c) Use of manipulative or deceptive devices; contravention of rules and regulations.
- (1)

(A) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member, or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS § 78c note]), by means of any manipulative, deceptive, or other fraudulent device or contrivance.

(B) No municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS § 78c note]) involving a municipal security by means of any manipulative, deceptive, or other fraudulent device or contrivance.

(C) No government securities broker or government securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or to attempt to induce the purchase or sale of, any government security or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS § 78c note]) involving a government security by means of any manipulative, deceptive, or other fraudulent device or contrivance.

(2)

(A) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member, in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation.

(B) No municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in connection with which such municipal securities dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation.

(C) No government securities broker or government securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or induce or attempt to induce the purchase or sale of, any government security in connection with which such government securities broker or government securities dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation.

(D) The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

(E) The Commission shall, prior to adopting any rule or regulation under subparagraph (C), consult with and consider the views of the Secretary of the Treasury and each appropriate regulatory agency. If the Secretary of the Treasury or any appropriate regulatory agency comments in writing on a proposed rule or regulation of the Commission under such subparagraph (C) that has been published for comment, the Commission shall respond in writing to such written comment before adopting the proposed rule. If the Secretary of the Treasury determines, and notifies the Commission, that such rule or regulation, if implemented, would, or as applied does (i) adversely affect the liquidity or efficiency of the market for government securities; or (ii) impose any burden on competition not necessary or appropriate in furtherance of the purposes of this section, the Commission shall, prior to adopting the proposed rule or regulation, find that such rule or regulation is necessary and appropriate in furtherance of the purposes of this section notwithstanding the Secretary's determination.

(3)

(A) No broker or dealer (other than a government securities broker or government securities dealer, except a registered broker or dealer) shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security (except a government security) or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall (A) require the maintenance of reserves with respect to customers' deposits or credit balances, and (B) no later than September 1, 1975, establish minimum financial responsibility requirements for all brokers and dealers.

(B) Consistent with this title [*15 USCS §§ 78a et seq.*], the Commission, in consultation with the Commodity Futures Trading Commission, shall issue such rules, regulations, or orders as are necessary to avoid duplicative or conflicting regulations applicable to any broker or dealer registered with the Commission pursuant to section 15(b) [*15 USCS § 78o(b)*] (except paragraph (11) thereof), that is also registered with the Commodity Futures Trading Commission pursuant to section 4f(a) of the Commodity Exchange Act [*7 USCS § 6f(a)*] (except paragraph (2) thereof), with respect to the application of (i) the provisions of section 8, section 15(c)(3), and section 17 of this title [*15 USCS § 78h, § 78o(c)(3), and § 78q*] and the rules and regulations thereunder related to the treatment of customer funds, securities, or property, maintenance of books and records, financial reporting, or other financial responsibility rules, involving security futures products and (ii) similar provisions of the Commodity Exchange Act [*7 USCS §§ 1 et seq.*] and rules and regulations thereunder involving security futures products.

(4) If the Commission finds, after notice and opportunity for a hearing, that any person subject to the provisions of section 12, 13, 14, or subsection (d) of section 15 of this title [*15 USCS § 78l, 78m, 78n, or 78o(d)*] or any rule or regulation thereunder has failed to comply with any such provision, rule, or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person, and any person who was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure to comply, to comply, or to take steps to effect compliance, with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.

(5) No dealer (other than a specialist registered on a national securities exchange) acting in the capacity of market maker or otherwise shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or a municipal security) in contravention of such specified and appropriate standards with respect to dealing as the Commission, by rule, shall prescribe as necessary or appropriate in the public interest and for the protection of investors, to maintain fair and orderly markets, or to remove impediments to and perfect the mechanism of a national market system. Under the rules of the Commission a dealer in a security may be prohibited from acting as a broker in that security.

(6) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security, municipal security, commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors or to perfect or remove impediments to a national system for the prompt and accurate clearance and settlement of securities transactions, with respect to the time and method of, and the form and format of documents used in connection with, making settlements of and payments for transactions in securities, making transfers and deliveries of securities, and closing accounts. Nothing in this paragraph shall be construed (A) to affect the authority of the Board of Governors of the Federal Reserve System, pursuant to section 7 of this title [15 USCS § 78g], to prescribe rules and regulations for the purpose of preventing the excessive use of credit for the purchase or carrying of securities, or (B) to authorize the Commission to prescribe rules or regulations for such purpose.

(7) In connection with any bid for or purchase of a government security related to an offering of government securities by or on behalf of an issuer, no government securities broker, government securities dealer, or bidder for or purchaser of securities in such offering shall knowingly or willfully make any false or misleading written statement or omit any fact necessary to make any written statement made not misleading.

(8) Prohibition of referral fees. No broker or dealer, or person associated with a broker or dealer, may solicit or accept, directly or indirectly, remuneration for assisting an attorney in obtaining the representation of any person in any private action arising under this title [15 USCS §§ 78a et seq.] or under the Securities Act of 1933 [15 USCS §§ 77a et seq.].

(d) Filing of supplementary and periodic information. Each issuer which has filed a registration statement containing an undertaking which is or becomes operative under this subsection as in effect prior to the date of enactment of the Securities Acts Amendments of 1964 [enacted Aug. 20, 1964], and each issuer which shall after such date file a registration statement which has become effective pursuant to the Securities Act of 1933, as amended [15 USCS §§ 77a et seq.], shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to section 13 of this title [15 USCS § 78m] in respect of a security registered pursuant to section 12 of this title [15 USCS § 78l]. The duty to file under this subsection shall be automatically suspended if and so long as any issue of securities of such issuer is registered pursuant to section 12 of this title [15 USCS § 78l]. The duty to file under this subsection shall also be automatically suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class to which the registration statement relates are held of record by less than three hundred persons. For the purposes of this subsection, the term "class" shall be construed to include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. The Commission may, for the purpose of this subsection, define by rules and regulations the term "held of record" as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection. Nothing in this subsection shall apply to securities issued by a foreign government or political subdivision thereof.

(e) Compliance with this chapter by members not required to be registered. The Commission, by rule, as it deems necessary or appropriate in the public interest and for the protection of investors or to assure equal regulation, may

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require any member of a national securities exchange not required to register under section 15 of this title [this section] and any person associated with any such member to comply with any provision of this title [15 USCS §§ 78a et seq.] (other than section 15(a) [subsec. (a) of this section]) or the rules or regulations thereunder which by its terms regulates or prohibits any act, practice, or course of business by a "broker or dealer" or "registered broker or dealer" or a "person associated with a broker or dealer," respectively.

(f) Prevention of misuse of material, nonpublic information. Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title [15 USCS §§ 78a et seq.], or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. The Commission, as it deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this title [15 USCS §§ 78a et seq.] (or the rules or regulations thereunder) of material, nonpublic information.

(g) Requirements for transactions in penny stocks.

(1) In general. No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any penny stock by any customer except in accordance with the requirements of this subsection and the rules and regulations prescribed under this subsection.

(2) Risk disclosure with respect to penny stocks. Prior to effecting any transaction in any penny stock, a broker or dealer shall give the customer a risk disclosure document that--

(A) contains a description of the nature and level of risk in the market for penny stocks in both public offerings and secondary trading;

(B) contains a description of the broker's or dealer's duties to the customer and of the rights and remedies available to the customer with respect to violations of such duties or other requirements of Federal securities laws;

(C) contains a brief, clear, narrative description of a dealer market, including "bid" and "ask" prices for penny stocks and the significance of the spread between the bid and ask prices;

(D) contains the toll free telephone number for inquiries on disciplinary actions established pursuant to section

15A(i) of this title [*15 USCS § 78o-3(i)*];

(E) defines significant terms used in the disclosure document or in the conduct of trading in penny stocks; and

(F) contains such other information, and is in such form (including language, type size, and format), as the Commission shall require by rule or regulation.

(3) Commission rules relating to disclosure. The Commission shall adopt rules setting forth additional standards for the disclosure by brokers and dealers to customers of information concerning transactions in penny stocks. Such rules--

(A) shall require brokers and dealers to disclose to each customer, prior to effecting any transaction in, and at the time of confirming any transaction with respect to any penny stock, in accordance with such procedures and methods as the Commission may require consistent with the public interest and the protection of investors--

(i) the bid and ask prices for penny stock, or such other information as the Commission may, by rule, require to provide customers with more useful and reliable information relating to the price of such stock;

(ii) the number of shares to which such bid and ask prices apply, or other comparable information relating to the depth and liquidity of the market for such stock; and

(iii) the amount and a description of any compensation that the broker or dealer and the associated person thereof will receive or has received in connection with such transaction;

(B) shall require brokers and dealers to provide, to each customer whose account with the broker or dealer contains penny stocks, a monthly statement indicating the market value of the penny stocks in that account or indicating that the market value of such stock cannot be determined because of the unavailability of firm quotes; and

(C) may, as the Commission finds necessary or appropriate in the public interest or for the protection of investors, require brokers and dealers to disclose to customers additional information concerning transactions in penny stocks.

(4) Exemptions. The Commission, as it determines consistent with the public interest and the protection of investors, may by rule, regulation, or order exempt in whole or in part, conditionally or unconditionally, any person or class of persons, or any transaction or class of transactions, from the requirements of this subsection. Such exemptions shall include an exemption for brokers and dealers based on the minimal percentage of the broker's or dealer's commissions, commission-equivalents, and markups received from transactions in penny stocks.

(5) Regulations. It shall be unlawful for any person to violate such rules and regulations as the Commission shall prescribe in the public interest or for the protection of investors or to maintain fair and orderly markets--

(A) as necessary or appropriate to carry out this subsection; or

(B) as reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices with respect to penny stocks.

(h) Limitations on State law.

(1) Capital, margin, books and records, bonding, and reports. No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under this title [15 USCS §§ 78a et seq.]. The Commission shall consult periodically the securities commissions (or any agency or office performing like functions) of the States concerning the adequacy of such requirements as established under this title [15 USCS §§ 78a et seq.].

(2) De minimis transactions by associated persons. No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof may prohibit an associated person of a broker or dealer from effecting a transaction described in paragraph (3) for a customer in such State if--

(A) such associated person is not ineligible to register with such State for any reason other than such a transaction;

(B) such associated person is registered with a registered securities association and at least one State; and

(C) the broker or dealer with which such person is associated is registered with such State.

(3) Described transactions.

(A) In general. A transaction is described in this paragraph if--

(i) such transaction is effected--

(I) on behalf of a customer that, for 30 days prior to the day of the transaction, maintained an account with the broker or dealer; and

(II) by an associated person of the broker or dealer--

(aa) to which the customer was assigned for 14 days prior to the day of the transaction; and

(bb) who is registered with a State in which the customer was a resident or was present for at least 30 consecutive days during the 1-year period prior to the day of the transaction; or

(ii) the transaction is effected--

(I) on behalf of a customer that, for 30 days prior to the day of the transaction, maintained an account with the broker or dealer; and

(II) during the period beginning on the date on which such associated person files an application for registration with the State in which the transaction is effected and ending on the earlier of--

(aa) 60 days after the date on which the application is filed; or

(bb) the date on which such State notifies the associated person that it has denied the application for registration or has stayed the pendency of the application for cause.

(B) Rules of construction. For purposes of subparagraph (A)(i)(II)--

(i) each of up to 3 associated persons of a broker or dealer who are designated to effect transactions during the absence or unavailability of the principal associated person for a customer may be treated as an associated person to which such customer is assigned; and

(ii) if the customer is present in another State for 30 or more consecutive days or has permanently changed his or her residence to another State, a transaction is not described in this paragraph, unless the associated person of the broker or dealer files an application for registration with such State not later than 10 business days after the later of the date of the transaction, or the date of the discovery of the presence of the customer in the other State for 30 or more consecutive days or the change in the customer's residence.

(i) Rulemaking to extend requirements to new hybrid products.

(1) Consultation. Prior to commencing a rulemaking under this subsection, the Commission shall consult with and seek the concurrence of the Board concerning the imposition of broker or dealer registration requirements with respect to any new hybrid product. In developing and promulgating rules under this subsection, the Commission shall consider the views of the Board, including views with respect to the nature of the new hybrid product; the history, purpose, extent, and appropriateness of the regulation of the new product under the Federal banking laws; and the impact of the proposed rule on the banking industry.

(2) Limitation. The Commission shall not--

(A) require a bank to register as a broker or dealer under this section because the bank engages in any transaction in, or buys or sells, a new hybrid product; or

(B) bring an action against a bank for a failure to comply with a requirement described in subparagraph (A), unless the Commission has imposed such requirement by rule or regulation issued in accordance with this section.

(3) Criteria for rulemaking. The Commission shall not impose a requirement under paragraph (2) of this subsection with respect to any new hybrid product unless the Commission determines that--

(A) the new hybrid product is a security; and

(B) imposing such requirement is necessary and appropriate in the public interest and for the protection of investors.

(4) Considerations. In making a determination under paragraph (3), the Commission shall consider--

(A) the nature of the new hybrid product; and

(B) the history, purpose, extent, and appropriateness of the regulation of the new hybrid product under the Federal securities laws and under the Federal banking laws.

(5) Objection to commission regulation.

(A) Filing of petition for review. The Board may obtain review of any final regulation described in paragraph (2) in the United States Court of Appeals for the District of Columbia Circuit by filing in such court, not later than 60 days after the date of publication of the final regulation, a written petition requesting that the regulation be set aside. Any proceeding to challenge any such rule shall be expedited by the Court of Appeals.

(B) Transmittal of petition and record. A copy of a petition described in subparagraph (A) shall be transmitted as soon as possible by the Clerk of the Court to an officer or employee of the Commission designated for that purpose. Upon receipt of the petition, the Commission shall file with the court the regulation under review and any documents referred to therein, and any other relevant materials prescribed by the court.

(C) Exclusive jurisdiction. On the date of the filing of the petition under subparagraph (A), the court has jurisdiction, which becomes exclusive on the filing of the materials set forth in subparagraph (B), to affirm and enforce or to set aside the regulation at issue.

(D) Standard of review. The court shall determine to affirm and enforce or set aside a regulation of the Commission under this subsection, based on the determination of the court as to whether--

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(i) the subject product is a new hybrid product, as defined in this subsection;

(ii) the subject product is a security; and

(iii) imposing a requirement to register as a broker or dealer for banks engaging in transactions in such product is appropriate in light of the history, purpose, and extent of regulation under the Federal securities laws and under the Federal banking laws, giving deference neither to the views of the Commission nor the Board.

(E) Judicial stay. The filing of a petition by the Board pursuant to subparagraph (A) shall operate as a judicial stay, until the date on which the determination of the court is final (including any appeal of such determination).

(F) Other authority to challenge. Any aggrieved party may seek judicial review of the Commission's rulemaking under this subsection pursuant to section 25 of this title [15 USCS § 78y].

(6) Definitions. For purposes of this subsection:

(A) New hybrid product. The term "new hybrid product" means a product that--

(i) was not subjected to regulation by the Commission as a security prior to the date of the enactment of the Gramm-Leach-Bliley Act [enacted Nov. 12, 1999];

(ii) is not an identified banking product as such term is defined in section 206 of such Act [15 USCS § 78c note]; and

(iii) is not an equity swap within the meaning of section 206(a)(6) of such Act [15 USCS § 78c note].

(B) Board. The term "Board" means the Board of Governors of the Federal Reserve System.

[(j)](i) Limitation on Commission authority. The authority of the Commission under this section with respect to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS § 78c note]) shall be subject to the restrictions and limitations of section 3A(b) of this title [15 USCS § 78c-1(b)].

Explanatory notes:

Brackets have been inserted around the word "or" in subsec. (b)(8) of this section to indicate the probable intent of Congress to delete such word.

The bracketed subsection designator "(j)" has been inserted in order to maintain alphabetical continuity.

(6) Definitions

For purposes of this subsection:

(A) New hybrid product

The term "new hybrid product" means a product that--

(i) was not subjected to regulation by the Commission as a security prior to the date of the enactment of the Gramm-Leach-Bliley Act [enacted November 12, 1999];

(ii) is not an identified banking product as such term is defined in section 206 of such Act [Pub. L. No. 106-102, 113 Stat. 1385, Nov. 12, 1999]; and

(iii) is not an equity swap within the meaning of section 206(a)(6) of such Act [Pub. L. No. 106-102, 113 Stat. 1385, Nov. 12, 1999].

(B) Board

The term "Board" means the Board of Governors of the Federal Reserve System.

The authority of the Commission under this section with respect to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) shall be subject to the restrictions and limitations of section 3A(b) of this title. n*

FOOTNOTES:

(n315)Footnote *.

Editor's Note: The Consolidated Futures Modernization Act of 2000, 106 Pub. L. No. 554, Dec. 21, 2000, enacted this subsection (i) even though another subsection (i) had previously been enacted.



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

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§ 15B [15 USC § 78o-4] Municipal securities

(a) Registration of municipal securities dealers

(1) It shall be unlawful for any municipal securities dealer (other than one registered as a broker or dealer under section 78o of this title) to make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security unless such municipal securities dealer is registered in accordance with this subsection.

(2) A municipal securities dealer may be registered by filing with the Commission an application for registration in such form and containing such information and documents concerning such municipal securities dealer and any persons associated with such municipal securities dealer as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Within forty-five days of the date of the filing of such application (or within such longer period as to which the applicant consents), the Commission shall--

(A) by order grant registration, or

(B) institute proceedings to determine whether registration should be denied. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within one hundred twenty days of the date of the filing of the application for registration. At the conclusion of such proceedings the Commission, by order, shall grant or deny such registration. The Commission may extend the time for the conclusion of such proceedings for up to ninety days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

The Commission shall grant the registration of a municipal securities dealer if the Commission finds that the

requirements of this section are satisfied. The Commission shall deny such registration if it does not make such a finding or if it finds that if the applicant were so registered, its registration would be subject to suspension or revocation under subsection (c) of this section.

(3) Any provision of this chapter (other than section 78e of this title or paragraph (1) of this subsection) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce is used in connection therewith shall also prohibit any such act, practice, or course of business by any registered municipal securities dealer or any person acting on behalf of such municipal securities dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

(4) The Commission, by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt any broker, dealer, or municipal securities dealer or class of brokers, dealers, or municipal securities dealers from any provision of this section or the rules or regulations thereunder, if the Commission finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of this section.

(b) Municipal Securities Rulemaking Board; rules and regulations

(1) Not later than one hundred twenty days after June 4, 1975, the Commission shall establish a Municipal Securities Rulemaking Board (hereinafter in this section referred to as the "Board"), to be composed initially of fifteen members appointed by the Commission, which shall perform the duties set forth in this section. The initial members of the Board shall serve as members for a term of two years, and shall consist of (A) five individuals who are not associated with any broker, dealer, or municipal securities dealer (other than by reason of being under common control with, or indirectly controlling, any broker or dealer which is not a municipal securities broker or municipal securities dealer), at least one of whom shall be representative of investors in municipal securities, and at least one of whom shall be representative of issuers of municipal securities (which members are hereinafter referred to as "public representatives"); (B) five individuals who are associated with and representative of municipal securities brokers and municipal securities dealers which are not banks or subsidiaries or departments or divisions of banks (which members are hereinafter referred to as "broker-dealer representatives"); and (C) five individuals who are associated with and representative of municipal securities dealers which are banks or subsidiaries or departments or divisions of banks (which members are hereinafter referred to as "bank representatives"). Prior to the expiration of the terms of office of the initial members of the Board, an election shall be held under rules adopted by the Board (pursuant to subsection (b)(2)(B) of this section) of the members to succeed such initial members.

(2)

The Board shall propose and adopt rules to effect the purposes of this chapter with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers. (Such rules are hereinafter collectively referred to in this chapter as "rules of the Board".) The rules of the Board, as a minimum, shall:

(A)

provide that no municipal securities broker or municipal securities dealer shall effect any transaction in, or induce or attempt to induce the purchase or sale of, any municipal security unless such municipal securities broker or municipal securities dealer meets such standards of operational capability and such municipal securities broker or municipal securities dealer and every natural person associated with such municipal securities broker or municipal securities dealer meet such standards of training, experience, competence, and such other qualifications as the Board finds necessary or appropriate in the public interest or for the protection of investors. In connection with the definition and application of such standards the Board may--

(i)

appropriately classify municipal securities brokers and municipal securities dealers (taking into account relevant matters, including types of business done, nature of securities other than municipal securities sold, and character of business organization), and persons associated with municipal securities brokers and municipal securities dealers;

(ii)

specify that all or any portion of such standards shall be applicable to any such class;

(iii)

require persons in any such class to pass tests administered in accordance with subsection (c)(7) of this section; and

(iv)

provide that persons in any such class other than municipal securities brokers and municipal securities dealers and partners, officers, and supervisory employees of municipal securities brokers or municipal securities dealers, may be qualified solely on the basis of compliance with such standards of training and such other qualifications as the Board finds appropriate.

(B)

establish fair procedures for the nomination and election of members of the Board and assure fair representation in such nominations and elections of municipal securities brokers and municipal securities dealers. Such rules shall provide that the membership of the Board shall at all times be equally divided among public representatives, broker-dealer representatives, and bank representatives, and that the public representatives shall be subject to approval by the Commission to assure that no one of them is associated with any broker, dealer, or municipal securities dealer (other than by reason of being under common control with, or indirectly controlling, any broker or dealer which is not a municipal securities broker or municipal securities dealer) and that at least one is representative of investors in municipal securities and at least one is representative of issuers of municipal securities. Such rules shall also specify the term members shall serve and may increase the number of members which shall constitute the whole Board provided

that such number is an odd number.

(C)

be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest; and not be designed to permit unfair discrimination between customers, issuers, municipal securities brokers, or municipal securities dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by municipal securities brokers or municipal securities dealers, to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the Board, or to impose any burden on competition not or appropriate in furtherance of the purposes of this chapter

(D)

if the Board deems appropriate, provide for the arbitration of claims, disputes, and controversies relating to transactions in municipal securities: Provided, however, That no person other than a municipal securities broker, municipal securities dealer, or person associated with such a municipal securities broker or municipal securities dealer may be compelled to submit to such arbitration except at his instance and in accordance with section 78cc of this title.

(E)

provide for the periodic examination in accordance with subsection (c)(7) of this section of municipal securities brokers and municipal securities dealers to determine compliance with applicable provisions of this chapter, the rules and regulations thereunder, and the rules of the Board. Such rules shall specify the minimum scope and frequency of such examinations and shall be designed to avoid unnecessary regulatory duplication or undue regulatory burdens for any such municipal securities broker or municipal securities dealer.

(F)

include provisions governing the form and content of quotations relating to municipal securities which may be distributed or published by any municipal securities broker, municipal securities dealer, or person associated with such a municipal securities broker or municipal securities dealer, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.

(G)

prescribe records to be made and kept by municipal securities brokers and municipal securities dealers and the periods for which such records shall be preserved.

(H)

define the term "separately identifiable department or division", as that term is used in section 78c(a)(30) of this title, in accordance with specified and appropriate standards to assure that a bank is not deemed to be engaged in the business of buying and selling municipal securities through a separately identifiable department or division unless such department or division is organized and administered so as to permit independent examination and enforcement of applicable provisions of this chapter, the rules and regulations thereunder, and the rules of the Board. A separately identifiable department or division of a bank may be engaged in activities other than those relating to municipal securities.

(I)

provide for the operation and administration of the Board, including the selection of a Chairman from among the members of the Board, the compensation of the members of the Board, and the appointment and compensation of such employees, attorneys, and consultants as may be necessary or appropriate to carry out the Board's functions under this section.

(J)

provide that each municipal securities broker and each municipal securities dealer shall pay to the Board such reasonable fees and charges as may be necessary or appropriate to defray the costs and expenses of operating and administering the Board. Such rules shall specify the amount of such fees and charges.

(K)

establish the terms and conditions under which any municipal securities dealer may sell, or prohibit any municipal securities dealer from selling, any part of a new issue of municipal securities to a municipal securities investment portfolio during the underwriting period.

(3)

Nothing in this section shall be construed to impair or limit the power of the Commission under this chapter.

(c) Discipline of municipal securities dealers; censure; suspension or revocation of registration; other sanctions; investigations

(1)

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No broker, dealer, or municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the Board.

(2)

The Commission, by order, shall censure, place limitations on the activities, functions, or operations, suspend for a period not exceeding twelve months, or revoke the registration of any municipal securities dealer, if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, denial, suspension, or revocation, is in the public interest and that such municipal securities dealer has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (A), (D), (E), (G) or (H) of paragraph (4) of section 78o(b) of this title, has been convicted of any offense specified in subparagraph (B) of such paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4).

(3)

Pending final determination whether any registration under this section shall be revoked, the Commission, by order, may suspend such registration, if such suspension appears to the Commission, after notice and opportunity for hearing, to be necessary or appropriate in the public interest or for the protection of investors. Any registered municipal securities dealer may, upon such terms and conditions as the Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered municipal securities dealer is no longer in existence or has ceased to do business as a municipal securities dealer, the Commission, by order, shall cancel the registration of such municipal securities dealer.

(4)

The Commission, by order, shall censure or place limitations on the activities or functions of any person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated with a municipal securities dealer, or suspend for a period not exceeding twelve months or bar any such person from being associated with a municipal securities dealer, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed any act, or is subject to an order or finding, enumerated in subparagraph (A), (D), (E), (G) or (H) of paragraph (4) of section 78o(b) of this title, has been convicted of any offense specified in subparagraph (B) of such paragraph (4) within 10 years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4). It shall be unlawful for any person as to whom an order entered pursuant to this paragraph or paragraph (5) of this subsection suspending or barring him from being associated with a municipal securities dealer is in effect willfully to become, or to be, associated with a municipal securities dealer without the consent of the Commission, and it shall be unlawful for any municipal securities dealer to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such municipal securities dealer knew, or, in the exercise of reasonable care should have known, of such order.

(5)

With respect to any municipal securities dealer for which the Commission is not the appropriate regulatory agency, the appropriate regulatory agency for such municipal securities dealer may sanction any such municipal securities dealer in the manner and for the reasons specified in paragraph (2) of this subsection and any person associated with such municipal securities dealer in the manner and for the reasons specified in paragraph (4) of this subsection. In addition, such appropriate regulatory agency may, in accordance with section 1818 of title 12, enforce compliance by such municipal securities dealer or any person associated with such municipal securities dealer with the provisions of this section, section 78q of this title, the rules of the Board, and the rules of the Commission pertaining to municipal securities dealers, persons associated with municipal securities dealers, and transactions in municipal securities. For purposes of the preceding sentence, any violation of any such provision shall constitute adequate basis for the issuance of any order under section 1818(b) or 1818(c) of title 12, and the customers of any such municipal securities dealer shall be deemed to be "depositors" as that term is used in section 1818(c) of title 12. Nothing in this paragraph shall be construed to affect in any way the powers of such appropriate regulatory agency to proceed against such municipal securities dealer under any other provision of law.

(6)

(A)

The Commission, prior to the entry of an order of investigation, or commencement of any proceedings, against any municipal securities dealer, or person associated with any municipal securities dealer, for which the Commission is not the appropriate regulatory agency, for violation of any provision of this section, section 78o(c)(1) or 78o(c)(2) of this title, any rule or regulation under any such section, or any rule of the Board, shall (i) give notice to the appropriate regulatory agency for such municipal securities dealer of the identity of such municipal securities dealer or person associated with such municipal securities dealer, the nature of and basis for such proposed action, and whether the Commission is seeking a monetary penalty against such municipal securities dealer or such associated person pursuant to section 78u-2 of this title; and (ii) consult with such appropriate regulatory agency concerning the effect of such proposed action on sound banking practices and the feasibility and desirability of coordinating such action with any proceeding or proposed proceeding by such appropriate regulatory agency against such municipal securities dealer or associated person.

(B)

The appropriate regulatory agency for a municipal securities dealer (if other than the Commission), prior to the entry of an order of investigation, or commencement of any proceedings, against such municipal securities dealer or person associated with such municipal securities dealer, for violation of any provision of this section, the rules of the Board, or the rules or regulations of the Commission pertaining to municipal securities dealers, persons associated with municipal securities dealers, or transactions in municipal securities shall (i) give notice to the Commission of the identity of such municipal securities dealer or person associated with such municipal securities dealer and the nature of and basis for such proposed action and (ii) consult with the Commission concerning the effect of such proposed action on the protection of investors and the feasibility and desirability of coordinating such action with any proceeding or proposed proceeding by the Commission against such municipal securities dealer or associated person.

(C)

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Nothing in this paragraph shall be construed to impair or limit (other than by the requirement of prior consultation) the power of the Commission or the appropriate regulatory agency for a municipal securities dealer to initiate any action of a class described in this paragraph or to affect in any way the power of the Commission or such appropriate regulatory agency to initiate any other action pursuant to this chapter or any other provision of law.

(7)

(A)

Tests required pursuant to subsection (b)(2)(A)(iii) of this section shall be administered by or on behalf of and periodic examinations pursuant to subsection (b)(2)(E) of this section shall be conducted by--

(i)

a registered securities association, in the case of municipal securities brokers and municipal securities dealers who are members of such association; and

(ii)

the appropriate regulatory agency for any municipal securities broker or municipal securities dealer, in the case of all other municipal securities brokers and municipal securities dealers.

(B)

A registered securities association shall make a report of any examination conducted pursuant to subsection (b)(2)(E) of this section and promptly furnish the Commission a copy thereof and any data supplied to it in connection with such examination. Subject to such limitations as the Commission, by rule, determines to be necessary or appropriate in the public interest or for the protection of investors, the Commission shall, on request, make available to the Board a copy of any report of an examination of a municipal securities broker or municipal securities dealer made by or furnished to the Commission pursuant to this paragraph or section 78q(c)(3) of this title.

(8)

The Commission is authorized, by order, if in its opinion such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise, in furtherance of the purposes of this chapter, to remove from office or censure any member or employee of the Board, who, the Commission finds, on the record after notice and opportunity for hearing, has willfully (A) violated any provision of this chapter, the rules and regulations thereunder, or the rules of the Board or (B) abused his authority.

(d) Issuance of municipal securities

(1)

Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.

(2)

The Board is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer: *Provided, however,* That the Board may require municipal securities brokers and municipal securities dealers to furnish to the Board or purchasers or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this chapter.



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 15C

§ 15C [15 USC § 78o-5] Government securities brokers and dealers

(a) Registration requirements; notice to regulatory agencies; manner of registration; exemption from registration requirements.

(1)

(A) It shall be unlawful for any government securities broker or government securities dealer (other than a registered broker or dealer or a financial institution) to make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government security unless such government securities broker or government securities dealer is registered in accordance with paragraph (2) of this subsection.

(B)

(i) It shall be unlawful for any government securities broker or government securities dealer that is a registered broker or dealer or a financial institution to make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government security unless such government securities broker or government securities dealer has filed with the appropriate regulatory agency written notice that it is a government securities broker or government securities dealer. When such a government securities broker or government securities dealer ceases to act as such it shall file with the appropriate regulatory agency a written notice that it is no longer acting as a government securities broker or government securities dealer.

(ii) Such notices shall be in such form and contain such information concerning a government securities broker or government securities dealer that is a financial institution and any persons associated with such government securities broker or government securities dealer as the Board of Governors of the Federal Reserve System shall, by rule, after

consultation with each appropriate regulatory agency (including the Commission), prescribe as necessary or appropriate in the public interest or for the protection of investors. Such notices shall be in such form and contain such information concerning a government securities broker or government securities dealer that is a registered broker or dealer and any persons associated with such government securities broker or government securities dealer as the Commission shall, by rule, prescribe as necessary or appropriate in the public interest or for the protection of investors.

(iii) Each appropriate regulatory agency (other than the Commission) shall make available to the Commission the notices which have been filed with it under this subparagraph, and the Commission shall maintain and make available to the public such notices and the notices it receives under this subparagraph.

(2) A government securities broker or a government securities dealer subject to the registration requirement of paragraph (1)(A) of this subsection may be registered by filing with the Commission an application for registration in such form and containing such information and documents concerning such government securities broker or government securities dealer and any persons associated with such government securities broker or government securities dealer as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Within 45 days of the date of filing of such application (or within such longer period as to which the applicant consents), the Commission shall--

(i) by order grant registration, or

(ii) institute proceedings to determine whether registration should be denied. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within 120 days of the date of the filing of the application for registration. At the conclusion of such proceedings, the Commission, by order, shall grant or deny such registration. The order granting registration shall not be effective until such government securities broker or government securities dealer has become a member of a national securities exchange registered under section 6 of this title [*15 USCS § 78f*], or a securities association registered under section 15A of this title [*15 USCS § 78o-3*], unless the Commission has exempted such government securities broker or government securities dealer, by rule or order, from such membership. The Commission may extend the time for the conclusion of such proceedings for up to 90 days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

The Commission shall grant the registration of a government securities broker or a government securities dealer if the Commission finds that the requirements of this section are satisfied. The Commission shall deny such registration if it does not make such a finding or if it finds that if the applicant were so registered, its registration would be subject to suspension or revocation under subsection (c) of this section.

(3) Any provision of this title [*15 USCS §§ 78a et seq.*] (other than section 5 [*15 USCS § 78e*] or paragraph (1) of this subsection) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce is used in connection therewith shall also prohibit any such act, practice, or course of business by any government securities broker or government securities dealer registered or having filed notice under paragraph (1) of this subsection or any person acting on behalf of such government securities broker or government securities dealer,

irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

(4) No government securities broker or government securities dealer that is required to register under paragraph (1)(A) and that is not a member of the Securities Investor Protection Corporation shall effect any transaction in any security in contravention of such rules as the Commission shall prescribe pursuant to this subsection to assure that its customers receive complete, accurate, and timely disclosure of the inapplicability of Securities Investor Protection Corporation coverage to their accounts.

(5) The Secretary of the Treasury (hereinafter in this section referred to as the "Secretary"), by rule or order, upon the Secretary's own motion or upon application, may conditionally or unconditionally exempt any government securities broker or government securities dealer, or class of government securities brokers or government securities dealers, from any provision of subsection (a), (b), or (d) of this section, other than subsection (d)(3), or the rules thereunder, if the Secretary finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of this title [15 USCS §§ 78a et seq.].

(b) Rules with respect to transactions in government securities.

(1) The Secretary shall propose and adopt rules to effect the purposes of this title [15 USCS §§ 78a et seq.] with respect to transactions in government securities effected by government securities brokers and government securities dealers as follows:

(A) Such rules shall provide safeguards with respect to the financial responsibility and related practices of government securities brokers and government securities dealers including, but not limited to, capital adequacy standards, the acceptance of custody and use of customers' securities, the carrying and use of customers' deposits or credit balances, and the transfer and control of government securities subject to repurchase agreements and in similar transactions.

(B) Such rules shall require every government securities broker and government securities dealer to make reports to and furnish copies of records to the appropriate regulatory agency, and to file with the appropriate regulatory agency, annually or more frequently, a balance sheet and income statement certified by an independent public accountant, prepared on a calendar or fiscal year basis, and such other financial statements (which shall, as the Secretary specifies, be certified) and information concerning its financial condition as required by such rules.

(C) Such rules shall require records to be made and kept by government securities brokers and government securities dealers and shall specify the periods for which such records shall be preserved.

(2) Risk assessment for holding company systems.

(A) Obligations to obtain, maintain, and report information. Every person who is registered as a government securities broker or government securities dealer under this section shall obtain such information and make and keep such records as the Secretary by rule prescribes concerning the registered person's policies, procedures, or systems for monitoring and controlling financial and operational risks to it resulting from the activities of any of its associated persons, other than a natural person. Such records shall describe, in the aggregate, each of the financial and securities activities conducted by, and customary sources of capital and funding of, those of its associated persons whose business activities are reasonably likely to have a material impact on the financial or operational condition of such registered person, including its capital, its liquidity, or its ability to conduct or finance its operations. The Secretary, by rule, may require summary reports of such information to be filed with the registered person's appropriate regulatory agency no more frequently than quarterly.

(B) Authority to require additional information. If, as a result of adverse market conditions or based on reports provided pursuant to subparagraph (A) of this paragraph or other available information, the appropriate regulatory agency reasonably concludes that it has concerns regarding the financial or operational condition of any government securities broker or government securities dealer registered under this section, such agency may require the registered person to make reports concerning the financial and securities activities of any of such person's associated persons, other than a natural person, whose business activities are reasonably likely to have a material impact on the financial or operational condition of such registered person. The appropriate regulatory agency, in requiring reports pursuant to this subparagraph, shall specify the information required, the period for which it is required, the time and date on which the information must be furnished, and whether the information is to be furnished directly to the appropriate regulatory agency or to a self-regulatory organization with primary responsibility for examining the registered person's financial and operational condition.

(C) Special provisions with respect to associated persons subject to Federal banking agency regulation.

(i) Cooperation in implementation. In developing and implementing reporting requirements pursuant to subparagraph (A) of this paragraph with respect to associated persons subject to examination by or reporting requirements of a Federal banking agency, the Secretary shall consult with and consider the views of each such Federal banking agency. If a Federal banking agency comments in writing on a proposed rule of the Secretary under this paragraph that has been published for comment, the Secretary shall respond in writing to such written comment before adopting the proposed rule. The Secretary shall, at the request of a Federal banking agency, publish such comment and response in the Federal Register at the time of publishing the adopted rule.

(ii) Use of banking agency reports. A registered government securities broker or government securities dealer shall be in compliance with any recordkeeping or reporting requirement adopted pursuant to subparagraph (A) of this paragraph concerning an associated person that is subject to examination by or reporting requirements of a Federal banking agency if such government securities broker or government securities dealer utilizes for such recordkeeping or reporting requirement copies of reports filed by the associated person with the Federal banking agency pursuant to

section 5211 of the Revised Statutes [*12 USCS § 161*], section 9 of the Federal Reserve Act [*12 USCS §§ 321 et seq.*], section 7(a) of the Federal Deposit Insurance Act [*12 USCS § 1817(a)*], section 10(b) of the Home Owners' Loan Act [*12 USCS § 1467a(b)*], or section 8 of the Bank Holding Company Act of 1956 [*12 USCS § 1847*]. The Secretary may, however, by rule adopted pursuant to subparagraph (A), require any registered government securities broker or government securities dealer filing such reports with the appropriate regulatory agency to obtain, maintain, or report supplemental information if the Secretary makes an explicit finding, based on information provided by the appropriate regulatory agency, that such supplemental information is necessary to inform the appropriate regulatory agency regarding potential risks to such government securities broker or government securities dealer. Prior to requiring any such supplemental information, the Secretary shall first request the Federal banking agency to expand its reporting requirements to include such information.

(iii) Procedure for requiring additional information. Prior to making a request pursuant to subparagraph (B) of this paragraph for information with respect to an associated person that is subject to examination by or reporting requirements of a Federal banking agency, the appropriate regulatory agency shall--

(I) notify such banking agency of the information required with respect to such associated person; and

(II) consult with such agency to determine whether the information required is available from such agency and for other purposes, unless the appropriate regulatory agency determines that any delay resulting from such consultation would be inconsistent with ensuring the financial and operational condition of the government securities broker or government securities dealer or the stability or integrity of the securities markets.

(iv) Exclusion for examination reports. Nothing in this subparagraph shall be construed to permit the Secretary or an appropriate regulatory agency to require any registered government securities broker or government securities dealer to obtain, maintain, or furnish any examination report of any Federal banking agency or any supervisory recommendations or analysis contained therein.

(v) Confidentiality of information provided. No information provided to or obtained by an appropriate regulatory agency from any Federal banking agency pursuant to a request under clause (iii) of this subparagraph regarding any associated person which is subject to examination by or reporting requirements of a Federal banking agency may be disclosed to any other person (other than a self-regulatory organization), without the prior written approval of the Federal banking agency. Nothing in this clause shall authorize the Secretary or any appropriate regulatory agency to withhold information from Congress, or prevent the Secretary or any appropriate regulatory agency from complying with a request for information from any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action brought by the United States or the Commission.

(vi) Notice to banking agencies concerning financial and operational condition concerns. The Secretary or appropriate regulatory agency shall notify the Federal banking agency of any concerns of the Secretary or the

appropriate regulatory agency regarding significant financial or operational risks resulting from the activities of any government securities broker or government securities dealer to any associated person thereof which is subject to examination by or reporting requirements of the Federal banking agency.

(vii) Definition. For purposes of this subparagraph, the term "Federal banking agency" shall have the same meaning as the term "appropriate Federal banking agency" in section 3(q) of the Federal Deposit Insurance Act (*12 U.S.C. 1813(q)*).

(D) Exemptions. The Secretary by rule or order may exempt any person or class of persons, under such terms and conditions and for such periods as the Secretary shall provide in such rule or order, from the provisions of this paragraph, and the rules thereunder. In granting such exemptions, the Secretary shall consider, among other factors--

(i) whether information of the type required under this paragraph is available from a supervisory agency (as defined in section 1101(6) of the Right to Financial Privacy Act of 1978 (*12 U.S.C. 3401(6)*)), a State insurance commission or similar State agency, the Commodity Futures Trading Commission, or a similar foreign regulator;

(ii) the primary business of any associated person;

(iii) the nature and extent of domestic or foreign regulation of the associated person's activities;

(iv) the nature and extent of the registered person's securities transactions; and

(v) with respect to the registered person and its associated persons, on a consolidated basis, the amount and proportion of assets devoted to, and revenues derived from, activities in the United States securities markets.

(E) Conformity with requirements under section 17(h). In exercising authority pursuant to subparagraph (A) of this paragraph concerning information with respect to associated persons of government securities brokers and government securities dealers who are also associated persons of registered brokers or dealers reporting to the Commission pursuant to section 17(h) of this title [*15 USCS § 78q(h)*], the requirements relating to such associated persons shall conform, to the greatest extent practicable, to the requirements under section 17(h) [*15 USCS § 78q(h)*].

(F) Authority to limit disclosure of information. Notwithstanding any other provision of law, the Secretary and any appropriate regulatory agency shall not be compelled to disclose any information required to be reported under this paragraph, or any information supplied to the Secretary or any appropriate regulatory agency by any domestic or foreign

regulatory agency that relates to the financial or operational condition of any associated person of a registered government securities broker or a government securities dealer. Nothing in this paragraph shall authorize the Secretary or any appropriate regulatory agency to withhold information from Congress, or prevent the Secretary or any appropriate regulatory agency from complying with a request for information from any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action brought by the United States or the Commission. For purposes of *section 552 of title 5, United States Code*, this paragraph shall be considered a statute described in subsection (b)(3)(B) of such section 552 [5 USCS § 552].

(3)

(A) With respect to any financial institution that has filed notice as a government securities broker or government securities dealer or that is required to file notice under subsection (a)(1)(B), the appropriate regulatory agency for such government securities broker or government securities dealer may issue such rules and regulations with respect to transactions in government securities as may be necessary to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade. If the Secretary of the Treasury determines, and notifies the appropriate regulatory agency, that such rule or regulation, if implemented, would, or as applied does (i) adversely affect the liquidity or efficiency of the market for government securities; or (ii) impose any burden on competition not necessary or appropriate in furtherance of the purposes of this section, the appropriate regulatory agency shall, prior to adopting the proposed rule or regulation, find that such rule or regulation is necessary and appropriate in furtherance of the purposes of this section notwithstanding the Secretary's determination.

(B) The appropriate regulatory agency shall consult with and consider the views of the Secretary prior to approving or amending a rule or regulation under this paragraph, except where the appropriate regulatory agency determines that an emergency exists requiring expeditious and summary action and publishes its reasons therefor. If the Secretary comments in writing to the appropriate regulatory agency on a proposed rule or regulation that has been published for comment, the appropriate regulatory agency shall respond in writing to such written comment before approving the proposed rule or regulation.

(C) In promulgating rules under this section, the appropriate regulatory agency shall consider the sufficiency and appropriateness of then existing laws and rules applicable to government securities brokers, government securities dealers, and persons associated with government securities brokers and government securities dealers.

(4) Rules promulgated and orders issued under this section shall--

(A) be designed to prevent fraudulent and manipulative acts and practices and to protect the integrity, liquidity, and efficiency of the market for government securities, investors, and the public interest; and

(B) not be designed to permit unfair discrimination between customers, issuers, government securities brokers, or

government securities dealers, or to impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title [15 USCS §§ 78a et seq.].

(5) In promulgating rules and issuing orders under this section, the Secretary--

(A) may appropriately classify government securities brokers and government securities dealers (taking into account relevant matters, including types of business done, nature of securities other than government securities purchased or sold, and character of business organization) and persons associated with government securities brokers and government securities dealers;

(B) may determine, to the extent consistent with paragraph (2) of this subsection and with the public interest, the protection of investors, and the purposes of this title [15 USCS §§ 78a et seq.], not to apply, in whole or in part, certain rules under this section, or to apply greater, lesser, or different standards, to certain classes of government securities brokers, government securities dealers, or persons associated with government securities brokers or government securities dealers;

(C) shall consider the sufficiency and appropriateness of then existing laws and rules applicable to government securities brokers, government securities dealers, and persons associated with government securities brokers and government securities dealers; and

(D) shall consult with and consider the views of the Commission and the Board of Governors of the Federal Reserve System, except where the Secretary determines that an emergency exists requiring expeditious or summary action and publishes its reasons for such determination.

(6) If the Commission or the Board of Governors of the Federal Reserve System comments in writing on a proposed rule of the Secretary that has been published for comment, the Secretary shall respond in writing to such written comment before approving the proposed rule.

(7) No government securities broker or government securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government security in contravention of any rule under this section.

(c) Sanctions for violations.

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(1) With respect to any government securities broker or government securities dealer registered or required to register under subsection (a)(1)(A) of this section--

(A) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of such government securities broker or government securities dealer, if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such government securities broker or government securities dealer, or any person associated with such government securities broker or government securities dealer (whether prior or subsequent to becoming so associated), has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (A), (D), (E), (H), or (G) of paragraph (4) of section 15(b) of this title [15 USCS § 78o(b)], has been convicted of any offense specified in subparagraph (B) of such paragraph (4) within 10 years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4).

(B) Pending final determination whether registration of any government securities broker or government securities dealer shall be revoked, the Commission, by order, may suspend such registration, if such suspension appears to the Commission, after notice and opportunity for hearing, to be necessary or appropriate in the public interest or for the protection of investors. Any registered government securities broker or registered government securities dealer may, upon such terms and conditions as the Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered government securities broker or registered government securities dealer is no longer in existence or has ceased to do business as a government securities broker or government securities dealer, the Commission, by order, shall cancel the registration of such government securities broker or government securities dealer.

(C) The Commission, by order, shall censure or place limitations on the activities or functions of any person associated, or seeking to become associated, with a government securities broker or government securities dealer registered or required to register under subsection (a)(1)(A) of this section or suspend for a period not exceeding 12 months or bar any such person from being associated with such a government securities broker or government securities dealer, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (A), (D), (E), (H), or (G) of paragraph (4) of section 15(b) of this title [15 USCS § 78o(b)], has been convicted of any offense specified in subparagraph (B) of such paragraph (4) [15 USCS § 78o(b)(4)(B)] within 10 years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4) [15 USCS § 78o(b)(4)].

(2)

(A) With respect to any government securities broker or government securities dealer which is not registered or required to register under subsection (a)(1)(A) of this section, the appropriate regulatory agency for such government securities broker or government securities dealer may, in the manner and for the reasons specified in paragraph (1)(A) of this subsection, censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or bar from acting as a government securities broker or government securities dealer any such

government securities broker or government securities dealer, and may sanction any person associated with such government securities broker or government securities dealer in the manner and for the reasons specified in paragraph (1)(C) of this subsection.

(B) In addition, where applicable, such appropriate regulatory agency may, in accordance with section 8 of the Federal Deposit Insurance Act (*12 U.S.C. 1818*), section 5 of the Home Owners' Loan Act of 1933 (*12 U.S.C. 1464*), or section 407 of the National Housing Act (*12 U.S.C. 1730*), enforce compliance by such government securities broker or government securities dealer or any person associated with such government securities broker or government securities dealer with the provisions of this section and the rules thereunder.

(C) For purposes of subparagraph (B) of this paragraph, any violation of any such provision shall constitute adequate basis for the issuance of any order under section 8(b) or 8(c) of the Federal Deposit Insurance Act, section 5(d)(2) or 5(d)(3) of the Home Owners' Loan Act of 1933, or section 407(e) or 407(f) of the National Housing Act, and the customers of any such government securities broker or government securities dealer shall be deemed, respectively, "depositors" as that term is used in section 8(c) of the Federal Deposit Insurance Act, "savings account holders" as that term is used in section 5(d)(3) of the Home Owners' Loan Act of 1933, or "insured members" as that term is used in section 407(f) of the National Housing Act.

(D) Nothing in this paragraph shall be construed to affect in any way the powers of such appropriate regulatory agency to proceed against such government securities broker or government securities dealer under any other provision of law.

(E) Each appropriate regulatory agency (other than the Commission) shall promptly notify the Commission after it has imposed any sanction under this paragraph on a government securities broker or government securities dealer, or a person associated with a government securities broker or government securities dealer, and the Commission shall maintain, and make available to the public, a record of such sanctions and any sanctions imposed by it under this subsection.

(3) It shall be unlawful for any person as to whom an order entered pursuant to paragraph (1) or (2) of this subsection suspending or barring him from being associated with a government securities broker or government securities dealer is in effect willfully to become, or to be, associated with a government securities broker or government securities dealer without the consent of the appropriate regulatory agency, and it shall be unlawful for any government securities broker or government securities dealer to permit such a person to become, or remain, a person associated with it without the consent of the appropriate regulatory agency, if such government securities broker or government securities dealer knew, or, in the exercise of reasonable care should have known, of such order.

(d) Records of brokers and dealers subject to examination.

(1) All records of a government securities broker or government securities dealer are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the appropriate regulatory agency for such government securities broker or government securities dealer as such appropriate regulatory agency deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title [*15 USCS §§ 78a et seq.*].

(2) Information received by an appropriate regulatory agency, the Secretary, or the Commission from or with respect to any government securities broker, government securities dealer, any person associated with a government securities broker or government securities dealer, or any other person subject to this section or rules promulgated thereunder, may be made available by the Secretary or the recipient agency to the Commission, the Secretary, the Department of Justice, the Commodity Futures Trading Commission, any appropriate regulatory agency, any self-regulatory organization, or any Federal Reserve Bank.

(3) Government securities trade reconstruction.

(A) **Furnishing records.** Every government securities broker and government securities dealer shall furnish to the Commission on request such records of government securities transactions, including records of the date and time of execution of trades, as the Commission may require to reconstruct trading in the course of a particular inquiry or investigation being conducted by the Commission for enforcement or surveillance purposes. In requiring information pursuant to this paragraph, the Commission shall specify the information required, the period for which it is required, the time and date on which the information must be furnished, and whether the information is to be furnished directly to the Commission, to the Federal Reserve Bank of New York, or to an appropriate regulatory agency or self-regulatory organization with responsibility for examining the government securities broker or government securities dealer. The Commission may require that such information be furnished in machine readable form notwithstanding any limitation in subparagraph (B). In utilizing its authority to require information in machine readable form, the Commission shall minimize the burden such requirement may place on small government securities brokers and dealers.

(B) **Limitation; construction.** The Commission shall not utilize its authority under this paragraph to develop regular reporting requirements, except that the Commission may require information to be furnished under this paragraph as frequently as necessary for particular inquiries or investigations for enforcement or surveillance purposes. This paragraph shall not be construed as requiring, or as authorizing the Commission to require, any government securities broker or government securities dealer to obtain or maintain any information for purposes of this paragraph which is not otherwise maintained by such broker or dealer in accordance with any other provision of law or usual and customary business practice. The Commission shall, where feasible, avoid requiring any information to be furnished under this paragraph that the Commission may obtain from the Federal Reserve Bank of New York.

(C) **Procedures for requiring information.** At the time the Commission requests any information pursuant to subparagraph (A) with respect to any government securities broker or government securities dealer for which the Commission is not the appropriate regulatory agency, the Commission shall notify the appropriate regulatory agency for such government securities broker or government securities dealer and, upon request, furnish to the appropriate

regulatory agency any information supplied to the Commission.

(D) Consultation. Within 90 days after the date of enactment of this paragraph, and annually thereafter, or upon the request of any other appropriate regulatory agency, the Commission shall consult with the other appropriate regulatory agencies to determine the availability of records that may be required to be furnished under this paragraph and, for those records available directly from the other appropriate regulatory agencies, to develop a procedure for furnishing such records expeditiously upon the Commission's request.

(E) Exclusion for examination reports. Nothing in this paragraph shall be construed so as to permit the Commission to require any government securities broker or government securities dealer to obtain, maintain, or furnish any examination report of any appropriate regulatory agency other than the Commission or any supervisory recommendations or analysis contained in any such examination report.

(F) Authority to limit disclosure of information. Notwithstanding any other provision of law, the Commission and the appropriate regulatory agencies shall not be compelled to disclose any information required or obtained under this paragraph. Nothing in this paragraph shall authorize the Commission or any appropriate regulatory agency to withhold information from Congress, or prevent the Commission or any appropriate regulatory agency from complying with a request for information from any other Federal department or agency requesting information for purposes within the scope of its jurisdiction, or from complying with an order of a court of the United States in an action brought by the United States, the Commission, or the appropriate regulatory agency. For purposes of *section 552 of title 5, United States Code*, this subparagraph shall be considered a statute described in subsection (b)(3)(B) of such section 552.

(e) Membership in national securities exchange; exemptions.

(1) It shall be unlawful for any government securities broker or government securities dealer registered or required to register with the Commission under subsection (a)(1)(A) to effect any transaction in, or induce or attempt to induce the purchase or sale of, any government security, unless such government securities broker or government securities dealer is a member of a national securities exchange registered under section 6 of this title [*15 USCS § 78f*] or a securities association registered under section 15A of this title [*15 USCS § 78o-3*].

(2) The Commission, after consultation with the Secretary, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraph (1) of this subsection any government securities broker or government securities dealer or class of government securities brokers or government securities dealers specified in such rule or order.

(f) Large position reporting.

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(1) Reporting requirements. The Secretary may adopt rules to require specified persons holding, maintaining, or controlling large positions in to-be-issued or recently issued Treasury securities to file such reports regarding such positions as the Secretary determines to be necessary and appropriate for the purpose of monitoring the impact in the Treasury securities market of concentrations of positions in Treasury securities and for the purpose of otherwise assisting the Commission in the enforcement of this title [15 USCS §§ 78a et seq.], taking into account any impact of such rules on the efficiency and liquidity of the Treasury securities market and the cost to taxpayers of funding the Federal debt. Unless otherwise specified by the Secretary, reports required under this subsection shall be filed with the Federal Reserve Bank of New York, acting as agent for the Secretary. Such reports shall, on a timely basis, be provided directly to the Commission by the person with whom they are filed.

(2) Recordkeeping requirements. Rules under this subsection may require persons holding, maintaining, or controlling large positions in Treasury securities to make and keep for prescribed periods such records as the Secretary determines are necessary or appropriate to ensure that such persons can comply with reporting requirements under this subsection.

(3) Aggregation rules. Rules under this subsection--

(A) may prescribe the manner in which positions and accounts shall be aggregated for the purpose of this subsection, including aggregation on the basis of common ownership or control; and

(B) may define which persons (individually or as a group) hold, maintain, or control large positions.

(4) Definitional authority; determination of reporting threshold.

(A) In prescribing rules under this subsection, the Secretary may, consistent with the purpose of this subsection, define terms used in this subsection that are not otherwise defined in section 3 of this title [15 USCS § 78c].

(B) Rules under this subsection shall specify--

(i) the minimum size of positions subject to reporting under this subsection, which shall be no less than the size that provides the potential for manipulation or control of the supply or price, or the cost of financing arrangements, of an issue or the portion thereof that is available for trading;

(ii) the types of positions (which may include financing arrangements) to be reported;

(iii) the securities to be covered; and

(iv) the form and manner in which reports shall be transmitted, which may include transmission in machine readable form.

(5) Exemptions. Consistent with the public interest and the protection of investors, the Secretary by rule or order may exempt in whole or in part, conditionally or unconditionally, any person or class of persons, or any transaction or class of transactions, from the requirements of this subsection.

(6) Limitation on disclosure of information. Notwithstanding any other provision of law, the Secretary and the Commission shall not be compelled to disclose any information required to be kept or reported under this subsection. Nothing in this subsection shall authorize the Secretary or the Commission to withhold information from Congress, or prevent the Secretary or the Commission from complying with a request for information from any other Federal department or agency requesting information for purposes within the scope of its jurisdiction, or from complying with an order of a court of the United States in an action brought by the United States, the Secretary, or the Commission. For purposes of *section 552 of title 5, United States Code*, this paragraph shall be considered a statute described in subsection (b)(3)(B) of such section 552.

(g) Effect on other laws; authority of Commission.

(1) Nothing in this section except paragraph (2) of this subsection shall be construed to impair or limit the authority under any other provision of law of the Commission, the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the Federal Savings and Loan Insurance Corporation, the Secretary of Housing and Urban Development, and the Government National Mortgage Association.

(2) Notwithstanding any other provision of this title [*15 USCS §§ 78a et seq.*], the Commission shall not have any authority to make investigations of, require the filing of a statement by, or take any other action under this title [*15 USCS §§ 78a et seq.*] against a government securities broker or government securities dealer, or any person associated with a government securities broker or government securities dealer, for any violation or threatened violation of the provisions of this section, other than subsection (d)(3)[,] or the rules or regulations thereunder, unless the Commission is the appropriate regulatory agency for such government securities broker or government securities dealer. Nothing in the preceding sentence shall be construed to limit the authority of the Commission with respect to violations or threatened violations of any provision of this title [*15 USCS §§ 78a et seq.*] other than this section (except subsection

(d)(3)), the rules or regulations under any such other provision, or investigations pursuant to section 21(a)(2) of this title [15 USCS § 78u(a)(2)] to assist a foreign securities authority.

(h) Emergency authority. The Secretary may, by order, take any action with respect to a matter or action subject to regulation by the Secretary under this section, or the rules of the Secretary under this section, involving a government security or a market therein (or significant portion or segment of that market), that the Commission may take under section 12(k)(2) [15 USCS § 78l(k)(2)] with respect to transactions in securities (other than exempted securities) or a market therein (or significant portion or segment of that market).



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 20

§ 20 [15 USC § 78t] Liability of controlling persons and persons who aid and abet violations

(a) Joint and several liability; good faith defense

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(b) Unlawful activity through or by means of any other person

It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.

(c) Hindering, delaying, or obstructing the making or filing of any document, report, or information

It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or under this chapter or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information.

(d) Liability for trading in securities while in possession of material nonpublic information

Wherever communicating, or purchasing or selling a security while in possession of, material nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provisions of this title, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, privilege or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security or with respect to a group or index of securities including such security, shall also violate and

result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.

(e) Prosecution of persons who aid and abet violations

For purposes of any action brought by the Commission under paragraph (1) or (3) of section 78u-4(d) of this title, any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

(f) The authority of the Commission under this section with respect to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) shall be subject to the restrictions and limitations of section 3A(b) of this title.



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Securities Enforcement: Counseling and Defense

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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 20A

§ 20A [15 USC § 78t-1] Liability to contemporaneous traders for insider trading

(a) Private rights of action based on contemporaneous trading

Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

(b) Limitations on liability

(1) Contemporaneous trading actions limited to profit gained or loss avoided.

The total amount of damages imposed under subsection (a) of this section shall not exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation.

(2) Offsetting disgorgements against liability

The total amount of damages imposed against any person under subsection (a) of this section shall be diminished by the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 78u(d) of this title relating to the same transaction or transactions.

(3) Controlling person liability

No person shall be liable under this section solely by reason of employing another person who is liable under this section, but the liability of a controlling person under this section shall be subject to section 78t(a) of this title.

(4) Statute of limitations

No action may be brought under this section more than 5 years after the date of the last transaction that is the subject of the violation.

(c) Joint and several liability for communicating

Any person who violates any provision of this chapter or the rules or regulations thereunder by communicating material, nonpublic information shall be jointly and severally liable under subsection (a) of this section with, and to the same extent as, any person or persons liable under subsection (a) of this section to whom the communication was directed.

(d) Authority not to restrict other express or implied rights of action

Nothing in this section shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of chapter or the availability of any cause of action implied from a provision of this chapter.

(e) Provisions not to affect public prosecutions

This section shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this chapter, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties.



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 21

§ 21 [15 USC § 78u] Investigations and actions

(a) Authority and discretion of Commission to investigate violations

(1)

The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this chapter, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, the rules of the Public Company Accounting Oversight Board, of which such person is a registered public accounting firm or a person associated with such a firm, or the rules of the Municipal Securities Rulemaking Board, 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 such provisions, in the prescribing of rules and regulations under this chapter, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this chapter relates.

(2)

On request from a foreign securities authority, the Commission may provide assistance in accordance with this paragraph if the requesting authority states that the requesting authority is conducting an investigation which it deems necessary to determine whether any person has violated, is violating, or is about to violate any laws or rules relating to securities matters that the requesting authority administers or enforces. The Commission may, in its discretion, conduct such investigation as the Commission deems necessary to collect information and evidence pertinent to the request for assistance. Such assistance may be provided without regard to whether the facts stated in the request would also constitute a violation of the laws of the United States. In deciding whether to provide such assistance, the Commission shall consider whether (A) the requesting authority has agreed to provide reciprocal assistance in securities matters to

the Commission; and

(B)

compliance with the request would prejudice the public interest of the United States.

(b) Attendance of witnesses; production of records

For the purpose of any such investigation, or any other proceeding under this chapter, 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.

(c) Judicial enforcement of investigative power of Commission; refusal to obey subpoena; criminal sanctions

In case of contumacy by, or refusal to obey a subpoena issued to, any person, the

Commission may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda, and other records. And such court may issue an order requiring such person to appear before the Commission or member or officer designated by the Commission, there to produce records, if so ordered, or to give testimony touching the matter under investigation or in question; and any failure to obey such order of the court may be punished by such court as a contempt thereof. All process in any such case may be served in the judicial district whereof such person is an inhabitant or wherever he may be found. Any person who shall, without just cause, fail or refuse to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, and other records, if in his power so to do, in obedience to the subpoena of the Commission, shall be guilty of a misdemeanor and, upon conviction, shall be subject to a fine of not more than \$1,000 or to imprisonment for a term of not more than one year, or both.

(d) Injunction proceedings; criminal proceedings; civil penalty actions relating to transactions when in possession of material nonpublic information: persons liable, exemptions, amount of penalty, payment into Treasury, and period of limitations

(1)

Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, the rules of the Public Company Accounting Oversight Board, of which such person is a registered public accounting firm or a person associated with

such a firm, or the rules of the Municipal Securities Rulemaking Board, it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this chapter or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.

(2)

Authority of a court to prohibit persons from serving as officers and directors. In any proceeding under paragraph (1) of this subsection, the court may prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who violated section 78j(b) of this title or the rules or regulations thereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 78l of this title or that is required to file reports pursuant to section 78o(d) of this title if the person's conduct demonstrates unfitness to serve as an officer or director of any such issuer.

(3)

Money penalties in civil actions

(A)

Authority of commission

Whenever it shall appear to the Commission that any person has violated any provision of this chapter, the rules or regulations thereunder, or a cease-and-desist order entered by the Commission pursuant to section 78u-3 of this title, other than by committing a violation subject to a penalty pursuant to section 78u-1 of this title, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

(B)

Amount of penalty

(i)

First tier

The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (I) \$5,000 for a natural person or \$50,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation.

(ii)

Second tier

Notwithstanding clause (i), the amount of penalty for each such violation shall not exceed the greater of (I) \$50,000 for a natural person or \$250,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation, if the violation described in subparagraph (A) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(iii)

Third tier

Notwithstanding clauses (i) and (ii), the amount of penalty for each such violation shall not exceed the greater of (I) \$100,000 for a natural person or \$500,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation, if--

(aa) the violation described in subparagraph (A) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and (bb) such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.

(C)

Procedures for collection

(i)

Payment of penalty to treasury

A penalty imposed under this section shall be payable into the Treasury of the United States, except as otherwise provided in section 308 of the Sarbanes-Oxley Act of 2002.

(ii)

Collection of penalties

If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

(iii)

Remedy not exclusive

The actions authorized by this paragraph may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring.

(iv)

Jurisdiction and venue

For purposes of section 78aa of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this chapter.

(D)

Special provisions relating to a violation of a cease-and-desist order

In an action to enforce a cease-and-desist order entered by the Commission pursuant to section 78u-3 of this title, each separate violation of such order shall be a separate offense, except that in the case of a violation through a continuing failure to comply with the order, each day of the failure to comply shall be deemed a separate offense.

(4)

Prohibition of attorneys' fees paid from Commission disgorgement funds

Except as otherwise ordered by the court upon motion by the Commission, or, in the case of an administrative action, as otherwise ordered by the Commission, funds disgorged as the result of an action brought by the Commission in Federal court, or as a result of any Commission administrative action, shall not be distributed as payment for attorneys' fees or expenses incurred by private parties seeking distribution of the disgorged funds.

(5)

Equitable Relief

In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.

(6)

Authority of a court to prohibit persons from participating in an offering of penny stock

(A)

In general--In any proceeding under paragraph (1) against any person participating in, or, at the time of the alleged misconduct who was participating in, an offering of penny stock, the court may prohibit that person from participating in an offering of penny stock, conditionally or unconditionally, and permanently or for such period of time as the court shall determine.

(B)

Definition--For purposes of this paragraph, the term "person participating in an offering of penny stock" includes any person engaging in activities with a broker, dealer, or issuer for purposes of issuing, trading, or inducing or attempting to induce the purchase or sale of, any penny stock. The Commission may, by rule or regulation, define such term to include other activities, and may, by rule, regulation, or order, exempt any person or class of persons, in whole or in part, conditionally or unconditionally, from inclusion in such term.

(e) Mandamus

Upon application of the Commission the district courts of the United States and the United States courts of any territory or other place subject to the jurisdiction of the United States shall have jurisdiction to issue writs of mandamus, injunctions, and orders commanding (1) any person to comply with the provisions of this chapter, the rules, regulations, and orders thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or person associated with a member, the rules of a registered clearing agency in which such person is a participant, the rules of the Public Company Accounting Oversight Board, of which such person is a registered public accounting firm or a person associated with such a firm, the rules of the Municipal Securities Rulemaking Board, or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, (2) any national securities exchange or registered securities association to enforce compliance by its members and persons associated with its members with the provisions of this chapter, the rules, regulations, and orders thereunder, and the rules of such exchange or association, or (3) any registered clearing agency to enforce compliance by its participants with the provisions of the rules of such clearing agency.

(f) Rules of self-regulatory organizations

Notwithstanding any other provision of this chapter, the Commission shall not bring any action pursuant to subsection (d) or (e) of this section against any person for violation of, or to command compliance with, the rules of a self-regulatory organization or the Public Company Accounting Oversight Board unless it appears to the Commission that (1) such self-regulatory organization or the Public Company Accounting Oversight Board is unable or unwilling to take appropriate action against such person in the public interest and for the protection of investors, or (2) such action is otherwise necessary or appropriate in the public interest or for the protection of investors.

(g) Consolidation of actions; consent of Commission

Notwithstanding the provisions of section 1407(a) of title 28, or any other provision of law, no action for equitable relief instituted by the Commission pursuant to the securities laws shall be consolidated or coordinated with other actions not brought by the Commission, even though such other actions may involve common questions of fact, unless

such consolidation is consented to by the Commission.

(h) Access to records

(1)

The Right to Financial Privacy Act of 1978 [*12 U.S.C. 3401 et seq.*] shall apply with respect to the Commission, except as otherwise provided in this subsection.

(2)

Notwithstanding section 1105 or 1107 of the Right to Financial Privacy Act of 1978 [*12 U.S.C. 3405 or 3407*], the Commission may have access to and obtain copies of, or the information contained in financial records of a customer from a financial institution without prior notice to the customer upon an ex parte showing to an appropriate United States district court that the Commission seeks such financial records pursuant to a subpoena issued in conformity with the requirements of section 19(b) of the Securities Act of 1933 [*15 U.S.C. 77s(b)*], section 21(b) of the Securities Exchange Act of 1934 [*15 U.S.C. 78u(b)*], section 18(c) of the Public Utility Holding Company Act of 1935 [*15 U.S.C. 79r(c)*], section 42(b) of the Investment Company Act of 1940 [*15 U.S.C. 80a-41(b)*], or section 209(b) of the Investment Advisers Act of 1940 [*15 U.S.C. 80b-9(b)*], and that the Commission has reason to believe that--

(A)

delay in obtaining access to such financial records, or the required notice, will result in--

(i)

flight from prosecution;

(ii)

destruction of or tampering with evidence;

(iii)

transfer of assets or records outside the territorial limits of the United States;

(iv)

improper conversion of investor assets; or

(v)

impeding the ability of the Commission to identify or trace the source or disposition of funds involved in any securities transaction;

(B)

such financial records are necessary to identify or trace the record or beneficial ownership interest in any security;

(C)

the acts, practices or course of conduct under investigation involve--

(i)

the dissemination of materially false or misleading information concerning any security, issuer, or market, or the failure to make disclosures required under the securities laws, which remain uncorrected; or

(ii)

a financial loss to investors or other persons protected under the securities laws which remains substantially uncompensated; or

(D)

the acts, practices or course of conduct under investigation--

(i)

involve significant financial speculation in securities; or

(ii)

endanger the stability of any financial or investment intermediary.

(3)

Any application under paragraph (2) for a delay in notice shall be made with reasonable specificity.

(4)

(A)

Upon a showing described in paragraph (2), the presiding judge or magistrate shall enter an ex parte order granting the requested delay for a period not to exceed ninety days and an order prohibiting the financial institution involved from disclosing that records have been obtained or that a request for records has been made.

(B)

Extensions of the period of delay of notice provided in subparagraph (A) of up to ninety days each may be granted by the court upon application, but only in accordance with this subsection or section 1109(a), (b)(1), or (b)(2) of the Right to Financial Privacy Act of 1978 [*12 U.S.C. 3409(a), (b)(1), or (b)(2)*].

(C)

Upon expiration of the period of delay of notification ordered under subparagraph (A) or (B), the customer shall be served with or mailed a copy of the subpoena insofar as it applies to the customer together with the following notice which shall describe with reasonable specificity the nature of the investigation for which the Commission sought the financial records: "Records or information concerning your transactions which are held by the financial institution named in the attached subpoena were supplied to the Securities and Exchange Commission on (date). Notification was withheld pursuant to a determination by the (title of court so ordering) under section 21(h) of the Securities Exchange Act of 1934 that (state reason). The purpose of the investigation or official proceeding was (state purpose)."

(5)

Upon application by the Commission, all proceedings pursuant to paragraphs (2) and (4) shall be held in camera and the records thereof sealed until expiration of the period of delay or such other date as the presiding judge or magistrate may permit.

(6)

The Commission shall compile an annual tabulation of the occasions on which the Commission used each separate subparagraph or clause of paragraph (2) of this subsection or the provisions of the Right to Financial Privacy Act of 1978 [*12 U.S.C. 3401 et seq.*] to obtain access to financial records of a customer and include it in its annual report to the Congress. Section 1121(b) of the Right to Financial Privacy Act of 1978 [*12 U.S.C. 3421(b)*] shall not apply with

respect to the Commission.

(7)

(A)

Following the expiration of the period of delay of notification ordered by the court pursuant to paragraph (4) of this subsection, the customer may, upon motion, reopen the proceeding in the district court which issued the order. If the presiding judge or magistrate finds that the movant is the customer to whom the records obtained by the Commission pertain, and that the Commission has obtained financial records or information contained therein in violation of this subsection, other than paragraph (1), it may order that the customer be granted civil penalties against the Commission in an amount equal to the sum of--

(i)

\$100 without regard to the volume of records involved;

(ii)

any out-of-pocket damages sustained by the customer as a direct result of the disclosure; and

(iii)

if the violation is found to have been willful, intentional, and without good faith, such punitive damages as the court may allow, together with the costs of the action and reasonable attorney's fees as determined by the court.

(B)

Upon a finding that the Commission has obtained financial records or information contained therein in violation of this subsection, other than paragraph (1), the court, in its discretion, may also or in the alternative issue injunctive relief to require the Commission to comply with this subsection with respect to any subpoena which the Commission issues in the future for financial records of such customer for purposes of the same investigation.

(C)

Whenever the court determines that the Commission has failed to comply with this subsection, other than paragraph (1), and the court finds that the circumstances raise questions of whether an officer or employee of the Commission acted in a willful and intentional manner and without good faith with respect to the violation, the Office of Personnel Management shall promptly initiate a proceeding to determine whether disciplinary action is warranted against the agent or employee who was primarily responsible for the violation. After investigating and considering the evidence

submitted, the Office of Personnel Management shall submit its findings and recommendations to the Commission and shall send copies of the findings and recommendations to the officer or employee or his representative. The Commission shall take the corrective action that the Office of Personnel Management recommends.

(8)

The relief described in paragraphs (7) and (10) shall be the only remedies or sanctions available to a customer for a violation of this subsection, other than paragraph (1), and nothing herein or in the Right to Financial Privacy Act of 1978 [12 U.S.C. 3401 *et seq.*] shall be deemed to prohibit the use in any investigation or proceeding of financial records, or the information contained therein, obtained by a subpoena issued by the Commission. In the case of an unsuccessful action under paragraph (7), the court shall award the costs of the action and attorney's fees to the Commission if the presiding judge or magistrate finds that the customer's claims were made in bad faith.

(9)

(A)

The Commission may transfer financial records or the information contained therein to any government authority if the Commission proceeds as a transferring agency in accordance with section 1112 of the Right to Financial Privacy Act of 1978 [12 U.S.C. 3412], except that the customer notice required under section 1112(b) or (c) of such Act [12 U.S.C. 3412(b) or (c)] may be delayed upon a showing by the Commission, in accordance with the procedure set forth in paragraphs (4) and (5), that one or more of subparagraphs (A) through (D) of paragraph (2) apply.

(B)

The Commission may, without notice to the customer pursuant to section 1112 or the Right to Financial Privacy Act of 1978 [12 U.S.C. 3412], transfer financial records or the information contained therein to a State securities agency or to the Department of Justice. Financial records or information transferred by the Commission to the Department of Justice or to a State securities agency pursuant to the provisions of this subparagraph may be disclosed or used only in an administrative, civil, or criminal action or investigation by the Department of Justice or the State securities agency which arises out of or relates to the acts, practices, or courses of conduct investigated by the Commission, except that if the Department of Justice or the State securities agency determines that the information should be disclosed or used for any other purpose, it may do so if it notifies the customer, except as otherwise provided in the Right to Financial Privacy Act of 1978 [12 U.S.C. 3401 *et seq.*], within 30 days of its determination, or complies with the requirements of section 1109 of such Act [12 U.S.C. 3409] regarding delay of notice.

(10)

Any government authority violating paragraph (9) shall be subject to the procedures and penalties applicable to the Commission under paragraph (7)(A) with respect to a violation by the Commission in obtaining financial records.

(11)

Notwithstanding the provisions of this subsection, the Commission may obtain financial records from a financial institution or transfer such records in accordance with provisions of the Right to Financial Privacy Act of 1978 [12 U.S.C. 3401 *et seq.*].

(12)

Nothing in this subsection shall enlarge or restrict any rights of a financial institution to challenge requests for records made by the Commission under existing law. Nothing in this subsection shall entitle a customer to assert any rights of a financial institution.

(13)

Unless the context otherwise requires, all terms defined in the Right to Financial Privacy Act of 1978 [12 U.S.C. 3401 *et seq.*] which are common to this subsection shall have the same meaning as in such Act.

(i) Information to CFTC

The Commission shall provide the Commodity Futures Trading Commission with notice of the commencement of any proceeding and a copy of any order entered by the Commission against any broker or dealer registered pursuant to section 15(b)(11), any exchange registered pursuant to section 6(g), or any national securities association registered pursuant to section 15A(k).



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 21A

§ 21A [15 USC § 78u-1] Civil penalties for insider trading

(a) Authority to impose civil penalties

(1)

Judicial actions by Commission authorized

Whenever it shall appear to the Commission that any person has violated any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) while in possession of material, nonpublic information in, or has violated any such provision by communicating such information in connection with, a transaction on or through the facilities of a national securities exchange or from or through a broker or dealer, and which is not part of a public offering by an issuer of securities other than standardized options or security futures products, the Commission--

(A)

may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by the person who committed such violation; and

(B)

may, subject to subsection (b)(1) of this section, bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by a person who, at the time of the violation, directly or indirectly controlled the person who committed such violation.

(2)

Amount of penalty for person who committed violation

The amount of the penalty which may be imposed on the person who committed such violation shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication.

(3)

Amount of penalty for controlling person

The amount of the penalty which may be imposed on any person who, at the time of the violation, directly or indirectly controlled the person who committed such violation, shall be determined by the court in light of the facts and circumstances, but shall not exceed the greater of \$1,000,000, or three times the amount of the profit gained or loss avoided as a result of such controlled person's violation. If such controlled person's violation was a violation by communication, the profit gained or loss avoided as a result of the violation shall, for purposes of this paragraph only, be deemed to be limited to the profit gained or loss avoided by the person or persons to whom the controlled person directed such communication.

(b) Limitations on liability

(1)

Liability of controlling persons

No controlling person shall be subject to a penalty under subsection (a)(1)(B) of this section unless the Commission establishes that--

(A)

such controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred; or

(B)

such controlling person knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under section 78o(f) of this title or section 80b-4a of this title and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.

(2)

Additional restrictions on liability

No person shall be subject to a penalty under subsection (a) of this section solely by reason of employing another person who is subject to a penalty under such subsection, unless such employing person is liable as a controlling person under paragraph (1) of this subsection. Section 78t(a) of this title shall not apply to actions under subsection (a) of this section.

(c) Authority of Commission

The Commission, by such rules, regulations, and orders as it considers necessary or appropriate in the public interest or for the protection of investors, may exempt, in whole or in part, either unconditionally or upon specific terms and conditions, any person or transaction or class of persons or transactions from this section.

(d) Procedures for collection

(1)

Payment of penalty to Treasury

A penalty imposed under this section shall (subject to subsection (e) of this section) be payable into the Treasury of the United States, except as otherwise provided in section 308 of the Sarbanes-Oxley Act of 2002.

(2)

Collection of penalties

If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

(3)

Remedy not exclusive

The actions authorized by this section may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring.

(4)

Jurisdiction and venue

For purposes of section 78aa of this title, actions under this section shall be actions to enforce a liability or a duty created by this chapter.

(5)

Statute of limitations

No action may be brought under this section more than 5 years after the date of the purchase or sale. This section shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this chapter, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties, imposed in an action commenced within 5 years of such transaction.

(e) Authority to award bounties to informants

Notwithstanding the provisions of subsection (d)(1) of this section, there shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition of such penalty. Any determinations under this subsection, including whether, to whom, or in what amount to make payments, shall be in the sole discretion of the Commission, except that no such payment shall be made to any member, officer, or employee of any appropriate regulatory agency, the Department of Justice, or a self-regulatory organization. Any such determination shall be final and not subject to judicial review.

(f) Definition

For purposes of this section, "profit gained" or "loss avoided" is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information.

(g) The authority of the Commission under this section with respect to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) shall be subject to the restrictions and limitations of section 3A(b) of this title.



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 21B

§ 21B [15 USC § 78u-2] Civil remedies in administrative proceedings

(a) Commission authority to assess money penalties. In any proceeding instituted pursuant to sections 15(b)(4), 15(b)(6), 15D, 15B, 15C, 15E, or 17A of this title [15 USCS § 78o(b)(4), (6), 78o-6, 78o-4, 78o-5, 78o-7, or 78q-1] against any person, the Commission or the appropriate regulatory agency may impose a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person--

(1) has willfully violated any provision of the Securities Act of 1933 [15 USCS §§ 77a et seq.], the Investment Company Act of 1940 [15 USCS §§ 80a-1 et seq.], the Investment Advisers Act of 1940 [15 USCS §§ 80b-1 et seq.], or this title [15 USCS §§ 78a et seq.], or the rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board;

(2) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

(3) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission or with any other appropriate regulatory agency under this title [15 USCS §§ 78a et seq.], or in any proceeding before the Commission with respect to registration, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or

(4) has failed reasonably to supervise, within the meaning of section 15(b)(4)(E) of this title [15 USCS § 78o(b)(4)(E)], with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision;

and that such penalty is in the public interest.

(b) Maximum amount of penalty.

(1) First tier. The maximum amount of penalty for each act or omission described in subsection (a) shall be \$ 5,000 for a natural person or \$ 50,000 for any other person.

(2) Second tier. Notwithstanding paragraph (1), the maximum amount of penalty for each such act or omission shall be \$ 50,000 for a natural person or \$ 250,000 for any other person if the act or omission described in subsection (a) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(3) Third tier. Notwithstanding paragraphs (1) and (2), the maximum amount of penalty for each such act or omission shall be \$ 100,000 for a natural person or \$ 500,000 for any other person if--

(A) the act or omission described in subsection (a) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(B) such act or omission directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission.

(c) Determination of public interest. In considering under this section whether a penalty is in the public interest, the Commission or the appropriate regulatory agency may consider--

(1) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

(2) the harm to other persons resulting either directly or indirectly from such act or omission;

(3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

(4) whether such person previously has been found by the Commission, another appropriate regulatory agency, or a

self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a court of competent jurisdiction of violations of such laws or of any felony or misdemeanor described in section 15(b)(4)(B) of this title [*15 USCS § 78o(b)(4)(B)*];

(5) the need to deter such person and other persons from committing such acts or omissions; and

(6) such other matters as justice may require.

(d) Evidence concerning ability to pay. In any proceeding in which the Commission or the appropriate regulatory agency may impose a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission or the appropriate regulatory agency may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.

(e) Authority to enter an order requiring an accounting and disgorgement. In any proceeding in which the Commission or the appropriate regulatory agency may impose a penalty under this section, the Commission or the appropriate regulatory agency may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.



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APPENDIX G Securities Exchange Act of 1934 Selected Provisions

002-G Securities Enforcement: Counseling and Defense Section 21C

§ 21C [15 USC § 78u-3] Cease-and-desist proceedings

(a) Authority of the Commission

If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this chapter, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule, or regulation with respect to any security, any issuer, or any other person.

(b) Hearing

The notice instituting proceedings pursuant to subsection (a) of this section shall fix a hearing date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served.

(c) Temporary order

(1) In general Whenever the Commission determines that the alleged violation or threatened violation specified in the notice instituting proceedings pursuant to subsection (a) of this section, or the continuation thereof, is likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest,

including, but not limited to, losses to the Securities Investor Protection Corporation, prior to the completion of the proceedings, the Commission may enter a temporary order requiring the respondent to cease and desist from the violation or threatened violation and to take such action to prevent the violation or threatened violation and to prevent dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest as the Commission deems appropriate pending completion of such proceedings. Such an order shall be entered only after notice and opportunity for a hearing, unless the Commission determines that notice and hearing prior to entry would be impracticable or contrary to the public interest. A temporary order shall become effective upon service upon the respondent and, unless set aside, limited, or suspended by the Commission or a court of competent jurisdiction, shall remain effective and enforceable pending the completion of the proceedings.

(2) Applicability Paragraph (1) subsection shall apply only to a respondent that acts, or, at the time of the alleged misconduct acted, as a broker, dealer, investment adviser, investment company, municipal securities dealer, government securities broker, government securities dealer, registered public accounting firm (as defined in section 2 of the Sarbanes-Oxley Act of 2002), or transfer agent, or is, or was at the time of the alleged misconduct, an associated person of, or a person seeking to become associated with, any of the foregoing.

(3) Temporary freeze

(A) In general

(i) Issuance of temporary order--Whenever, during the course of a lawful investigation involving possible violations of the Federal securities laws by an issuer of publicly traded securities or any of its directors, officers, partners, controlling persons, agents, or employees, it shall appear to the Commission that it is likely that the issuer will make extraordinary payments (whether compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days.

(ii) Standard--A temporary order shall be entered under clause (i), only after notice and opportunity for a hearing, unless the court determines that notice and hearing prior to entry of the order would be impracticable or contrary to the public interest.

(iii) Effective period--A temporary order issued under clause (i) shall--

(I) become effective immediately;

(II) be served upon the parties subject to it; and

(III) unless set aside, limited or suspended by a court of competent jurisdiction, shall remain effective and enforceable for 45 days.

(iv) Extensions authorized--The effective period of an order under this subparagraph may be extended by the court upon good cause shown for not longer than 45 additional days, provided that the combined period of the order shall not exceed 90 days.

(B) Process on Determination of violations

(i) Violations charged--If the issuer or other person described in subparagraph (A) is charged with any violation of the Federal securities laws before the expiration of the effective period of a temporary order under subparagraph (A) (including any applicable extension period), the order shall remain in effect, subject to court approval, until the conclusion of any legal proceedings related thereto, and the affected issuer or other person, shall have the right to petition the court for review of the order.

(ii) Violations not charged--If the issuer or other person described in subparagraph (A) is not charged with any violation of the Federal securities laws before the expiration of the effective period of a temporary order under subparagraph (A) (including any applicable extension period), the escrow shall terminate at the expiration of the 45-day effective period (or the expiration of any extension period, as applicable), and the disputed payments (with accrued interest) shall be returned to the issuer or other affected person.

(d) Review of temporary orders

(1) Commission review At any time after the respondent has been served with a temporary cease-and-desist order pursuant to subsection (c) of this section, the respondent may apply to the Commission to have the order set aside, limited, or suspended. If the respondent has been served with a temporary cease-and-desist order entered without a prior Commission hearing, the respondent may, within 10 days after the date on which the order was served, request a hearing on such application and the Commission shall hold a hearing and render a decision on such application at the earliest possible time.

(2) Judicial review Within--

(A) 10 days after the date the respondent was served with a temporary cease-and-desist order entered with a prior Commission hearing, or

(B) 10 days after the Commission renders a decision on an application and hearing under paragraph (1), with respect to any temporary cease-and-desist order entered without a prior Commission hearing, the respondent may apply to the United States district court for the district in which the respondent resides or has its principal place of business, or for the District of Columbia, for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order, and the court shall have jurisdiction to enter such an order. A respondent served with a temporary cease-and-desist order entered without a prior Commission hearing may not apply to the court except after hearing and decision by the Commission on the respondent's application under paragraph (1) of this subsection.

(3) No automatic stay of temporary order The commencement of proceedings under paragraph (2) of this subsection shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

(4) Exclusive review Section 78y of this title shall not apply to a temporary order entered pursuant to this section.

(e) Authority to enter an order requiring an accounting and disgorgement

In any cease-and-desist proceeding under subsection (a) of this section, the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

(f) Authority of the Commission to Prohibit Persons From Serving as Officers or Directors

In any cease-and-desist proceeding under subsection (a), the Commission may issue an order to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated section 10(b) or the rules or regulations thereunder, from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12, or that is required to file reports pursuant to section 15(d), if the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer.



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2-H Securities Enforcement: Counseling and Defense APPENDIX H.syn

§ H.syn Synopsis to Appendix H: Securities Exchange Act of 1934, Selected Rules & Regulations

17 CFR § 240.10b-5

§ 240.10b-5. Employment of manipulative and deceptive devices.

§ 240.10b5-1. Trading "on the basis of" material nonpublic information in insider trading cases.

17 CFR§ 240.10b5-2

§ 240.10b5-2. Duties of trust or confidence in misappropriation insider trading cases.

17 CFR§ 240.13b2-1

§ 240.13b2-1. Falsification of accounting records.

17 CFR§ 240.13b2-2

§ 240.13b2-2. Representations and conduct in connection with the preparation of required reports and documents.

17 CFR § 240.13a-1

§ 240.13a-1. Requirements of annual reports.

17 CFR § 240.13a-13

§ 240.13a-13. Quarterly reports on Form 10-Q and Form 10-QSB (§ 249.308a of this chapter).

17 CFR § 240.12b-20

§ 240.12b-20. Additional information.



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APPENDIX H Securities Exchange Act of 1934, Selected Rules & Regulations

2-H Securities Enforcement: Counseling and Defense § 240.10b-5

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.



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APPENDIX H Securities Exchange Act of 1934, Selected Rules & Regulations

2-H Securities Enforcement: Counseling and Defense § 240.10b5-1

§ 240.10b5-1 Trading "on the basis of" material nonpublic information in insider trading cases.

Preliminary Note to § 240.10b5-1: This provision defines when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases brought under Section 10(b) of the Act and *Rule 10b-5* thereunder. The law of insider trading is otherwise defined by judicial opinions construing *Rule 10b-5*, and Rule 10b5-1 does not modify the scope of insider trading law in any other respect.

(a) General. The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act (*15 U.S.C. 78j*) and § 240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

(b) Definition of "on the basis of." Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.

(c) Affirmative defenses.

(1)

(i) Subject to paragraph (c)(1)(ii) of this section, a person's purchase or sale is not "on the basis of" material

nonpublic information if the person making the purchase or sale demonstrates that:

(A) Before becoming aware of the information, the person had:

- (1) Entered into a binding contract to purchase or sell the security,
- (2) Instructed another person to purchase or sell the security for the instructing person's account, or
- (3) Adopted a written plan for trading securities;

(B) The contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section:

(1) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;

(2) Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or

(3) Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and

(C) The purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities.

(ii) Paragraph (c)(1)(i) of this section is applicable only when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this

section.

(iii) This paragraph (c)(1)(iii) defines certain terms as used in paragraph (c) of this Section.

(A) Amount. "Amount" means either a specified number of shares or other securities or a specified dollar value of securities.

(B) Price. "Price" means the market price on a particular date or a limit price, or a particular dollar price.

(C) Date. "Date" means, in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution). "Date" means, in the case of a limit order, a day of the year on which the limit order is in force.

(2) A person other than a natural person also may demonstrate that a purchase or sale of securities is not "on the basis of" material nonpublic information if the person demonstrates that:

(i) The individual making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information; and

(ii) The person had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information. These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material nonpublic information, or those that prevent such individuals from becoming aware of such information.



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2-H Securities Enforcement: Counseling and Defense § 240.10b5-2

§ 240.10b5-2 Duties of trust or confidence in misappropriation insider trading cases.

Preliminary Note to § 240.10b5-2: This section provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Act and *Rule 10b-5*. The law of insider trading is otherwise defined by judicial opinions construing *Rule 10b-5*, and Rule 10b5-2 does not modify the scope of insider trading law in any other respect.

(a) Scope of Rule. This section shall apply to any violation of Section 10(b) of the Act (*15 U.S.C. 78j(b)*) and § 240.10b-5 thereunder that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence.

(b) Enumerated "duties of trust or confidence." For purposes of this section, a "duty of trust or confidence" exists in the following circumstances, among others:

(1) Whenever a person agrees to maintain information in confidence;

(2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or

(3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust

or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.



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APPENDIX H Securities Exchange Act of 1934, Selected Rules & Regulations

2-H Securities Enforcement: Counseling and Defense § 240.13b2-1

§ 240.13b2-1 Falsification of accounting records.

No person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act.



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2-H Securities Enforcement: Counseling and Defense § 240.13b2-2

§ 240.13b2-2 Representations and conduct in connection with the preparation of required reports and documents.

(a) No director or officer of an issuer shall, directly or indirectly:

(1) Make or cause to be made a materially false or misleading statement to an accountant in connection with; or

(2) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading, to an accountant in connection with:

(i) Any audit, review or examination of the financial statements of the issuer required to be made pursuant to this subpart; or

(ii) The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise.

(b)

(1) No officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have

known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.

(2) For purposes of paragraphs (b)(1) and (c)(2) of this section, actions that, "if successful, could result in rendering the issuer's financial statements materially misleading" include, but are not limited to, actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead, or fraudulently influence an auditor:

(i) To issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards, or other professional or regulatory standards);

(ii) Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;

(iii) Not to withdraw an issued report; or

(iv) (iv) Not to communicate matters to an issuer's audit committee.

(c) In addition, in the case of an investment company registered under section 8 of the Investment Company Act of 1940 (*15 U.S.C. 80a-8*), or a business development company as defined in section 2(a)(48) of the Investment Company Act of 1940 (*15 U.S.C. 80a-2(a)(48)*), no officer or director of the company's investment adviser, sponsor, depositor, trustee, or administrator (or, in the case of paragraph (c)(2) of this section, any other person acting under the direction thereof) shall, directly or indirectly:

(1)

(i) Make or cause to be made a materially false or misleading statement to an accountant in connection with; or

(ii) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with:

(A) Any audit, review, or examination of the financial statements of the investment company required to be made pursuant to this subpart; or

(B) The preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise; or

(2) Take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that investment company that are required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the investment company's financial statements materially misleading.



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2-H Securities Enforcement: Counseling and Defense § 240.13a-1

§ 240.13a-1 Requirements of annual reports.

Every issuer having securities registered pursuant to section 12 of the Act (*15 U.S.C. 78 l*) shall file an annual report on the appropriate form authorized or prescribed therefor for each fiscal year after the last full fiscal year for which financial statements were filed in its registration statement. Annual reports shall be filed within the period specified in the appropriate form.



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§ 240.13a-13 Quarterly reports on Form 10-Q and Form 10-QSB (§ 249.308a of this chapter).

(a) Except as provided in paragraphs (b) and (c) of this section, every issuer that has securities registered pursuant to section 12 of the Act and is required to file annual reports pursuant to section 13 of the Act, and has filed or intends to file such reports on Form 10 K (§ 249.310 of this chapter), shall file a quarterly report on Form 10 Q (§ 249.308a of this chapter) within the period specified in General Instruction A.1. to that form for each of the first three quarters of each fiscal year of the issuer, commencing with the first fiscal quarter following the most recent fiscal year for which full financial statements were included in the registration statement, or, if the registration statement included financial statements for an interim period subsequent to the most recent fiscal year end meeting the requirements of Article 10 of Regulation S X and Rule 8 03 of Regulation S X for smaller reporting companies, for the first fiscal quarter subsequent to the quarter reported upon in the registration statement. The first quarterly report of the issuer shall be filed either within 45 days after the effective date of the registration statement or on or before the date on which such report would have been required to be filed if the issuer has been required to file reports on Form 10 Q as of its last fiscal quarter, whichever is later.

(b) The provisions of this rule shall not apply to the following issuers:

- (1) Investment companies required to file reports pursuant to § 270.30b1 1;
- (2) Foreign private issuers required to file reports pursuant to § 240.13a 16; and
- (3) Asset backed issuers required to file reports pursuant to § 240.13a 17.

(c) Part I of the quarterly reports on Form 10 Q need not be filed by:

(1) Mutual life insurance companies; or

(2) Mining companies not in the production stage but engaged primarily in the exploration for the development of mineral deposits other than oil, gas or coal, if all of the following conditions are met:

(i) The registrant has not been in production during the current fiscal year or the two years immediately prior thereto; except that being in production for an aggregate period of not more than eight months over the three year period shall not be a violation of this condition.

(ii) Receipts from the sale of mineral products or from the operations of mineral producing properties by the registrant and its subsidiaries combined have not exceeded \$ 500,000 in any of the most recent six years and have not aggregated more than \$ 1,500,000 in the most recent six fiscal years.

(d) Notwithstanding the foregoing provisions of this section, the financial information required by Part I of Form 10 Q shall not be deemed to be "filed" for the purpose of Section 18 of the Act or otherwise subject to the liabilities of that section of the Act, but shall be subject to all other provisions of the Act.



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2-H Securities Enforcement: Counseling and Defense § 240.12b-20

§ 240.12b-20 Additional information.

In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.



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17 CFR § 203.1

002-I Securities Enforcement: Counseling and Defense Section 203.1

§ 203.1 Application of the rules of this part

The rules of this part apply only to investigations conducted by the Commission. They do not apply to adjudicative or rulemaking proceedings.



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APPENDIX I SEC Rules Of Investigation
17 CFR § 203.2

002-I Securities Enforcement: Counseling and Defense Section 203.2

§ 203.2 Information obtained in investigations and examinations

Information or documents obtained by the Commission in the course of any investigation or examination, unless made a matter of public record, shall be deemed non-public, but the Commission approves the practice whereby officials of the Divisions of Enforcement, Corporation Finance, Market Regulation and Investment Management and the Office of International Affairs at the level of Assistant Director or higher, and officials in Regional Offices at the level of Assistant Regional Director or higher, may engage in and may authorize members of the Commission's staff to engage in discussions with persons identified in § 240.24c-1(b) of this chapter concerning information obtained in individual investigations or examinations, including formal investigations conducted pursuant to Commission order.



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APPENDIX I SEC Rules Of Investigation
17 CFR § 203.3

002-I Securities Enforcement: Counseling and Defense Section 203.3

§ 203.3 Suspension and disbarment

The provisions of § 201.2(e) of this chapter (Rule 102(e) of the Commission's rules of practice) are hereby made specifically applicable to all investigations.



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APPENDIX I SEC Rules Of Investigation
17 CFR § 203.4

002-I Securities Enforcement: Counseling and Defense Section 203.4

§ 203.4 Applicability of §§ 203.4 through 203.8

(a) Sections 203.4 through 203.8 shall be applicable to a witness who is sworn in a proceeding pursuant to a Commission order for investigation or examination, such proceeding being hereinafter referred to as a formal investigative proceeding.

(b) Formal investigative proceedings may be held before the Commission, before one or more of its members, or before any officer designated by it for the purpose of taking testimony of witnesses and received other evidence. The term officer conducting the investigation shall mean any of the foregoing.



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APPENDIX I SEC Rules Of Investigation
17 CFR § 203.5

002-I Securities Enforcement: Counseling and Defense Section 203.5

§ 203.5 Non-public formal investigative proceedings

Unless otherwise ordered by the Commission, all formal investigative proceedings shall be non-public.



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APPENDIX I SEC Rules Of Investigation
17 CFR § 203.6

002-I Securities Enforcement: Counseling and Defense Section 203.6

§ 203.6 Transcripts

Transcripts, if any, of formal investigative proceedings shall be recorded solely by the official reporter, or by any other person or means designated by the officer conducting the investigation. A person who has submitted documentary evidence or testimony in a formal investigative proceeding shall be entitled, upon written request, to procure a copy of his documentary evidence or a transcript of his testimony on payment of the appropriate fees: Provided, however, That in a nonpublic formal investigative proceeding the Commission may for good cause deny such request. In any event, any witness, upon proper identification, shall have the right to inspect the official transcript of the witness' own testimony.



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17 CFR § 203.7

002-I Securities Enforcement: Counseling and Defense Section 203.7

§ 203.7 Rights of witnesses

(a) Any person who is compelled or requested to furnish documentary evidence or testimony at a formal investigative proceeding shall, upon request, be shown the Commission's order of investigation. Copies of formal orders of investigation shall not be furnished, for their retention, to such persons requesting the same except with the express approval of officials in the Regional Offices at the level of Assistant Regional Director or higher, or officials in the Division or Divisions conducting or supervising the investigation at the level of Assistant Director or higher. Such approval shall not be given unless the person granting such approval, in his or her discretion, is satisfied that there exist reasons consistent both with the protection of privacy of persons involved in the investigation and with the unimpeded conduct of the investigation.

(b) Any person compelled to appear, or who appears by request or permission of the Commission, in person at a formal investigative proceeding may be accompanied, represented and advised by counsel, as defined in § 201.101(a) of this chapter (Rule 101(a) of the Commission's rules of practice): Provided, however, That all witnesses shall be sequestered, and unless permitted in the discretion of the officer conducting the investigation no witness or the counsel accompanying any such witness shall be permitted to be present during the examination of any other witness called in such proceeding.

(c) The right to be accompanied, represented and advised by counsel shall mean the right of a person testifying to have an attorney present with him during any formal investigative proceeding and to have this attorney (1) advise such person before, during and after the conclusion of such examination, (2) question such person briefly at the conclusion of the examination to clarify any of the answers such person has given, and (3) make summary notes during such examination solely for the use of such person.

(d) Unless otherwise ordered by the Commission, in any public formal investigative proceeding, if the record shall contain implications of wrongdoing by any person, such person shall have the right to appear on the record; and in

addition to the rights afforded other witnesses hereby, he shall have a reasonable opportunity of cross-examination and production of rebuttal testimony or documentary evidence. Reasonable shall mean permitting persons as full an opportunity to assert their position as may be granted consistent with administrative efficiency and with avoidance of undue delay. The determination of reasonableness in each instance shall be made in the discretion of the officer conducting the investigation.

(e) The officer conducting the investigation may report to the Commission any instances where any witness or counsel has been guilty of dilatory, obstructionist or contumacious conduct during the course of an investigation or any other instance of violation of these rules. The Commission will thereupon take such further action as the circumstances may warrant, including suspension or disbarment of counsel from further appearance or practice before it, in accordance with § 201.102(e) of this chapter (Rule 102(e) of the Commission's rules of practice), or exclusion from further participation in the particular investigation.



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17 CFR § 203.8

002-I Securities Enforcement: Counseling and Defense Section 203.8

§ 203.8 Service of subpoenas

Service of subpoenas issued in formal investigative proceedings shall be effected in the manner prescribed by Rule 232(c) of the Commission's Rules of Practice, § 201.232(c) of this chapter.



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APPENDIX J Sarbanes-Oxley Act of 2002 Selected Provisions

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§ J.syn Synopsis to Appendix J: Sarbanes-Oxley Act of 2002 Selected Provisions

§ Sec. 304. Forfeiture of Certain Bonuses and Profits.

§ Sec. 308. Fair Funds for Investors.



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APPENDIX J Sarbanes-Oxley Act of 2002 Selected Provisions

2-J Securities Enforcement: Counseling and Defense § Sec. 304

§ Sec. 304. Forfeiture of Certain Bonuses and Profits.

(a) Additional Compensation Prior to Noncompliance With Commission Financial Reporting Requirements.--If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for--

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 12-month period.

(b) Commission Exemption Authority.-- The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.



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APPENDIX J Sarbanes-Oxley Act of 2002 Selected Provisions

2-J Securities Enforcement: Counseling and Defense § Sec. 308

§ Sec. 308. Fair Funds for Investors.

(a) Civil Penalties Added to Disgorgement Funds for the Relief of Victims.--If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934 (*15 U.S.C. 78c(a)(47)*)) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.

(b) Acceptance of Additional Donations.-- The Commission is authorized to accept, hold, administer, and utilize gifts, bequests and devises of property, both real and personal, to the United States for a disgorgement fund described in subsection (a). Such gifts, bequests, and devises of money and proceeds from sales of other property received as gifts, bequests, or devises shall be deposited in the disgorgement fund and shall be available for allocation in accordance with subsection (a).

(c) Study Required.--

(1)

Subject of study.--The Commission shall review and analyze--

(A) enforcement actions by the Commission over the five years preceding the date of the enactment of this Act that

have included proceedings to obtain civil penalties or disgorgements to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors; and

(B) other methods to more efficiently, effectively, and fairly provide restitution to injured investors, including methods to improve the collection rates for civil penalties and disgorgements.

(2) Report Required.-- The Commission shall report its findings to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate within 180 days after of the date of the enactment of this Act, and shall use such findings to revise its rules and regulations as necessary. The report shall include a discussion of regulatory or legislative actions that are recommended or that may be necessary to address concerns identified in the study.

(d) Conforming Amendments.-- Each of the following provisions is amended by inserting ", except as otherwise provided in section 308 of the Sarbanes-Oxley Act of 2002" after "Treasury of the United States":

(1) Section 21(d)(3)(C)(i) of the Securities Exchange Act of 1934 (*15 U.S.C. 78u(d)(3)(C)(i)*).

(2) Section 21A(d)(1) of such Act (*15 U.S.C. 78u-1(d)(1)*).

(3) Section 20(d)(3)(A) of the Securities Act of 1933 (*15 U.S.C. 77t(d)(3)(A)*).

(4) Section 42(e)(3)(A) of the Investment Company Act of 1940 (*15 U.S.C. 80a-41(e)(3)(A)*).

(5) Section 209(e)(3)(A) of the Investment Advisers Act of 1940 (*15 U.S.C. 80b-9(e)(3)(A)*).

(e) Definition.-- As used in this section, the term "disgorgement fund" means a fund established in any administrative or judicial proceeding described in subsection (a).



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APPENDIX K Investment Advisers Act of 1940 Selected Provisions

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§ K.syn Synopsis to Appendix K: Investment Advisers Act of 1940 Selected Provisions

Section 202 [15 U.S.C. § 80b-2] Definitions

Section 203 [15 U.S.C. § 80b-3] Registration of investment advisers

Section 206 [15 U.S.C. § 80b-6] Prohibited transactions by investment advisers

Section 207 [15 U.S.C. § 80b-7] Material misstatements

Section 208 [15 U.S.C. § 80b-8] General prohibitions

Section 209 [15 U.S.C. § 80b-9] Enforcement of subchapter

Section 213 [15 U.S.C. § 80b-13] Court review of orders

Section 214 [15 U.S.C. § 80b-14] Jurisdiction of offenses and suits

Section 217 [15 U.S.C. § 80b-17] Penalties



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APPENDIX K Investment Advisers Act of 1940 Selected Provisions

2-K Securities Enforcement: Counseling and Defense Section 202

§ 202 [15 U.S.C. § 80b-2] Definitions

(a) When used in this title [15 USCS §§ 80b-1 et seq.], unless the context otherwise requires, the following definitions shall apply:

(1) "Assignment" includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but if the investment adviser is a partnership, no assignment of an investment advisory contract shall be deemed to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after such admission, shall be only a minority of the members and shall have only a minority interest in the business.

(2) "Bank" means (A) a banking institution organized under the laws of the United States or a Federal savings association, as defined in section 2(5) of the Home Owners' Loan Act [12 USCS § 1462(5)], (B) a member bank of the Federal Reserve System, (C) any other banking institution, savings association, as defined in section 2(4) of the Home Owners' Loan Act [12 USCS § 1462(4)], or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of this title [15 USCS §§ 80b-1 et seq.], and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

(3) The term "broker" has the same meaning as given in section 3 of the Securities Exchange Act of 1934 [15 USCS § 78c].

(4) "Commission" means the Securities and Exchange Commission.

(5) "Company" means a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons, whether incorporated or not; or any receiver, trustee in a case under title 11 of the United States Code [11 USCS §§ 101 *et seq.*], or similar official, or any liquidating agent for any of the foregoing, in his capacity as such.

(6) "Convicted" includes a verdict, judgment, or plea of guilty, or a finding of guilt on a plea of nolo contendere, if such verdict, judgment, plea, or finding has not been reversed, set aside, or withdrawn, whether or not sentence has been imposed.

(7) The term "dealer" has the same meaning as given in section 3 of the Securities Exchange Act of 1934 [15 USCS § 78c], but does not include an insurance company or investment company.

(8) "Director" means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.

(9) "Exchange" means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

(10) "Interstate commerce" means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof.

(11) "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives

no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 [*15 USCS § 78c(a)(12)*], as exempted securities for the purposes of that Act; (F) any nationally recognized statistical rating organization, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934 [*15 USCS § 78c(a)(62)*], unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others; or (G) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

(12) "Investment company", ["affiliated person"], and "insurance company" have the same meanings as in the Investment Company Act of 1940. "Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.

(13) "Investment supervisory services" means the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client.

(14) "Means or instrumentality of interstate commerce" includes any facility of a national securities exchange.

(15) "National securities exchange" means an exchange registered under section 6 of the Securities Exchange Act of 1934 [*15 USCS § 78f*].

(16) "Person" means a natural person or a company.

(17) The term "person associated with an investment adviser" means any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser, except that for the purposes of section 203 of this title [*15 USCS § 80b-3*] (other than subsection (f) thereof), persons associated with an investment adviser whose functions are clerical or ministerial shall not be included in the meaning of such term. The Commission may by rules and regulations classify, for the purposes of any portion or portions of this title [*15 USCS §§ 80b-1 et seq.*], persons, including employees controlled by an investment adviser.

(18) "Security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a

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security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing.

(19) "State" means any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

(20) "Underwriter" means any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributor's or seller's commission. As used in this paragraph the term "issuer" shall include in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

(21) "Securities Act of 1933", "Securities Exchange Act of 1934", "Public Utility Holding Company Act of 1935", and "Trust Indenture Act of 1939", mean those Acts, respectively, as heretofore or hereafter amended.

(22) "Business development company" means any company which is a business development company as defined in section 2(a)(48) of title I of this Act [*15 USCS § 80a-2(a)(48)*] and which complies with section 55 of title I of this Act [*15 USCS § 80a-54*], except that--

(A) the 70 per centum of the value of the total assets condition referred to in sections 2(a)(48) and 55 of title I of this Act [*15 USCS §§ 80a-2(a)(48), 80a-54*] shall be 60 per centum for purposes of determining compliance therewith;

(B) such company need not be a closed-end company and need not elect to be subject to the provisions of sections 55 through 65 of title I of this Act [*15 USCS §§ 80a-54-80a-64*]; and

(C) the securities which may be purchased pursuant to section 55(a) of title I of this Act [*15 USCS § 80a-54(a)*] may be purchased from any person.

For purposes of this paragraph, all terms in sections 2(a)(48) and 55 of title I of this Act [*15 USCS §§ 80a-2(a)(48), 80a-54*] shall have the same meaning set forth in such title as if such company were a registered closed-end investment company, except that the value of the assets of a business development company which is not subject to the provisions

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of sections 55 through 65 of title I of this Act [*15 USCS §§ 80a-54-80a-64*] shall be determined as of the date of the most recent financial statements which it furnished to all holders of its securities, and shall be determined no less frequently than annually.

(23) "Foreign securities authority" means any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

(24) "Foreign financial regulatory authority" means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate the participation of its members in activities listed above.

(25) "Supervised person" means any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.

(26) The term "separately identifiable department or division" of a bank means a unit--

(A) that is under the direct supervision of an officer or officers designated by the board of directors of the bank as responsible for the day-to-day conduct of the bank's investment adviser activities for one or more investment companies, including the supervision of all bank employees engaged in the performance of such activities; and

(B) for which all of the records relating to its investment adviser activities are separately maintained in or extractable from such unit's own facilities or the facilities of the bank, and such records are so maintained or otherwise accessible as to permit independent examination and enforcement by the Commission of this Act [*15 USCS §§ 80b-1 et seq.*] or the Investment Company Act of 1940 and rules and regulations promulgated under this Act [*15 USCS §§ 80b-1 et seq.*] or the Investment Company Act of 1940.

(27) The terms "security future" and "narrow-based security index" have the same meanings as provided in section 3(a)(55) of the Securities Exchange Act of 1934 [*15 USCS § 78c(a)(55)*].

(28) The term "credit rating agency" has the same meaning as in section 3 of the Securities Exchange Act of 1934 [*15 USCS § 78c*].

(b) No provision in this title [*15 USCS §§ 80b-1 et seq.*] shall apply to, or be deemed to include, the United States, a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty, unless such provision makes specific reference thereto.

(c) Consideration of promotion of efficiency, competition, and capital formation. Whenever pursuant to this title [*15 USCS §§ 80b-1 et seq.*] the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.



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§ 203 [15 U.S.C. § 80b-3] Registration of investment advisers

(a) Necessity of registration. Except as provided in subsection (b) and section 203A [15 USCS § 80b-3a], it shall be unlawful for any investment adviser, unless registered under this section, to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser.

(b) Investment advisers who need not be registered. The provisions of subsection (a) shall not apply to--

(1) any investment adviser all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange;

(2) any investment adviser whose only clients are insurance companies;

(3) any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act, or a company which has elected to be a business development company pursuant to section 54 of title I of this Act [15 USCS § 80a-53] and has not withdrawn its election. For purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company, as defined in this title, shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner;

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(4) any investment adviser that is a charitable organization, as defined in section 3(c)(10)(D) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(10)(D)], or is a trustee, director, officer, employee, or volunteer of such a charitable organization acting within the scope of such person's employment or duties with such organization, whose advice, analyses, or reports are provided only to one or more of the following:

(A) any such charitable organization;

(B) a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(10)(B)]; or

(C) a trust or other donative instrument described in section 3(c)(10)(B) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(10)(B)], or the trustees, administrators, settlors (or potential settlors), or beneficiaries of any such trust or other instrument;

(5) any plan described in *section 414(e) of the Internal Revenue Code of 1986* [26 USCS § 414(e)], any person or entity eligible to establish and maintain such a plan under the Internal Revenue Code of 1986 [26 USCS §§ 1 *et seq.*], or any trustee, director, officer, or employee of or volunteer for any such plan or person, if such person or entity, acting in such capacity, provides investment advice exclusively to, or with respect to, any plan, person, or entity or any company, account, or fund that is excluded from the definition of an investment company under section 3(c)(14) of the Investment Company Act of 1940 [15 USCS § 80a-3(c)(14)]; or

(6) any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser, as defined in section 202(a)(11) of this title [15 USCS § 80b-2(a)(11)], and that does not act as an investment adviser to--

(A) an investment company registered under title I of this Act; or

(B) a company which has elected to be a business development company pursuant to section 54 of title I of this Act [15 USCS § 80a-53] and has not withdrawn its election.

(c) Procedure for registration; filing of application; effective date of registration; amendment of registration.

(1) An investment adviser, or any person who presently contemplates becoming an investment adviser, may be registered by filing with the Commission an application for registration in such form and containing such of the

following information and documents as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors:

(A) the name and form of organization under which the investment adviser engages or intends to engage in business; the name of the State or other sovereign power under which such investment adviser is organized; the location of his or its principal business office and branch offices, if any; the names and addresses of his or its partners, officers, directors, and persons performing similar functions or, if such an investment adviser be an individual, of such individual; and the number of his or its employees;

(B) the education, the business affiliations for the past ten years, and the present business affiliations of such investment adviser and of his or its partners, officers, directors, and persons performing similar functions and of any controlling person thereof;

(C) the nature of the business of such investment adviser, including the manner of giving advice and rendering analyses or reports;

(D) a balance sheet certified by an independent public accountant and other financial statements (which shall, as the Commission specifies, be certified);

(E) the nature and scope of the authority of such investment adviser with respect to clients' funds and accounts;

(F) the basis or bases upon which such investment adviser is compensated;

(G) whether such investment adviser, or any person associated with such investment adviser, is subject to any disqualification which would be a basis for denial, suspension, or revocation of registration of such investment adviser under the provisions of subsection (e) of this section; and

(H) a statement as to whether the principal business of such investment adviser consists or is to consist of acting as investment adviser and a statement as to whether a substantial part of the business of such investment adviser, consists or is to consist of rendering investment supervisory services.

(2) Within forty-five days of the date of the filing of such application (or within such longer period as to which the applicant consents) the Commission shall--

(A) by order grant such registration; or

(B) institute proceedings to determine whether registration should be denied. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within one hundred twenty days of the date of the filing of the application for registration. At the conclusion of such proceedings the Commission, by order, shall grant or deny such registration. The Commission may extend the time for conclusion of such proceedings for up to ninety days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

The Commission shall grant such registration if the Commission finds that the requirements of this section are satisfied and that the applicant is not prohibited from registering as an investment adviser under section 203A [15 USCS § 80b-3a]. The Commission shall deny such registration if it does not make such a finding or if it finds that if the applicant were so registered, its registration would be subject to suspension or revocation under subsection (e) of this section.

(d) Other acts prohibited by 15 USCS §§ 80b-1 et seq. Any provision of this title (other than subsection (a) of this section) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith shall also prohibit any such act, practice, or course of business by any investment adviser registered pursuant to this section or any person acting on behalf of such an investment adviser, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

(e) Censure, denial, or suspension of registration; notice and hearing. The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such investment adviser, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associated--

(1) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.

(2) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor or of a substantially equivalent crime by a foreign court of competent jurisdiction which the Commission finds--

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(A) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, any substantially equivalent activity however denominated by the laws of the relevant foreign government, or conspiracy to commit any such offense;

(B) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, investment adviser, bank, insurance company, or government securities broker, government securities dealer, fiduciary, transfer agent, credit rating agency, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation;

(C) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities or substantially equivalent activity however denominated by the laws of the relevant foreign government; or

(D) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of title 18, *United States Code* [18 *USCS* §§ 152, 1341, 1342, or 1343 or 471 *et seq.* or 1001 *et seq.*], or a violation of [a] substantially equivalent foreign statute.

(3) has been convicted during the 10-year period preceding the date of filing of any application for registration, or at any time thereafter, of--

(A) any crime that is punishable by imprisonment for 1 or more years, and that is not described in paragraph (2); or

(B) a substantially equivalent crime by a foreign court of competent jurisdiction.

(4) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction, including any foreign court of competent jurisdiction, from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, credit rating agency, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation, or as an affiliated person or employee of any investment company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

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(5) has willfully violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, this title, the Commodity Exchange Act, or the rules or regulations under any such statutes or any rule of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(6) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, this title, the Commodity Exchange Act, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this paragraph no person shall be deemed to have failed reasonably to supervise any person, if--

(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

(7) is subject to any order of the Commission barring or suspending the right of the person to be associated with an investment adviser;

(8) has been found by a foreign financial regulatory authority to have--

(A) made or caused to be made in any application for registration or report required to be filed with a foreign securities authority, or in any proceeding before a foreign securities authority with respect to registration, any statement that was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to a foreign securities authority any material fact that is required to be stated therein;

(B) violated any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade; or

(C) aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on

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or subject to the rules of a contract market or any board of trade, or has been found, by the foreign financial [financial] regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of statutory provisions, and rules and regulations promulgated thereunder, another person who commits such a violation, if such other person is subject to his supervision; or

(9) is subject to any final order of a State securities commission (or any agency or officer performing like functions), State authority that supervises or examines banks, savings associations, or credit unions, State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act (*12 U.S.C. 1813(q)*)), or the National Credit Union Administration, that--

(A) bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or

(B) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.

(f) Bar or suspension from association with investment adviser; notice and hearing. The Commission, by order, shall censure or place limitations on the activities of any person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated with an investment adviser, or suspend for a period not exceeding twelve months or bar any such person from being associated with an investment adviser, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in paragraph (1), (5), (6), (8), or (9) of subsection (e) of this section or has been convicted of any offense specified in paragraph (2) or (3) of subsection (e) within ten years of the commencement of the proceedings under this subsection, or is enjoined from any action, conduct, or practice specified in paragraph (4) of subsection (e). It shall be unlawful for any person as to whom such an order suspending or barring him from being associated with an investment adviser is in effect willfully to become, or to be, associated with an investment adviser without the consent of the Commission, and it shall be unlawful for any investment adviser to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such investment adviser knew, or in the exercise of reasonable care, should have known, of such order.

(g) Registration of successor to business of investment adviser. Any successor to the business of an investment adviser registered under this section shall be deemed likewise registered hereunder, if within thirty days from its succession of such business it shall file an application for registration under this section, unless and until the Commission, pursuant to subsection (c) or subsection (e) of this section, shall deny registration to or revoke or suspend the registration of such successor.

(h) Withdrawal of registration. Any person registered under this section may, upon such terms and conditions as the

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Commission finds necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any person registered under this section, or who has pending an application for registration filed under this section, is no longer in existence, is not engaged in business as an investment adviser, or is prohibited from registering as an investment adviser under section 203A [15 USCS § 80b-3a], the Commission shall by order cancel the registration of such person.

(i) Money penalties in administrative proceedings.

(1) Authority of Commission. In any proceeding instituted pursuant to subsection (e) or (f) against any person, the Commission may impose a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person--

(A) has willfully violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, or this title, or the rules or regulations thereunder;

(B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

(C) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which was required to be stated therein; or

(D) has failed reasonably to supervise, within the meaning of subsection (e)(6), with a view to preventing violations of the provisions of this title and the rules and regulations thereunder, another person who commits such a violation, if such other person is subject to his supervision;

and that such penalty is in the public interest.

(2) Maximum amount of penalty.

(A) First tier. The maximum amount of penalty for each act or omission described in paragraph (1) shall be \$5,000 for a natural person or \$50,000 for any other person.

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(B) Second tier. Notwithstanding subparagraph (A), the maximum amount of penalty for each such act or omission shall be \$50,000 for a natural person or \$250,000 for any other person if the act or omission described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(C) Third tier. Notwithstanding subparagraphs (A) and (B), the maximum amount of penalty for each such act or omission shall be \$100,000 for a natural person or \$500,000 for any other person if--

(i) the act or omission described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(ii) such act or omission directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission.

(3) Determination of public interest. In considering under this section whether a penalty is in the public interest, the Commission may consider--

(A) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

(B) the harm to other persons resulting either directly or indirectly from such act or omission;

(C) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

(D) whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a court of competent jurisdiction of violations of such laws or of any felony or misdemeanor described in section 203(e)(2) of this title [subsec. (e)(2) of this section];

(E) the need to deter such person and other persons from committing such acts or omissions; and

(F) such other matters as justice may require.

(4) Evidence concerning ability to pay. In any proceeding in which the Commission may impose a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.

(j) Authority to enter an order requiring an accounting and disgorgement. In any proceeding in which the Commission may impose a penalty under this section, the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

(k) Cease-and-desist proceedings.

(1) Authority of the Commission. If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this title, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule, or regulation with respect to any security, any issuer, or any other person.

(2) Hearing. The notice instituting proceedings pursuant to paragraph (1) shall fix a hearing date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served.

(3) Temporary order.

(A) In general. Whenever the Commission determines that the alleged violation or threatened violation specified in the notice instituting proceedings pursuant to paragraph (1), or the continuation thereof, is likely to result in significant

dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest, including, but not limited to, losses to the Securities Investor Protection Corporation, prior to the completion of the proceedings, the Commission may enter a temporary order requiring the respondent to cease and desist from the violation or threatened violation and to take such action to prevent the violation or threatened violation and to prevent dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest as the Commission deems appropriate pending completion of such proceedings. Such an order shall be entered only after notice and opportunity for a hearing, unless the Commission, notwithstanding section 211(c) of this title [15 USCS § 80b-11(c)], determines that notice and hearing prior to entry would be impracticable or contrary to the public interest. A temporary order shall become effective upon service upon the respondent and, unless set aside, limited, or suspended by the Commission or a court of competent jurisdiction, shall remain effective and enforceable pending the completion of the proceedings.

(B) Applicability. This paragraph shall apply only to a respondent that acts, or, at the time of the alleged misconduct acted, as a broker, dealer, investment adviser, investment company, municipal securities dealer, government securities broker, government securities dealer, or transfer agent, or is, or was at the time of the alleged misconduct, an associated person of, or a person seeking to become associated with, any of the foregoing.

(4) Review of temporary orders.

(A) Commission review. At any time after the respondent has been served with a temporary cease-and-desist order pursuant to paragraph (3), the respondent may apply to the Commission to have the order set aside, limited, or suspended. If the respondent has been served with a temporary cease-and-desist order entered without a prior Commission hearing, the respondent may, within 10 days after the date on which the order was served, request a hearing on such application and the Commission shall hold a hearing and render a decision on such application at the earliest possible time.

(B) Judicial review. Within--

(i) 10 days after the date the respondent was served with a temporary cease-and-desist order entered with a prior Commission hearing, or

(ii) 10 days after the Commission renders a decision on an application and hearing under subparagraph (A), with respect to any temporary cease-and-desist order entered without a prior Commission hearing, the respondent may apply to the United States district court for the district in which the respondent resides or has its principal place of business, or for the District of Columbia, for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order, and the court shall have jurisdiction to enter such an order. A respondent served with a temporary cease-and-desist order entered without a prior Commission hearing may not apply to the court except after hearing and decision by the Commission on the respondent's application under subparagraph (A) of this paragraph.

(C) No automatic stay of temporary order. The commencement of proceedings under subparagraph (B) of this paragraph shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

(D) Exclusive review. Section 213 of this title [*15 USCS § 80b-13*] shall not apply to a temporary order entered pursuant to this section.

(5) Authority to enter an order requiring an accounting and disgorgement. In any cease-and-desist proceeding under paragraph (1), the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.



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APPENDIX K Investment Advisers Act of 1940 Selected Provisions

2-K Securities Enforcement: Counseling and Defense Section 206

§ 206 [15 U.S.C. § 80b-6] Prohibited transactions by investment advisers

It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly--

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.



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§ 207 [15 U.S.C. § 80b-7] Material misstatements

It shall be unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission under section 80b-3 or 80b-4 of this title, or willfully to omit to state in any such application or report any material fact which is required to be stated therein.



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2-K Securities Enforcement: Counseling and Defense Section 208

§ 208 [15 U.S.C. § 80b-8] General prohibitions

(a) Representations of sponsorship by United States or agency thereof

It shall be unlawful for any person registered under section 80b-3 of this title to represent or imply in any manner whatsoever that such person has been sponsored, recommended, or approved, or that his abilities or qualifications have in any respect been passed upon by the United States or any agency or any officer thereof.

(b) Statement of registration under Securities Exchange Act of 1934 provisions

No provision of subsection (a) of this section shall be construed to prohibit a statement that a person is registered under this subchapter or under the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.], if such statement is true in fact and if the effect of such registration is not misrepresented.

(c) Use of name "investment counsel" as descriptive of business

It shall be unlawful for any person registered under section 80b-3 of this title to represent that he is an investment counsel or to use the name "investment counsel" as descriptive of his business unless (1) his or its principal business consists of acting as investment adviser, and (2) a substantial part of his or its business consists of rendering investment supervisory services.

(d) Use of indirect means to do prohibited act

It shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this subchapter or any rule or regulation thereunder.



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APPENDIX K Investment Advisers Act of 1940 Selected Provisions

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§ 209 [15 U.S.C. § 80b-9] Enforcement of subchapter

(a) Investigation. Whenever it shall appear to the Commission, either upon complaint or otherwise, that the provisions of this title or of any rule or regulation prescribed under the authority thereof, have been or are about to be violated by any person, it may in its discretion require, and in any event shall permit, such person to file with it a statement in writing, under oath or otherwise, as to all the facts and circumstances relevant to such violation, and may otherwise investigate all such facts and circumstances.

(b) Administration of oaths and affirmations, subpoena of witnesses, etc. For the purposes of any investigation or any proceeding under this title, any member of the Commission or any officer thereof 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, contracts, agreements, or other records which are relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in any State or in any Territory or other place subject to the jurisdiction of the United States at any designated place of hearing.

(c) Jurisdiction of courts of United States. In case of contumacy by, or refusal to obey a subpoena issued to, any person, the Commission may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda, contracts, agreements, and other records. And such court may issue an order requiring such person to appear before the Commission or member or officer designated by the Commission, there to produce records, if so ordered, or to give testimony touching the matter under investigation or in question; and any failure to obey such order of the court may be punished by such court as a contempt thereof. All process in any such case may be served in the judicial district whereof such person is an inhabitant or wherever he may be found. Any person who without just cause shall fail or refuse to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, contracts, agreements, or other records, if in his or its power so to do, in obedience to the subpoena of the Commission, shall be guilty of a misdemeanor, and upon conviction shall be subject to a fine of not more than \$1,000 or to imprisonment for a term of not more than one year, or both.

(d) Action for injunction. Whenever it shall appear to the Commission that any person has engaged, is engaged, or is about to engage in any act or practice constituting a violation of any provision of this title, or of any rule, regulation, or order hereunder, or that any person has aided, abetted, counseled, commanded, induced, or procured, is aiding, abetting, counseling, commanding, inducing, or procuring, or is about to aid, abet, counsel, command, induce, or procure such a violation, it may in its discretion bring an action in the proper district court of the United States, or the proper United States court of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices and to enforce compliance with this title or any rule, regulation, or order hereunder. Upon a showing that such person has engaged, is engaged, or is about to engage in any such act or practice, or in aiding, abetting, counseling, commanding, inducing, or procuring any such act or practice, a permanent or temporary injunction or decree or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning any violation of the provisions of this title, or of any rule, regulation, or order thereunder, to the Attorney General, who, in his discretion, may institute the appropriate criminal proceedings under this title.

(e) Money penalties in civil actions.

(1) Authority of Commission. Whenever it shall appear to the Commission that any person has violated any provision of this title, the rules or regulations thereunder, or a cease and desist order entered by the Commission pursuant to section 203(k) of this title [15 USCS § 80b 3(k)], the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

(2) Amount of penalty.

(A) First tier. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (i) \$5,000 for a natural person or \$ 50,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation.

(B) Second tier.

Notwithstanding subparagraph (A), the amount of penalty for each such violation shall not exceed the greater of (i) \$50,000 for a natural person or \$ 250,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation, if the violation described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(C) Third tier. Notwithstanding subparagraphs (A) and (B), the amount of penalty for each such violation shall not exceed the greater of (i) \$100,000 for a natural person or \$500,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation, if--

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(I) the violation described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(II) such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.

(3) Procedures for collection.

(A) Payment of penalty to Treasury. A penalty imposed under this section shall be payable into the Treasury of the United States, except as otherwise provided in section 308 of the Sarbanes Oxley Act of 2002 [15 USCS § 7246].

(B) Collection of penalties. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

(C) Remedy not exclusive. The actions authorized by this subsection may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring.

(D) Jurisdiction and venue. For purposes of section 214 of this title [15 USCS § 80b 14], actions under this paragraph shall be actions to enforce a liability or a duty created by this title.

(4) Special provisions relating to a violation of a cease and desist order. In an action to enforce a cease and desist order entered by the Commission pursuant to section 203(k) [15 USCS § 80b 3(k)], each separate violation of such order shall be a separate offense, except that in the case of a violation through a continuing failure to comply with the order, each day of the failure to comply shall be deemed a separate offense.



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APPENDIX K Investment Advisers Act of 1940 Selected Provisions

2-K Securities Enforcement: Counseling and Defense Section 213

§ 213 [15 U.S.C. § 80b-13] Court review of orders

(a) Petition; jurisdiction; findings of Commission; additional evidence; finality

Any person or party aggrieved by an order issued by the Commission under this subchapter may obtain a review of such order in the United States court of appeals within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith transmitted by the clerk of the court to any member of the Commission, or any officer thereof designated by the Commission for that purpose, and thereupon the Commission shall file in the court the record upon which the order complained of was entered, as provided in section 2112 of title 28. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record shall be exclusive, to affirm, modify, or set aside such order, in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission or unless there were reasonable grounds for failure so to do. The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If application is made to the court for leave to adduce additional evidence, and it is shown to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceeding before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court affirming, modifying, or setting aside, in whole or in part, any such order of the Commission shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in section 1254 of title 28.

(b) Stay of Commission's order

The commencement of proceedings under subsection (a) of this section shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.



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APPENDIX K Investment Advisers Act of 1940 Selected Provisions

2-K Securities Enforcement: Counseling and Defense Section 214

§ 214 [15 U.S.C. § 80b-14] Jurisdiction of offenses and suits

The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this subchapter or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of this subchapter or the rules, regulations, or orders thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by, or to enjoin any violation of this subchapter or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, 1292, and 1294 of title 28. No costs shall be assessed for or against the Commission in any proceeding under this subchapter brought by or against the Commission in any court.



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APPENDIX K Investment Advisers Act of 1940 Selected Provisions

2-K Securities Enforcement: Counseling and Defense Section 217

§ 217 [15 U.S.C. § 80b-17] Penalties

Any person who willfully violates any provision of this subchapter, or any rule, regulation, or order promulgated by the Commission under authority thereof, shall, upon conviction, be fined not more than \$10,000, imprisoned for not more than five years, or both.



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§ Rule 206(4)-4 [17 C.F.R. § 275.206(4)-4] Financial and disciplinary information that investment advisers must disclose to clients.



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APPENDIX L Rules and Regulations Under the Investment Advisers Act of 1940

2-L Securities Enforcement: Counseling and Defense § Rule 206(4)-4

§ Rule 206(4)-4 [17 C.F.R. § 275.206(4)-4] Financial and disciplinary information that investment advisers must disclose to clients.

(a) It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (*15 U.S.C. 80b-6(4)*) for any investment adviser registered or required to be registered under section 203 of the Act (*15 U.S.C. 80b-3*) to fail to disclose to any client or prospective client all material facts with respect to:

(1) A financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet contractual commitments to clients, if the adviser has discretionary authority (express or implied) or custody over such client's funds or securities, or requires prepayment of advisory fees of more than \$500 from such client, 6 months or more in advance; or

(2) A legal or disciplinary event that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients.

(b) It shall constitute a rebuttable presumption that the following legal or disciplinary events involving the adviser or a management person of the adviser (any of the foregoing being referred to hereafter as "person") that were not resolved in the person's favor or subsequently reversed, suspended, or vacated are material within the meaning of paragraph (a)(2) of the rule for a period of 10 years from the time of the event:

(1) A criminal or civil action in a court of competent jurisdiction in which the person--

2-L Securities Enforcement: Counseling and Defense § Rule 206(4)-4

(i) Was convicted, pleaded guilty or nolo contendere ("no contest") to a felony or misdemeanor, or is the named subject of a pending criminal proceeding (any of the foregoing referred to hereafter as "action"), and such action involved: an investment-related business; fraud, false statements, or omissions; wrongful taking of property; or bribery, forgery, counterfeiting, or extortion;

(ii) Was found to have been involved in a violation of an investment-related statute or regulation; or

(iii) Was the subject of any order, judgment, or decree permanently or temporarily enjoining the person from, or otherwise limiting the person from, engaging in any investment-related activity.

(2) Administrative proceedings before the Securities and Exchange Commission, and other federal regulatory agency or any state agency (any of the foregoing being referred to hereafter as "agency") in which the person--

(i) Was found to have caused an investment-related business to lose its authorization to do business; or

(ii) Was found to have been involved in a violation of an investment-related statute or regulation and was the subject of an order by the agency denying, suspending, or revoking the authorization of the person to act in, or barring or suspending the person's association with, an investment-related business; or otherwise significantly limiting the person's investment-related activities.

(3) Self-Regulatory Organization (SRO) proceedings in which the person--

(i) Was found to have caused an investment-related business to lose its authorization to do business; or

(ii) Was found to have been involved in a violation of the SRO's rules and was the subject of an order by the SRO barring or suspending the person from membership or from association with other members, or expelling the person from membership; fining the person more than \$2,500; or otherwise significantly limiting the person's investment-related activities.

(c) The information required to be disclosed by paragraph (a) of this section shall be disclosed to clients promptly, and to prospective clients not less than 48 hours prior to entering into any written or oral investment advisory contract, or no later than the time of entering into such contract if the client has the right to terminate the contract without penalty within five business days after entering into the contract.

(d) For purposes of this rule:

(1) "Management person" means a person with power to exercise, directly or indirectly, a controlling influence over the management or policies of an adviser which is a company or to determine the general investment advice given to clients.

(2) "Found" means determined or ascertained by adjudication or consent in a final SRO proceeding, administrative proceeding, or court action.

(3) "Investment-related" means pertaining to securities commodities, banking, insurance, or real estate (including, but not limited to, action as or being associated with a broker, dealer, investment company, investment adviser, government securities broker or dealer, municipal securities dealer, bank, savings and loan association, entity or person required to be registered under the Commodity Exchange Act [7 U.S.C. *I et seq.*], or fiduciary).

(4) "Involved" means acting or aiding, abetting, causing, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act.

(5) "Self-Regulatory Organization" or "SRO" means any national securities or commodities exchange, registered association, or registered clearing agency.

(e) For purposes of calculating the 10-year period during which events are presumed to be material under paragraph (b), the date of a reportable event shall be the date on which the final order, judgment, or decree was entered, or the date on which any rights of appeal from preliminary orders, judgments, or decrees lapsed.

(f) Compliance with paragraph (b) of this rule shall not relieve any investment adviser from the disclosure obligations of paragraph (a) of the rule; compliance with paragraph (a) of the rule shall not relieve any investment adviser from any other disclosure requirement under the Act, the rules and regulations thereunder, or under any other federal or state law.

Note:

Registered investment advisers may disclose this information to clients and prospective clients in their "brochure," the written disclosure statement to clients under Rule 204-3 [17 CFR 275.204-3]; Provided, That the delivery of the brochure satisfies the timing of disclosure requirements described in paragraph (c) of this rule.



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§ Sec. 34 [15 U.S.C. § 80a-33]. Destruction and falsification of reports and records

§ Sec. 36 [15 U.S.C. § 80a-35]. Breach of fiduciary duty

§ Sec. 41 [15 U.S.C. § 80a-40]. Hearings by Commission

§ Sec. 42 [15 U.S.C. § 80a-41]. Enforcement of subchapter

§ Sec. 44 [15 U.S.C. § 80a-43]. Jurisdiction of offenses and suits

§ Sec. 49 [15 U.S.C. § 80a-48]. Penalties



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2-M Securities Enforcement: Counseling and Defense § Sec. 34

§ 34 [15 U.S.C. § 80a-33]. Destruction and falsification of reports and records

(a) Willful destruction

It shall be unlawful for any person, except as permitted by rule, regulation, or order of the Commission, willfully to destroy, mutilate, or alter any account, book, or other document the preservation of which has been required pursuant to section 80a-30(a) or 80a-31(c) of this title.

(b) Untrue statements or omissions

It shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this subchapter or the keeping of which is required pursuant to section 80a-30(a) of this title. It shall be unlawful for any person so filing, transmitting, or keeping any such document to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading. For the purposes of this subsection, any part of any such document which is signed or certified by an accountant or auditor in his capacity as such shall be deemed to be made, filed, transmitted, or kept by such accountant or auditor, as well as by the person filing, transmitting, or keeping the complete document.



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2-M Securities Enforcement: Counseling and Defense § Sec. 36

§ 36 [15 U.S.C. § 80a-35]. Breach of fiduciary duty

(a) Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts--

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a-1(b) of this title.

(b) Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated

person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payment received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loads for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

(c) Corporate or other trustees performing functions of investment advisers

For the purposes of subsections (a) and (b) of this section, the term "investment adviser" includes a corporate or

other trustee performing the functions of an investment adviser.



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2-M Securities Enforcement: Counseling and Defense § Sec. 41

§ 41 [15 U.S.C. § 80a-40]. Hearings by Commission

Hearings may be public and may be held before the Commission, any member or members thereof, or any officer or officers of the Commission designated by it, and appropriate records thereof shall be kept.



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2-M Securities Enforcement: Counseling and Defense § Sec. 42

§ 42 [15 U.S.C. § 80a-41]. Enforcement of subchapter

(a) Investigation. The Commission may make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of this subchapter or of any rule, regulation, or order hereunder, or to determine whether any action in any court or any proceeding before the Commission shall be instituted under this subchapter against a particular person or persons, or with respect to a particular transaction or transactions. The Commission shall 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.

(b) Administration of oaths and affirmations, subpoena of witnesses, etc. For the purpose of any investigation or any other proceeding under this title, any member of the Commission, or any officer thereof 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, contracts, agreements, or other records which are relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in any State or in any Territory or other place subject to the jurisdiction of the United States at any designated place of hearing.

(c) Jurisdiction of courts of United States. In case of contumacy by, or refusal to obey a subpoena issued to, any person, the Commission may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda, contracts, agreements, and other records. And such court may issue an order requiring such person to appear before the Commission or member or officer designated by the Commission, there to produce records, if so ordered, or to give testimony touching the matter under investigation or in question; any failure to obey such order of the court may be punished by such court as a contempt thereof. All process in any such case may be served in the judicial district whereof such person is an inhabitant or wherever he may be found. Any person who without just cause shall fail or refuse to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, contracts, agreements, or other records, if in his or its power so to do, in obedience to the subpoena of the Commission, shall be guilty of a misdemeanor, and upon conviction shall be subject to a fine of not more than \$1,000 or to imprisonment for a term of

not more than one year, or both.

(d) Action for injunction. Whenever it shall appear to the Commission that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this title, or of any rule, regulation, or order hereunder, it may in its discretion bring an action in the proper district court of the United States, or the proper United States court of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices and to enforce compliance with this title or any rule, regulation, or order hereunder. Upon a showing that such person has engaged or is about to engage in any such act or practice, a permanent or temporary injunction or decree or restraining order shall be granted without bond. In any proceeding under this subsection to enforce compliance with section 7 [15 USCS § 80a 7], the court as a court of equity may, to the extent it deems necessary or appropriate, take exclusive jurisdiction and possession of the investment company or companies involved and the books, records, and assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, who with the approval of the court shall have power to dispose of any or all of such assets, subject to such terms and conditions as the court may prescribe. The Commission may transmit such evidence as may be available concerning any violation of the provisions of this title, or of any rule, regulation, or order thereunder, to the Attorney General, who, in his discretion, may institute the appropriate criminal proceedings under this title.

(e) Money penalties in civil actions.

(1) Authority of Commission. Whenever it shall appear to the Commission that any person has violated any provision of this title, the rules or regulations thereunder, or a cease and desist order entered by the Commission pursuant to section 9(f) of this title [15 USCS § 80a 9(f)], the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

(2) Amount of penalty.

(A) First tier. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (i) \$5,000 for a natural person or \$50,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation.

(B) Second tier. Notwithstanding subparagraph (A), the amount of penalty for each such violation shall not exceed the greater of (i) \$50,000 for a natural person or \$250,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation, if the violation described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(C) Third tier. Notwithstanding subparagraphs (A) and (B), the amount of penalty for each such violation shall not

exceed the greater of (i) \$100,000 for a natural person or \$500,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation, if--

(I) the violation described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(II) such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.

(3) Procedures for collection.

(A) Payment of penalty to Treasury. A penalty imposed under this section shall be payable into the Treasury of the United States, except as otherwise provided in section 308 of the Sarbanes Oxley Act of 2002 [*15 USCS § 7246*].

(B) Collection of penalties. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

(C) Remedy not exclusive. The actions authorized by this subsection may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring.

(D) Jurisdiction and venue. For purposes of section 44 of this title [*15 USCS § 80a 43*], actions under this paragraph shall be actions to enforce a liability or a duty created by this title.

(4) Special provisions relating to a violation of a cease and desist order. In an action to enforce a cease and desist order entered by the Commission pursuant to section 9(f) [*15 USCS § 80a 9(f)*], each separate violation of such order shall be a separate offense, except that in the case of a violation through a continuing failure to comply with the order, each day of the failure to comply shall be deemed a separate offense.



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2-M Securities Enforcement: Counseling and Defense § Sec. 44

§ 44 [15 U.S.C. § 80a-43]. Jurisdiction of offenses and suits

The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this subchapter or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this subchapter or the rules, regulations, or orders thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. A criminal proceeding based upon a violation of section 80a-33 of this title, or upon a failure to file a report or other document required to be filed under this subchapter, may be brought in the district wherein the defendant is an inhabitant or maintains his principal office or place of business. Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, this subchapter or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, 1292, and 1294 of title 28. No costs shall be assessed for or against the Commission in any proceeding under this subchapter brought by or against the Commission in any court. The Commission may intervene as a party in any action or suit to enforce any liability or duty created by, or to enjoin any noncompliance with, section 80a-35(b) of this title at any stage of such action or suit prior to final judgment therein.



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2-M Securities Enforcement: Counseling and Defense § Sec. 49

§ 49 [15 U.S.C. § 80a-48]. Penalties

Any person who willfully violates any provision of this subchapter or of any rule, regulation, or order hereunder, or any person who willfully in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this subchapter or the keeping of which is required pursuant to section 80a-30(a) of this title makes any untrue statement of a material fact or omits to state any material fact necessary in order to prevent the statements made therein from being materially misleading in the light of the circumstances under which they were made, shall upon conviction be fined not more than \$10,000 or imprisoned not more than five years, or both; but no person shall be convicted under this section for the violation of any rule, regulation, or order if he proves that he had no actual knowledge of such rule, regulation, or order.