PROCEEDINGS OF THE 2005 MIDWEST SECURITIES LAW INSTITUTE SYMPOSIUM*

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***Note from the Editor and Disclaimer:**
The following is a minimally-edited transcript of the panel speakers and keynote speech from the 2006 Midwest Securities Law Institute (MWSLI) Symposium, an annual one-day gathering of securities lawyers held at Michigan State University College of Law on October 21, 2005. Biographies of the speakers are footnoted throughout. Readers interested in attending next year's event and finding additional information on the MWSLI can visit http://www.mwsli.org.

None of the opinions of these persons is necessarily the opinion of their respective agencies. They are their own opinions and they are not to be used nor will they be able to be used for any legally binding purpose regarding them or any agency.

INTRODUCTION

Joe Spiegel[1]:
Welcome. As someone who is near and dear to most of our hearts has said, "the times are a changing." Direct ownership of stocks by American households has declined from 91 percent in 1950 to just 32 percent today. The nine percent ownership stake held by financial institutions in 1950 crossed the 50 percent mark in 1983 and now totals 68 percent. The times are a changing, and the program we have for you today reflects not only the existing state of the law and regulation, but will reflect a trend that we believe we have identified and you will see from the speakers. I want to thank Dean Terence Blackburn, Assistant Dean Elliot Spoon, the staff, and the students, but in particular I'd like to point out some of the attorneys who have spent an enormous amount of time helping to put this seminar together, which is really a world class seminar: Raymond Henney, Mel Moesely, Dennis Egan, Dennis Levasseur, and Robert Hudson. These folks have spent an enormous amount of time putting together some incredible materials.

We have decided to break this down into a two-fold program. This morning you are going to hear a panel on NYSE (New York Stock Exchange) updates, then an NASD (National Association of Securities Dealers) enforcement update, and then a short break, and then SEC (Securities and Exchange Commission) enforcement issues. This afternoon we have various breakout sessions, and these breakout sessions are essentially divided so that individuals who have certain kinds of interests can focus in on them.

With that, I'd like to turn to our first panel on NYSE enforcement, featuring Susan Light, Vice President of the Division of Enforcement for the New York Stock Exchange, and Hugh Makens and Dennis Egan.

[1] Mr. Joe Spiegel founded Joseph H. Spiegel, P.C., in 1987, a general practice firm emphasizing business law litigation and specializing in securities-related matters. He has lectured in the areas of Securities and Commodities Law and Federal Civil Procedure for a variety of professional associations and institutes. He received his J.D. from John Marshall Law School and his B.A. from Cornell College.

PANEL ONE: NEW YORK STOCK EXCHANGE (NYSE) ENFORCEMENT ISSUES

Susan Light[2]:
Good morning. Imagine, if you will, a securities attorney, Bob Barr, who's come to the Midwest Securities Law Institute for many years and has become friendly with a gentleman who's just about ready to retire. This gentleman offers him an opportunity to take over representation of one of his clients, Bilkum & Stealum Brokers. So Bob Barr does his homework: he looks at the NYSE website, he looks at the CRD, he looks at prior disciplinary decisions, and he decides that indeed he will represent Bilkum & Stealum Brokers. Well, about a week into his representation of that brokerage firm, the president of the firm comes to him and tells him that he's gotten a letter from Klark Kent, an enforcement attorney in the NYSE Division of Enforcement, who is investigating Bilkum & Stealum Brokers and many of his brokers for many violations of securities law. What is Bob to do? After this morning's talk, hopefully Bob, and you, will have a better idea of what to do in your representation of clients.

My Division of Enforcement is part of regulation of the NYSE, and regulation has about 700 staff members. My division has about 188 staff members, most of them attorneys, and regulation makes up 42 percent of the NYSE. We're made up of six divisions. Enforcement, which I'll be mostly talking about, investigates and prosecutes violative conduct. Member Firm Regulation conducts examinations of the brokerage firms. Market Surveillance surveils for trading on the floor of the exchange and upstairs. They look for violations such as insider trading and market manipulations and observe the trading of the specialists. Arbitration obviously conducts the arbitrations and administers them. Listed Company Compliance reviews compliance with initial and continued listing standards, and Risk Assessment monitors areas in the industry for potential risk.

Within the last couple of years there have been vast changes to regulation. We have the new Chief Regulatory Officer, Rick Ketchum. There's been a migration of Arbitration and Listed Company Compliance from the business side into the regulatory side. We formed the Risk Unit just a year ago and this is all for the goal of independence of regulation and absence of a perceived conflict of interest. Our mission, as we see it, is to passionately and vigorously enforce the securities laws, protect the investor, and protect the integrity of the market.

Now, on to my division, the Enforcement division. We get our cases from any number of sources, both internally and externally. Internally they come from the divisions in regulation that I just told you about, and externally they come from you. Anybody can send in a complaint into the NYSE; the website is http://www.nyse.com. We get them

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[2] Ms. Susan Light is the Vice President of the Division of Enforcement for the New York Stock Exchange. In her position, Ms. Light is responsible for managing a department that investigates and prosecutes violations of SEC and NYSE rules and regulations. She also manages the Enforcement Division's preliminary investigations unit and case-management system. Prior to joining the NYSE in 1988, Ms. Light was an assistant district attorney in the Bronx District Attorney's Office. Ms. Light received her law degree from Boston University School of Law and her L.L.M. from New York University School of Law. She received her B.A. from the University of Michigan.

from the member firms who are obligated to report to us, we get them from other regulators, and we pick up cases on our own.

Our investigatory process is designed to gather the facts as efficiently as possible and come to a fair and just resolution. We have limited jurisdiction: we only have jurisdiction over the members, the member organizations, and the employees of the member organizations. That's not intuitively obvious. Many people think that we have jurisdiction over the listed companies. So, for example, in an insider trading case, we'll have jurisdiction over the brokers who may facilitate insider trading, but we don't have jurisdiction over a company that might be listed on the exchange whose stock was being insider traded and who may have leaked the information. We also don't have jurisdiction over the public. We don't have subpoena power. We rely on our member organizations who are obligated to cooperate with the Exchange in their investigations. The investigations and the hearing board procedures are all confidential. The only thing that the public can see is if a decision results from the investigation, and that's again on our website, www.nyse.com, but it's also on Lexis, and Westlaw, and other search engines.

Our sanctions are growing. Last year, the NYSE imposed over $25 million in fines, which was just about twice what it was the year before. Those are just cases that NYSE prosecuted by itself through my Enforcement division. We're also very, very active with other regulators in bringing market cases, and last year alone we, with the other regulators, settled cases for a total of $424 million. The SEC on its own, I'm sure, did more than that, but these are just cases where the NYSE was involved as well.

I'll talk to you about a few of the major cases we're working on. One example of a recent priority case involves prospectuses. It is very important to the NYSE that the brokerage firms send out prospectuses on new issues when they are obligated to do so. What happens when you don't send it out? Well, we learned of one firm who didn't send out 140,000 prospectuses to their customers. The firm was fined $13 million by the NYSE and entered into an agreement of rescission of each and every one of those new issues. It's a significant sanction and a significant message to the securities industry. We brought that case in December of 2004. We also realized in investigating that case that it probably wasn't this one brokerage firm that was making the mistake on its own. We expanded the case to twenty-five firms and we expect to have a resolution from many firms within the next two months.

This is a good example to bring to you not only because that's an interesting case with a large sanction—a meaningful sanction—but also because it's a message that we're trying to get out to the industry of internal controls. A brokerage firm cannot put their back office functions on autopilot and assume that they're working right. These internal control cases we're bringing are not the kind of cases where a brokerage firm, or an employee of a brokerage firm, is intentionally doing something wrong. Instead, these kind of cases are situations where a firm sets up a procedure – for example, sending out proxies, voting procedures, or prospectuses – and doesn't review it to see whether or not what they set up is happening. And in this day and age, when so much is controlled by technology—a very good thing—and less by manual processes, we found that firms change their computer systems, or change their functions, and something "tweaks off" in procedure that they've already had in place. So our message to the industry is: you can't put your internal functions on autopilot. You have to routinely check them and make sure that what you intended to happen is actually happening.

Market timing is an area that we're very involved in; it's a very hot topic. The NYSE is involved usually with other regulators, but sometimes on our own as well. I have a few cases where just the NYSE is bringing the case: market timing area, lay trading area, and revenue sharing. These are very exciting cases. I was just in Boston on Wednesday with seven regulators from the NYSE, the NASD, the SEC, the state of New York, the state of Massachusetts, the state of New Jersey, and the U.S. Attorney's Office, all negotiating with the brokerage firms on the market timing issue. These are really still very important to all of us.

Sales practice investigations are perhaps the most interesting to the practitioners of the group and that is really the backbone of our program. Even when we bring the huge cases today, still amongst the most important are the mom-and-pops that are being hurt by the brokers. They make up today over half of our cases, last year about a third of our cases. Last year we brought 195 formal actions; by "formal action" I mean we went to a hearing and it resulted in a decision that you can look at. We brought about the same number of informal actions, which would be a letter of education, an admonition letter, or a summary find; those are not viewable to the public.

We have many regulatory developments. Amongst the biggest is our merger with Archipelago, which should happen in the beginning of 2006. We're also instituting a hybrid market, which means that instead of the NYSE floor having the specialists, we'll have a combination of specialists and electronic trading. The goal is to present the best of both – fast trading, reduced volatility, price improvement – and we expect that to be happening in the beginning of 2006. My challenge is to monitor that market. The NYSE Enforcement Division recently put out two memos that I included in your handouts on cooperation and sanctions information. This is significant and valuable information for the industry as to how the Enforcement Division runs its programs and evaluates its cases.

Now, let's go back to Bob Barr. He's just received a letter from Klark Kent, from my enforcement division, and the letter explains that the Exchange is investigating the firm, the president of the firm, and many of its brokers for sales practice violations. One of the brokers under investigation is Carl Conniver. Carl has a practice that's mostly senior citizen clients, and Conniver sold these customers out of their blue chip stocks and their conservative mutual funds and put them in a high tech stock. In addition, Conniver told his customers that he's got secret information that he's received from the companies that tells him what are the good stocks to buy. And finally, the firm recently realized when they looked over Conniver's trading that Conniver was selling for himself from the same stocks on the same day at better prices than the stock that he was putting his customers in. What is Bob to do?

Well, Bob just received a letter that we call a jurisdiction letter. The purpose of this letter is threefold. It's to give notice to the firm and the individual that they are indeed under investigation now. Second of all, it's to establish jurisdiction. The NYSE retains jurisdiction, as long as we send out this jurisdiction letter, for a year from when we receive notice of a termination. So even if you're at a brokerage firm, we'll typically send what we call this jurisdiction letter, so that if you leave at any point in the future we retain jurisdiction over you. We also typically ask for a response in this jurisdiction letter as to what we're investigating, the subject's version of what we're investigating. What should Bob do? He should give us a call, introduce himself, establish a working relationship, and answer the letter.

What is the legal effect of the letter? If I had spoken to you three or four months ago it would have been a different answer. The answer used to be that there's an obligation to disclose this investigation on the individual's CRD (Central Registration Depository). But that's not today. The NYSE has changed its procedure, and when the brokerage firm or the individual receives a jurisdiction letter from us, he or she no longer needs to disclose that on the CRD. Instead, we are coming to conformity with the SEC and the NASD and disclosing it later on in the investigation when there is some sort of formal notice, often known as a Wells notice, that the investigation is proceeding in a formal matter.

So Bob answers the jurisdiction letter, and a few weeks later he receives a document request from the Exchange, asking for numerous documents, information, and email. Well, Bilkum & Stealum Brokers is a small firm with a limited budget and resources and the cost of finding and copying is going to be significant. What is Bob to do?

Again, Bob should call Klark Kent and talk to him about the problems that are faced and talk to him about the information that Klark Kent from the Division of Enforcement is really looking for. Sometimes what's in the document request is exactly what we need, and sometimes we phrase it in a way to capture more than we actually need because we don't know how the firm or the individual is keeping records. Give us a call and talk to us about it. Also, note the timing. We'll typically say that the documents are due within two weeks. Some of the documents I'm sure are able to be produced within two weeks: for example, account statements and account documents and correspondence are at your fingertips as soon as you get the file out. Other documents, for example the email, we understand are not going to be easily produced within two weeks. Give us a call and talk to us about it.

This is a good time in this call from Bob Barr, representing Bilkum & Stealum Brokers, to Klark Kent, from the Division of Enforcement, to talk about what benefit can be derived, and this is a good time to talk about the "Cooperation Memo."[3] This memo that we just released in September is a new memo to the industry but it reflects long-standing practice that firms and individuals that cooperate with the NYSE do indeed get credit for

[3] The cooperation memo is Information Memo No. 05-65 (September 14, 2005). It is available online at: http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E88525707C004C6DE0/$FILE/Microsoft%20Word%20-%20Document%20in%2005-65.pdf

that cooperation. And the memo reflects that there are indeed tiers of cooperation. If Bilkum & Stealum Brokers reports exactly what they're legally obligated to report, and they answer on the document request exactly what they're obligated to deliver to us, they don't get any extra credit. But, as the brokerage firm and the individuals cooperate more, and give us more, then that's seen in the end result. Some results might be expedited hearings; some results might be that the firm takes the hit and not the individuals; some results might be that we say in the decision that the firm cooperated and did x, y, and z, and ultimately some cooperation might be a reduced sanction or no sanction at all. The latter result of no sanction, although very rare, does happen—it has happened twice this year already. Typically, it is for those firms that have really gone above and beyond: given us reports that they have no legal obligation to report; waived attorney-client privilege; given us internal revues; brought us documents and people and information that is beyond our jurisdiction; brought evidence to us of violations in the securities industry that we wouldn't have known about had it not been for the individual or the firm telling us. That's rare, and we don't seek it out, but if a firm wants that kind of sanction mitigation then that's what some of the firms are willing to do.

Back to Bob. He was successful in getting some of the documents, limited in scope and breadth, and a few months later he receives another call from Klark Kent concerning scheduling on-the-record testimony for several of the employees of the firm. Where is the testimony held? Basically, most places that the defense attorney asks for. Our offices at the NYSE are in New York, but we'll fly out and take testimony wherever it makes the most sense.

Well, prior to the testimony, while Bob is talking with the employees, he learns from Carl Conniver that he's under investigation by the local prosecutor's office for activity that he conducted while he was at Bilkum & Stealum Brokers. Conniver wants to take the Fifth Amendment during testimony for the Exchange. Can he do that? Absolutely not. It's well-settled law that anybody that is called to testify before the NYSE over whom we have jurisdiction is required to do so. We understand that it is a tough decision for Carl Conniver to testify before the NYSE when he's under criminal investigation, and we also understand that at that point in his life we are probably the least of his worries, but he still has to make a decision and make a choice. He can take the Fifth and not testify for us, and then he will be prosecuted by us for failure to cooperate, or he could testify. Obviously, it is an individual decision that Carl Conniver has to make with Bob Barr. But it is important to understand that if he fails to cooperate with us, we will absolutely bring a case for failure to cooperate and the sanction will be either a permanent bar from the securities industry or a bar after a three month time period.
Well, all testify, as you can guess, all except Carl Conniver, and Bob gets a call soon thereafter from Klark explaining that the Exchange has completed this investigation and is now authorized to bring charges against the firm and several of its brokers. What is Bob to do?

Here, I'd like to refer to the "Factors Memo."[4] This is what Bob should look at before he talks to the NYSE. This is another memo that we just recently issued a couple of weeks ago, and it lays out for the industry the factors that we take into consideration in recommending the sanction in the case. Our goal is to make the process more transparent. Thank you very much.

Hugh Makens[5]:
Susan, let's tee up a couple of the more interesting questions. Obviously one of the more sensitive areas is that of attorney-client privilege waiver, and there's a great deal of controversy going on at this time over regulatory requests for attorney-client privilege waiver. The American Bar Association has a task force that is studying and sort of has a preliminary graphed out that's extremely negative on the position taken in the Thompson Memo,[6] which is the U.S. Justice Department memo laying out the terms and conditions under which they will consider prosecution and the effect of cooperation on that prosecution. The sentencing commission is now going back and revisiting the credit they had been giving for attorney-client privilege waiver and considering whether that is appropriate. The SEC supposedly is taking a greater look at the issue and yet recently we've had both NASD and the NYSE come out and join the party late, saying "give us attorney-client privilege waivers." Recently, NYSE seemed to soften the language that we see in the release by suggesting that what the NYSE is really interested in is the facts, not the waiver, and that there are ways to get at the information without waiver. Your observations, please.

Susan Light: You just provided the answer as well. We really are interested in the information, in getting the facts. As I said in the beginning, our investigation is really at getting the facts in the most efficient ways possible, and we don't require any waiver of the attorney-client privilege; we honor that privilege, it's certainly important. And if a brokerage firm chooses to rely on that and not tell us the substance of what we need to know, then we'll conduct our investigation and come to our conclusions the best way we can. Other firms would give us the information that's needed without waiving the client privilege; there are lots of ways to do that. And then others choose to go, as I said, above and beyond that, and give us whatever notes or information, and completely waive privilege. We care about getting the facts, that's what we care about.

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[4] The factors memo is Information Memo No. 05-77 (October 7, 2005). It is available online at: http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E8852570920068314A/$FILE/Microsoft%20Word%20-%20Document%20in%2005-77.pdf

[5] Mr. Hugh Makens, of Warner Norcross & Judd, LLP, has been involved in the securities industry for over thirty-five years as an attorney, regulator and advisor. For the past twenty-four years, he has represented broker-dealers, investment advisors, issuers, regulatory authorities and industry professionals in conjunction with compliance with securities regulatory requirements, investigations and regulatory proceedings. He is chair of the firm's Broker-Dealer/Investment Advisers Practice Group. Mr. Makens is also an adjunct professor at the Michigan State University College of Law, teaching in the area of securities law. He is a graduate of Northwestern University School of Law and also Michigan Technological University.

[6] U.S. Department of Justice, Office of the Deputy Attorney General, Memorandum, Jan. 20, 2003, *available at* http://www.usdoj.gov/dag/cftf/business_organizations.pdf. (*last accessed* Feb. 7, 2006).

Hugh Makens: Obviously if you've got something that can turn into civil litigation you're less likely to waive your privilege. Cases over the last three or four years have been very negative on your ability to retain the privilege once you've turned over your documents to the SEC or to an agency that's empowered under the '34 Act. What do you do with the request for confidentiality? What happens when you get a confidentiality waiver demand or a subpoena that says, "Produce this information?" How does that process work?

Susan Light: We don't have subpoena power.

Hugh Makens: I was thinking if you, the NYSE, got a subpoena from an outside counsel.

Susan Light: We would fight that in court. We do that routinely. I have daily calls with the Office of the General Counsel when fighting those. We get less of those today than we used to in the past and I think that's because the parties know that they're not successful in getting the information from us. The only cases that I have seen that would be required by the courts to give over documents are when the cases are long closed.

Hugh Makens: Dennis and I are now going to talk about what attorneys do who are faced with this, and we hope that you will jump in with both feet as we go through the different stages of how you get involved in an investigation.

Let me talk generally about the scope of the investigation. When I look at something from the NYSE, the NASD, or the SEC, I look at the following stages. First is the engagement stage. What do I do in terms of who am I going to represent? What's the scope of the representation? I then go to my investigative stage as opposed to their investigative stage, and that is trying to understand specifically what happened and the issue is how much must you do and how do you get your hands around the case? The third is to identify documents and prepare for what I call "OTR", or on-the-record testimony. Then you have the issue of cooperation with regulators, and you really don't have a lot of choice about cooperation with regulators because when you get up tomorrow morning, the NYSE is going to be there at the end of your case and they're going to be right back in your office to do another inspection, and if they're mad at you, that's going to have some consequences, too. So you have to figure out "How do I best do this in such a way that I can arrive at an orderly resolution?" You're potentially also looking at the issue of parallel investigations, and that can be, on one hand, a criminal investigation offset by a NYSE investigation. On the other hand, it may be a variety of regulatory agencies all proceeding at the same time. As Susan just mentioned, you were working with the New York Attorney General, the Massachusetts Securities Office, and with the SEC all at the same time. And when you've got a multiple investigation or examination going on, you've got a whole new set of strategies that you need to bring to bear to try and consolidate and manage document flow and information, and not create great disruption in the firm – and believe me, it's very, very easy for that great disruption to occur to the point that it almost paralyzes a firm if you don't organize for the large investigation.

Susan Light: And that is something that I hope that all regulators are getting better at, which is coordinating and cooperating with one another in these investigations.

Hugh Makens: We had a case very recently where the NYSE and the NASD both descended on a client within a couple of months of each other, and we called and the Exchange just said, "Here, NASD, take this case. We both don't need to be here."

Susan Light: Right, we do that more and more. There was a case I mentioned where we have done a sweep and are bringing a case against twenty-five firms that you'll see public soon, and we called the other regulators and said "We're doing this. If you've got an open investigation into any one of them, come and join us right now. Otherwise we expect that you wouldn't bring a similar case the next day." And every one of them said yes.

Dennis Egan[7]:
For instance, one thing a firm wants if it has a problem and doesn't want to have to deal with it five separate times, it's one thing to deal with an issue, but then say a politician interested in running for governor of New York, whose name I won't mention, starts an investigation, how does it happen that there is coordination? In other words, is it that somebody calls somebody else, or somebody on the defense side says, "Wait a minute, Susan. The SEC's already called us." What's the best way to get the cooperation so you can deal with it in an orderly fashion?

Susan Light: It happens either of those ways. We start an investigation and we find out either right away that somebody was already there, or we're in it and we find out that somebody else, another regulator, has started an investigation afterwards. Then we'll pick up the phone and call the other regulator. If it's an important enough case, then we'll work at them together. If it's not the kind of case that needs both regulators, then one will bow out. We also learn about it, as you said, from the brokerage firm, who will tell us, "We got your letter yesterday but two months ago we got a letter from the NASD."

Hugh Makens: I'm seeing more instances of concurrent interviews – that is, both parties present; concurrent on-site inspections; sharing of documents where, if you provide them to one party, they will provide them to the other party rather than you having to do both the maintenance and the central data bank. These are obviously on larger cases. In one of the market timing cases I was involved in, I saw that level of cooperation.

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[7] Mr. Dennis Egan, of Butzel Long in Bloomfield Hills, Michigan, practices in the area of commercial litigation and arbitration, with particular emphasis in the area of representation of securities and commodity broker-dealers in a variety of matters, including customer-related litigation and SEC, self-regulatory organization and state enforcement investigations and proceedings, employee "raiding"/trade secret cases, and employment litigation. Mr. Egan is a member of the State Bar of Michigan - Litigation Section, the American Bar Association - Broker-Dealer Litigation Subcommittee, and the Federal Regulation of Securities Committee - Litigation Section, having contributed to that subcommittee's Annual Review of Securities Litigation published by the ABA and circulated at the annual Securities Industry Association Legal & Compliance Seminar. He is a graduate of the University of Michigan Law School (J.D., with honors, 1978) and Northern Michigan University (B.S., *summa cum laude*, 1975).

Susan Light: Right, and it is, in a way, expedited, so that, in one particular case, we took half the testimony, the SEC took the other half of the testimony, and the NASD did the financial analysis, so it benefited everybody.

Dennis Egan: Another question. You had mentioned the first step is the engagement stage. I think one of the toughest issues you have is, "Who's your client if you're Mr. Bar?" Now, if you get a call from the broker and he says, "I'm under investigation from my firm. The NYSE is investigating me, I need a lawyer," I think it's pretty easy: you're representing the broker. And you'll typically find out that somebody else is representing the firm. The more difficult one is, one of your corporate broker-dealer clients calls, says, "We have an investigation that's been started by the NYSE. We want to hire you," and now who are you representing, and can you represent both the broker and the firm, and how do you go about finessing that? I guess the starting point is that you're representing the firm. Then there's the second question: can you represent the broker? What I have always done is, first of all, try to get an idea from the firm: do we really have a problem here? Is this, for example, a judgment call? We've got a couple of customers who have filed suitability claims, but everything was on the approved list. The documentation looks to be in order, but the customers have written a couple of letters and the Exchange is looking at it. That's a different situation than the hypothetical, where it sounds from the facts given that there's a couple of *per se* violations of various securities laws – trading ahead of customers, etc. – that really isn't a judgment call. When you're interviewing people with the organization, I think you first of all have to make it very clear at the start of every interview that "I'm the lawyer for the firm, and anybody who wants to have a lawyer for himself or herself can have one." And you really need to have *carte blanche* from the firm management to not only have the interviews but be able to have them one on one with the employees. In other words, if you're going in to talk to brokers, you don't want the branch manager sitting in there because that's going to affect what they're going to say. After you do your investigation of the facts for the firm, then you can make a decision on whether or not you can or want to represent the broker or the other employee, whoever's involved. In any event, you always advise that person that he or she needs to think about whether they want his or her own counsel. But if you are going to represent that person, you need to get a letter, signed by the employee, disclosing, among other things, that he has the option of having his own lawyer on his own nickel; the firm has authorized you to represent him in connection with this proceeding; based on your interview, you don't see any conflict of interest, but, if one arises, you will withdraw from representation; and, most importantly, anything he tells you, you will share with firm management. If you end up in a situation where you haven't covered the bases on this, and you've got this dual representation, and suddenly the employee sits down with you in your office and says, "Yeah, I did it, but don't tell my boss," you now have a really irreconcilable conflict of interest because you have information adverse to the interest of another client, but you do not have permission of the first client to disclose it to your other client. So I'd like to at least hear Hugh's comments on the best way to handle these touchy legal, ethical issues in an investigation.

Hugh Makens: What I look for in the first instance is "fingers." If there is any possibility, *any* possibility, that there's going to be a finger-pointing to the rep or a finger-pointing to the firm in terms of assessing blame, then I would prefer to have another counsel. If, on the other hand, the firm takes the position that "We understand what the rep did, we want to keep the rep, we'll deal with the rep in terms of special supervision, in terms of whatever else we need to do, but we want to keep the rep," then, under those circumstances, you may very well retain representation of both sides. Your engagement letter is so crucial. In fact, we do two letters: we do an engagement letter and a conflict letter that specifically addresses the conflict, and we have both the firm and the rep sign off on it, and the content is dead-on – an extremely important way to go.

One of the other issues that arises here is the role of in-house counsel. If the client has in-house counsel, it's very, very important to coordinate it early on and strategically decide what role is in-house counsel going to play during these interviews. Do they want to be present? Do they not want to be present because they are afraid it would discourage candor? And I've had counsel go both ways on that approach. Do they want to do the questioning? Do they want you to take the lead in carrying the questioning? Do they want to do informal sessions before you go into the more formal session? And one very basic rule of thumb is that you always have two people at least in the room, one of whom is taking very careful notes. You never go in by yourself and do a single-person interview.

One other issue, I think, that comes up a lot in investigations, too, is "What do you want to do before the investigation by the regulators gets going?" You have found something wrong. You conclude it's wrong. There's a school of thought among lawyers not in this industry that you don't give up the bargaining chip until you get something back for it. I think, in this business, if in fact there's something wrong, you fix it right away before the regulators hear about it or knock on the door. And ideally you fix it and then go to them and say, "We had a problem here. We have fixed it." I had a situation where a representative had a large, large number of complaints. I represented him, not the firm, and that was understood. But one of the things that happened at the very end of it was that he had been fined by the firm, put on special supervision, and in the intervening time had no problems at all. He got very thorough audits. We had given those audits to the enforcement division, basically took the position that most of the complaints were not valid, that they were cookie-cutters, because there'd been some newspaper articles, and then made the point that he had "got religion" and, more importantly, the firm had been very aggressive in finding him and sending him a message. The Exchange accepted that as a satisfactory result, but I don't think we would have had that result had the firm not already disciplined him and been able to say, "Look, we dealt with it."

I think one of the interesting things is in developing your strategy on a case. Susan, please comment on this. My preference is that when I find something bad that's occurred to someone in the firm, I advise the firm itself to take aggressive action – that may be a fine, that may be a suspension, that may be retaking the exam. How do you respond to that kind of action by the firm?

Susan Light: That's very important. Now, it depends on the level of seriousness. I'd say on a low-level violation, the firm might fine or suspend an individual, and we'll take that as the complete discipline – we won't feel we need to go there as well. But if you've got something that's very, very serious, then we take it into consideration. We got authorized on action on two cases this week: one where the firm fined the individual $65,000, and another where a different firm fined the individual $50,000, but the action was so serious that we took it into consideration when recommending our sanction, but we still brought disciplinary action. So it's very important that the firm note it, take action, and tell us about it.

Joe Spiegel: One of the other things you need to work out early on is the role of management, particularly if someone in management has been involved in what's perceived to be the wrongdoing. It is much better if that individual or those individuals can be isolated in the investigation, instructed not to talk to each other – and you can suppress any of the in-house gossip as well – so what you get is just the actual recollection of the events rather than a whole mess of stories that get jumbled together. And we try to enforce that as we move into this kind of a situation. It's generally standard practice now for both the NYSE and the NASD to permit Wells submissions. For those of you who are not familiar with Wells submissions, we're referring to a concept that arose from a study group the SEC put together, I want to say thirty years ago. The purpose of the Committee was to analyze the SEC's enforcement methods and come up with a series of recommendations on how they might be improved. One of the recommendations was before a respondent got charged – other than in extraordinary cases, where there was some sense of urgency to prevent continued wrongdoing – the respondent should be afforded the opportunity to provide his or her statement, view, summary of the law, and whatever else he or she might wish, in the context of a Wells submission. This was formalized at the SEC level, and it's migrated now, down to not only the Exchange and the NASD, but most of the states as well. Now, obviously, the Wells submission is something that can be fairly damning if it's used against you; on the other hand, it can be a valuable tool for trying to set the grounds for a settlement and move to resolution without going through a hearing. It's a two-way street.

Given this, how relevant are Wells submissions in light of the cooperation efforts that have been pushed over the last two or three years. In other words, does a practitioner have to make a decision whether he is going to cooperate? Is that cooperation going to be in the form of a Wells submission, or does that make the Wells submission less relevant given the guidelines and the mitigation for cooperation?

Hugh Makens: Generally my experience is that if you are in cooperation mode, the Wells submission is nice for tying together information or making some points of law – if you have points of law to make – but it becomes far less relevant if you have been actively cooperating in the case, because most of that information is out there. I'll tell you what I do. One of the principle benefits of the Wells submission is an opportunity to wrap up and summarize the case so that when the staff takes the case up for senior approval, you've helped sell the staff's recommendation on your settlement with the way that your Wells submission is used, which is a different spin that what historically has happened.

Joe Spiegel: The other question, Susan, is sanctions guidelines. The NASD is moving towards a very public sanctions guideline format. What is the NYSE's sanctions guideline that is available to the practitioner so that he or she can make a determination as to whether or not the recommended sanction is reasonable or unreasonable, or where to start with negotiations?

Susan Light: Where we are on sanction guidelines is sort of a "stay tuned for the future" position. I myself use them, but we've got a couple of new people in management that don't, so we'll have to wait and see. The cooperation memo and the factors taken into consideration on sanctions are really our attempt at making our procedures more transparent to the industry. So I would say that the best thing you have is the new memo for factors we take into consideration and our precedents, and those are the two areas that we in the Enforcement Division look at in determining what we think the sanctions should be. The trouble with the sanction guidelines are that if you take any area – let's take suitability, that's an excellent example – we can come up with a hypothetical. That way you've got a poor woman, in her eighties, living in a trailer park, that gave the broker all the money that she's got left in the world, and he did terrible things to it. Well, that is about the worst case you can get. That should have years' worth of a sanction. And then you've got a very wealthy person who says, "Take my fifty thousand dollars," – this person is a multimillionaire – "and I want you to invest it in x." Then the broker does not invest it in x, he does negative x. That's a suitability case: he violated the suitability, that's not what that customer wanted. It wasn't suitable for that customer, for that group of funds. But it's a smaller case, it's not as egregious, and yet we've got a sanction guideline that would read "Suitability: x amount of money and x amount of customers." So that's why we think that the cooperation/factors memo would take into consideration the two different hypotheticals, and the precedence would show you that we've got both kinds of cases on our books: one gets a long time, and one gets a short time.

Dennis Egan: It's the same debate that has gone on for years with the federal and state sentencing guidelines. Are we better letting judges look at individual cases in fashioning a sentence or are we better off trying to formulize it and invariably end up with inequities within that formula, because not everything can be taken into account that a judge would take into account? I have mixed feelings. The NASD sanction guidelines are helpful simply because as a practitioner I at least can say, "Look at page 53. This is probably what we're looking at if things don't go well." And secondly, in the sanction guidelines, the NASD tells you, sort of, what they're looking at, so when you're doing your Wells submission, you have a laundry list of the points you want to end up covering because they told you, "Here are the things we're going to look at." By the same token, Susan just laid out the factors that the NYSE looks at. Number one, she showed us at least what she sees the list to be, and secondly, they're pretty basic concepts anyway. Are you cooperating? What kind of action have you taken? What's the compliance history? And so on. So I have mixed feelings: there are times you like them and there are times you don't.

Hugh Makens: And the other problem that you run into with sanction guidelines when you're representing a firm is that invariably you're going to end up with a whole series of different elements in your investigation, and how do you combine them and put them together? And you haven't got a clue and neither does the NASD. It's going to be played out on an *ad hoc* basis. It's going to work its way out based on your negotiations. Dennis, what about joint defense agreements? When do you use those between the rep and the firm, and when do you stay away from them?

Dennis Egan: If I'm comfortable with the counsel, and generally comfortable with the broker – but I think a lot of it has to do with being comfortable with the counsel – I like to have joint defense agreements. I think they do a better job of representing my client, the corporation – or my client, the broker, if I'm on the other side – by having a better idea of what the other part of the defense is doing. I think most of the time I like to have them.

One of the other things that you worry about at the start of the case is trying to negotiate or determine what is the scope of what you can do as counsel. Are there going to be any limitations on what you can do? What kind of budgets are you working on? Is it possible for you to do your job within the context of what the expectations are from the company? The other thing to bear in mind when you're dealing with an investigation is that you never get it right first. Invariably, there's more. I never know what more is, but there's always more, and it keeps surprising you, and therefore you have to continually be watching what else is there. You don't accept: you ask questions, you verify, you test, you look for conflicting testimony between parties, you look for things that don't make sense, and those are the ways that you work your way through and say, "Ah, yes. I finally understand what this case is about." When you've got it all down and it's just right, something else happens.

PANEL TWO: NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD) ENFORCEMENT ISSUES

Joe Spiegel:
This is a good segue into the next topic. I think we have to keep in mind that the NASD[8] has two thousand people working for them, and therefore it has, with all due respect, become the two thousand pound gorilla. The NYSE, on the other hand, has seven hundred employees, yet it regulates essentially those firms that deal with ninety million individual shareholders. NASD enforcement has become an extremely hot topic over the last two to three years. We have the honor of having Roger Sherman, Senior Vice President of Enforcement at the NASD, Merri Jo Gillette, Regional Director of the SEC, and they are going to be led by Gary Saretsky, who is going to help moderate this section. I would suggest that we all listen very carefully to this particular section, as a NYSE, NASD, or SEC investigation can cost a firm, at a minimum, $50,000 to $100,000 in legal fees, and upwards to $250,000 to $300,000, depending upon how serious it is. These are all factors that have to be taken into consideration, so Roger and Merri Jo and Gary, I'm going to turn it over to you.

Gary Saretsky[9]: Good morning everyone. I'm Gary Saretsky. I'm with the Bloomfield Hills, Michigan, law firm of Hertz, Schram, and Saretsky. Our practice concentrates in the area of representation of the securities industry, representing broker-dealers, registered representatives, compliance personnel, financial planners, investment advisors, and the like.

I have the privilege of sitting on the panel with two of the country's preeminent experts in the area of securities law and enforcement. Roger Sherman comes to us today from the NASD in Washington. Roger is the Senior Vice President of the NASD and focuses in the Enforcement Division. Roger is going to speak today discussing the NASD's scope, what its functions are in terms of enforcement activities, and he is going to talk about some of the NASD's priorities in its Enforcement Division and talk about some of the sanctions that the industry has recently faced and may face in the future. Merri Jo is the regional director of the SEC, from Chicago, and Merri Jo, even though this is an NASD enforcement panel, is going to talk about some of the similarities and differences, and areas of overlap, between the NASD and the SEC. And our intent is to provide an

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[8] The website for the NASD is http://www.nasd.com.

[9] Mr. Gary M. Saretsky is a partner of Hertz, Schram & Saretsky PC and has been practicing law for more than twenty years. His practice is litigation oriented, concentrating in the areas of securities, commercial and employment litigation. Mr. Saretsky has handled approximately 1,000 securities, commercial and employment lawsuits and arbitrations. This experience has provided him with a command of the governing statutes, rules, regulations, the common law and legal precedent. His litigation skills are acknowledged and appreciated by clients (who have asked him to arbitrate cases in thirty-six states), and attorneys, CPAs, broker-dealers, investments advisors, financial planners and arbitrators, before whom Mr. Saretsky frequently lectures. He believes that arbitration and mediation are effective tools in helping clients to achieve expeditious and economical dispute resolution, and he frequently represents clients before the National Association of Securities Dealers, the NYSE, and the American Arbitration Association. He is also certified and sits as an arbitrator and mediator for these arbitration fora as well. Mr. Saretsky is a graduate of Wayne State University School of Law and the University of Michigan.

interactive discussion, if you will, between us as colleagues and with you as members of the audience. So with that introduction, I'm going to turn things over to Roger.

Roger Sherman[10]:
Thanks Gary, it's a pleasure to be here today. What I'm going to try to do, hopefully with help from my colleagues and Merri Jo and Gary, is to talk to you a little bit about the NASD. I don't know the level of familiarity that you all have with it, but I want to talk a little bit in the beginning about NASD, who we are, our enforcement process, interacting with opposing counsel, what to do if you are representing someone under investigation, issues of coordination with other regulators and the SEC, and then, time permitting, I'd like to talk a little bit about some of our substantive priorities as a self-regulatory organization.

We do have about two thousand employees nationwide. They are located in Washington, where I'm located, in Rockville, Maryland, and in fifteen district offices around the country in mostly major cities, such as Chicago. We handle a large number of customer complaints because customers not only file arbitrations but they make customer complaints to us. Last year, for example, we had 4,600 customer complaints, and we have to review each and every one of them. Now, what's interesting in the customer complaint area is that it used to be that wherever the broker was located, that would be the office that looked at those customer complaints. We thought that was not a very efficient way of handling customer complaints, nor would it likely yield meaningful results because no one was there putting the whole picture together. So we moved to a new model, and in our new model we have an intake unit in Washington that initially looks at and catalogs all customer complaints. They may decide to do nothing with it if it just raises operational issues. They may see it as kind of a one-off situation, or they may see a pattern of customer complaints involving a branch, involving a firm, or involving a product. When they see that, we, as an organization, are able to deal with that in a much more meaningful fashion today than we were five years ago. So that's a rather significant change that we've had in dealing with customer complaints.

In terms of disciplinary actions, last year we brought about 1,400 disciplinary actions. Those ranged from very minor ones, all the way to significant ones. We collected over $100 million in fines, so some of the actions that we bring against firms and against individuals can result in very meaningful sanctions.

Our disciplinary actions, broadly speaking, arise in a number of different ways. Every time a broker leaves a firm, a U5 (Uniform Termination Notice for Securities Industry Registration form) is completed. If a broker is terminated for cause, brokerage firms have to indicate that on the U5. That will prompt an investigation. It will be investigated either

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[10] Mr. Roger B. Sherman is Senior Vice President of the Enforcement Department for NASD Regulation, Inc. He joined NASD Regulation in 1986 as a staff attorney and thereafter held positions of increasing responsibility, including Chief Counsel and Director of Enforcement, before assuming the position of Vice President in January of 1997 and Senior VP this year. Mr. Sherman is a Magna Cum Laude graduate of Syracuse University College of Law and holds a Bachelors degree, Phi Beta Kappa, from Colby College (ME).

by the NASD, if it's an NASD firm – and of course every brokerage firm in the United States that does business with the public has to be a member of the NASD. Some of those firms are also members of the NYSE, so some of the terminations for cause will be reviewed by the NYSE. There is really an agreement on an individual basis between the NYSE and the NASD as to who is going to conduct the specific inquiry. Normally, one of the SROs will defer to the other in the review of that termination for cause. So terminations for cause are probably the single most important source of our disciplinary actions. Customer complaints are another source.

Our district offices are a third source of actions and our district offices go out and examine firms. We examine all NASD firms according to their perceived or our perceived view of the risk that those firms have to the investing public. And they are tiered. A level one firm, which poses the highest degree of risk – and it can pose the highest degree of risk either because it's involved in some suspect sales practice issues or because they actually hold customer funds and thereby necessarily have a higher degree of risk –would be examined every year, and other firms would be examined on a lesser basis. Examiners would go into a firm and they would undertake an examination. Those examinations can result in a range of different outcomes. Sometimes, and in most instances, there would be an informal sit-down following the conclusion of the exam, and there might be absolutely nothing done or a modest reminder to the firm. We call those letters of caution. The firm would receive a letter of caution indicating that the examiners have gone in and they are cautioning the firm about certain aspects of their business that they should improve. Firms would write back and they would say that they have taken into account what the NASD has done and they have made the following improvements in those areas. Those are not part of NASD's formal disciplinary program; that is a certain part of the diversionary program that we have. But, should the examiners go back into the following firm the following year, and the next exam they see the same problem, it's very likely that that's going to be ratcheted up and there will not be another letter of caution. Slightly more serious outcomes can also occur. There can be compliance conferences. In a compliance conference, NASD has taken the view that they really need to have a more serious sit-down talk with management of the firm, and management would be invited to come into our district office and there would be a formal discussion of the more serious matters that have been uncovered during the examination but, again, at a level below that of formal disciplinary action.

Finally, there will be a certain number of these exams that will result in disciplinary action, because of the nature of the problems – serious sales practice problems, significant operational issues, issues that are of importance to the investing public or NASD. These would be examined and referred over to our enforcement area, and each of our district offices has attorneys in them. Depending on the size of the office, they may have a large number of attorneys or, in some cases, as few as one or two attorneys. They would go about taking statements from customers. They would go about interviewing the potential subject of the matter, and typically today, before we are going to charge an individual, we would take that individual's testimony on the record. Now, we don't do that necessarily if we're just going to bring an action against the firm. But if we're going to focus on an individual, we are going to want to know that person's story. Historically, that was not always the case. Historically, we were able to years ago have a kind of letter writing campaign back and forth and try to get the story from the particular broker, and for those of you who've been in practice a while you may remember those letters. The problem with those letters is that you're never really able to cover the full waterfront of issues, and you think you know the story but you've never met the person, and so, lo and behold, you bring charges against them, and what comes out at a hearing is far different than what was stated back and forth in the letters, either because you didn't ask the right questions, or because you didn't pin down the individual, and now at a hearing there's a whole different story that you hear for the first time.

Given the significance of the sanctions that NASD has available to it, and given the fact that sanctions against an individual carry a significant blemish on that individual's record, we think it's very important to discuss with individuals in a formalized setting those proposed charges and issues that are under investigation and so we normally do. It doesn't mean that if your client is asked to come in for an on-the-record interview that he or she is necessarily going to be named in an action. We probably talk to ten individuals on the record for every single person that actually ends up getting named. Particularly where you're dealing with medium and large-size firms, there is a process through which we try to gather evidence, and normally that evidence-gathering is done in the formalized setting of an on-the-record interview. So you should not be overly concerned if a client of yours is asked to come in for a deposition, but on the other hand it is a matter to be taken seriously.

At the conclusion of an investigation, the staff will pull the evidence together and they will come up with their idea of potential violations. You may receive a call at that time or, if the individual is unrepresented, the individual will receive a call, and will be told that the staff is investigating the matter and has determined that it is likely that charges will result. At that time, you or your client will have an opportunity to submit a Wells submission, which we talked about that in the last session. We routinely grant to firms and individuals the opportunity to submit a Wells. I think they're very useful in a number of areas. Whether you want to settle or not, you are often able to advance your case through submitting a Wells. In many cases where the issues are murky, you are able to really bring to management's attention issues with a different perspective than the staff who investigated the case will have. We read those Wells. There is a page limit, because we can get overwhelmed, and that page limit is normally thirty-five pages, and, trust me, you should be able to state your case in thirty-five pages. But we do read them, and, as a manager, I'm not involved in taking testimony, I'm not involved in reviewing the evidence, and we think it's very important to hear from firms, to hear from the people representing the individuals, their view on the particular facts. I think the Wells submission sometimes—not always, probably not even usually—convinces us not to bring a case, and where that is likely to happen is where you are dealing with policy issues. If there is a policy issue, that is a type of case that is particularly ripe for a Wells submission. If there is just a swearing match between your client, on the one hand, and other individuals, on the other hand, that type of swearing match is not likely to be resolved through a Wells submission. On the other hand, even in that type of situation, I think it's important if you have mitigating facts to bring those out through the Wells because it serves the process of "softening up the beaches."

As a self-regulatory organization (SRO), we have limited resources, and we like to settle cases; we would like to settle all of our cases. That's not possible, but I would say we probably settle 80% of the cases that we bring, probably close to 90% before a hearing itself. We will give a settlement discount simply to save staff resources and to be able to move on to other pressing matters. So there is an opportunity for you to settle cases, particularly before they are filed. We are much less likely to give a lot of discount once the case gets filed, particularly once we have to prepare for hearing, just as I'm sure, in civil litigation, once you have gone through all the work, you've spent the time, your clients have spent the money preparing for a hearing, you've done 90% of the work, and there really is not much extra effort in trying a case—although, of course, the outcome is uncertain. From a practitioner's standpoint, what I would strongly encourage you to do is to attempt to settle your cases before they're ever filed. We have a whole process for that, and that is called an AWC: acceptance, waiver, and consent. What would happen there is you get the phone call, you decide to submit a Wells, or go directly into settlement discussions. Out of all that, a settlement document would occur; that settlement document is known as an AWC. The sanctions that are put forth by the staff largely stem from the sanction guidelines, which we talked a little bit about in the last period. If you go onto our website, you will find our sanction guidelines, and I actually think that they are very helpful.[11] The range for particular violations may be large, like $5000 to $100,000, so it's not like federal sentencing guidelines in that regard. They do give a broad range, but even more importantly, for each of the substantive violations, they talk about the principle considerations to take into account when assessing sanctions, and they are different for different violations. It's very useful, either in terms of the Wells or in terms of your settlement discussion, to organize that around those principle considerations because that's what's going to be guiding the staff, and if you go to hearing, that's what is going to be guiding our hearing panels in imposing sanctions. So that's a very useful exercise for you and your clients to go through. Once you have reached a settlement with the staff, that's not the end of the story, because the enforcement department does not have authority on its own to resolve matters. We can recommend the acceptance of the settlement – of course we would if we got together and agreed on the terms of an AWC – but that goes to a separate body within NASD known as the Office of Disciplinary Affairs, or ODA, and they are the ones that actually accept settlements. They look at a lot of different issues, they are more familiar with the finer points of all the settlements, and they are there to insure a level of consistency probably beyond that in the knowledge of any particular attorney that you might be dealing with. So that is how the process works. Gary, what has your experience been in the settlement process?

Gary Saretsky: Well, I find that the sanction guidelines are very helpful. Obviously, you heard expressed in the last session a different point of view as to the sanction guidelines from a practitioner's perspective. Knowing what a likely disposition is helps to advise a client as to how best to approach a matter. I'm just wondering: the NASD, Roger, is a

[11] The guidelines are available at:
http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_011038.pdf.

distinct type of organization – it's a self-regulatory organization as opposed to the SEC. What type of feedback has the NASD received from its sanction guidelines? Does the industry seem to like them? Are they useful guidance? Does it help to "grease the slide," so to speak, in reaching settlement?

Roger Sherman: Years ago, we did not have sanction guidelines. We were asked by our members to come up with sanction guidelines. I think it's very useful when you have a membership as diverse as ours – and we run all the way from firms with single persons all the way up to bulge bracket firms – and you have attorneys and people around the country trying to examine and investigate for various issues. It is a very good organizing principle. It's certainly nothing that we slavishly adhere to. The facts are always going to control. But at least as guidance, I think it's helpful. We have a group within NASD made up of members that are constantly looking at the guidelines, determining if they have remained meaningful, and coming up with new ones as we get into new areas of the law.

Gary Saretsky: Roger, you mentioned at the onset of your presentation that there were about 1,400 disciplinary actions initiated by the NASD, and the NASD collected $100 million in fines. How does that compare to, let's say, five years ago, ten years ago? What does that suggest to this group about not only the present but the future for us as either members of the securities industry or, on the other hand, as counsel representing claimants or representing the industry in arbitration or litigation proceedings?

Roger Sherman: I think the size of the fines is certainly dramatically higher than it used to be five or ten years ago. Understand, by the way, that these fines do not inure in any way to my benefit or to the organization's benefit. These are segregated, and a group within NASD decides how those are to be spent for purposes largely of investor protection, additional surveillance techniques, new technology, issues such as that. But they certainly are a reflection of the significance of some of our actions. We've been running about 1,400 actions now for several years, and that also represents a gradual increase in the number of actions. It was not so many years ago that we had maybe 900 or 1,000 actions. I think our statistics for this year are running roughly comparable to that. I think at the end of the year we will be somewhere where we are today. Understand that while it's a very large amount of money, and while we do suspend and bar about 825 people a year, that's a very small number of individuals compared to the 600,000 registered individuals. So this is a very good industry; by and large, it's a clean industry. But, one of the things that we're trying to do, and it was touched upon in the last panel, is we're trying more than ever – for purposes of saving our resources, if nothing else – to get meaningful credit for firms that self-report violations to us. We think that we have always taken that into account as an organization in imposing sanctions. In fact, if you go to our sanction guidelines, you will see that one of our sanction guidelines – our sort of overarching sanction guideline – is whether the member firm accepted responsibility for and acknowledged the misconduct to a regulator prior to detection and intervention by a regulator. So, it's always been there; it's always been taken into account.

Joe Spiegel: Roger, you may want to explain that there are two sets of guidelines: the overarching set and then the specific guidelines for particular infractions, if you will.

Roger Sherman: It's worth it to spend some time in our sanction guidelines if you're representing a client. There are, in the beginning, these overarching considerations, and these are applicable to any disciplinary action, and then there are more specific ones for each of our substantive violations.

Gary Saretsky: Roger, wouldn't you have to admit that self-reporting is a little bit of a counterintuitive concept? For example, if I'm going to drive back to my office after today's presentation, and I'm going to exceed the speed limit, it's almost like calling a cop along the road home saying, "Listen, I'm going 75 or 80 now. Hit me with a ticket so I only have to pay 50 bucks instead of 100."

Roger Sherman: That's true, and I guess in some sense it's a little bit of a crapshoot. Will we at the NASD find out that you were speeding? The issue is, with speeding, once you've sped, it's gone.

Gary Saretsky: It's the same with investing: once you invest, it's gone.

Roger Sherman: But there will be traces left, and those traces are large audit trails, and those audit trails have a way of not disappearing. I think there's a high degree of likelihood that we will either find it or, as sometimes happens, firms get ratted out by their competitors. That is another source of cases: pointing down the street, "You think I've got problems…"

Gary Saretsky: Roger, before we leave that topic, you say that the NASD is willing to credit self-reporting, but the bottom line in the real world where people have to operate is how much love will the NASD show someone who self-reports? Because, if the response is, "Thank you for reporting, we're going to put you at the lower end of the sanction guidelines," most practitioners, and I think most people in the industry, are going to say, "I might as well take my chances because I probably would have fallen somewhere within the guidelines anyway, and hopefully at the lower end, if I have a strong position to advance."

Roger Sherman: There are certainly cases that we have not brought at all, and of course those are the cases that you never hear about. But as a securities regulator – and I'm sure this is true for the SEC as well – we have a large amount of discretion in the cases that we choose to bring, whether we choose to bring a case, and the sanctions that we settle for. I can assure everyone in the audience that there are cases that we have not brought, cases that might even be close calls. But what put the case over the line and resulted in us not bringing the case was the fact that the firm engaged in a very rigorous self-review process, corrected the problem before we had ever found out about it, and it was not such an egregious situation that we felt that we had to bring a case. Obviously, just because you self-report does not mean we are not going to bring an action. The facts will dictate. Firms have supervisory responsibility to police each line of business that they are involved in, with a view to preventing violations. So, if a firm failed in its supervisory responsibilities, we're not going to simply drop it. But, there is a large amount of discretion, and I do think it's important in this environment, where reputation is so important, that firms try to squeeze out all of the reputational benefit they can from their unfortunate encounters with us or with some of the other self-regulatory or regulatory organizations, and I'll give you an example.

We have a program area involving directed brokerage payments, which are payments from mutual funds to retailers, and, in effect, they are payments made for enhanced visibility at retail firms; in effect, paying for shelf space. We brought twenty-eight actions so far in this area. One of the actions we brought was against Piper Jaffray. But in Piper's case, what they did before we really got involved in the investigation was to self-report these violations to us: they saw that we had taken action; they saw that it was an important area for the NASD; they did a self-assessment; they came in; they laid it all out before us. We looked at it, we said, "You're right, we have a problem, it shouldn't have happened." The sanctions that we imposed against Piper were significantly smaller than they would have been. In fact, we announced the case against Piper at the same time that we announced the case against another firm. The sanctions against Piper were less than half of those against the other firm that we were announcing at the same time. There was a statement by the President of NASD, Mary Schapiro, in that press release, acknowledging the importance of self-reporting to the overall process. I would think that this would be important to Piper and to other firms out there.

Similarly, we announced a case recently against Morgan Stanley. This was an issue where, after we started looking at it, Morgan Stanley separately started looking at the issue, and really did an excellent job of getting ahead of the curve and in really dealing with the issue in a very forthright manner; it really helped speed up the investigation that we were involved in. We acknowledged that, again, in announcing the action that we brought against Morgan Stanley. Merri Jo, how does the SEC deal with that?

Merri Jo Gillette[12]:
What the Commission does parallels a lot of what Roger has mentioned here. I guess I would make a couple points. First of all, if you go back historically to the framework that Congress envisioned when they thought about sort of a multi-tiered regulatory environment across the securities industry, it really envisioned not just relying on regulators and/or SROs to catch people when they had their pants down. It had intended and envisioned an environment where firms did self-report, where firms did come in and make regulators aware when necessary of others within the industry who were violating rules; it depended upon the SROs, on the state regulators, and I think, bringing it more into the current day, it also is depending to a great degree on what we at the SEC

[12] Ms. Merri Jo Gillette was appointed Regional Director of the U.S. Securities and Exchange Commission's Midwest Regional Office in Chicago, Illinois in June of 2004. Prior to her current appointment, she was the Associate District Administrator for Enforcement in the SEC's Philadelphia District Office, where she worked on litigation and enforcement matters for eighteen years. Ms. Gillette practiced labor law for four years before joining the SEC. She is a graduate of Northwestern University (1979) and received her J.D. from the Dickinson School of Law (1982).

traditionally call gatekeepers. All of you sitting in this room who represent broker-dealers may fall into that category. The concept that you know you've violated the law and should now come forward and do the stand-up thing and recognize that there may have been harm and that there may be a regulatory impact that occurred in the result that needed to occur, as far as I'm concerned, is consistent with the way the regulatory environment ought to work. Now, obviously when you're counseling an individual client and you're telling them to do something which sounds a whole lot to them like something that's against their self-interest, it becomes a much more difficult advocacy piece.

But I think again, to touch on something that Roger said, the reputations of the firms do carry weight with the regulators. Their willingness to accept responsibility for misconduct when they come upon it will be remembered by the regulators when there may be another problem down the road. And, perhaps equally important to some of you in this room, is the reputation of the attorneys that come before us and represent firms. I can tell you that there are practitioners who have established a very clear reputation that they will counsel clients to do things that are consistently what the regulatory community is looking for, and those practitioners are in very high demand, they earn a lot of money, and they carry a lot of credibility with the regulators. So, for all of those reasons, I think it really is in the interest of all of us to continue to urge this type of self-reporting and addressing the problem to the extent you can, once it comes to your client's attention, and urging your client to address the problem and not waiting for the regulators to swoop in and pounce.

Joe Spiegel: Let me raise an issue in light of what you just said, and it's a three-fold issue. One: letters, Roger, from the NASD regarding not taking action cannot be used in arbitration – when did that letter form change? And secondly, regarding settlements without admitting or denying: what impact does that have on customer complaints, and what availability do those customers have to your files after a settlement has been entered into? Would you address the balancing issue of a settlement which is good for the firm because of cooperation, and the inability or the ability of the customers to then take action to rectify economic loss they believe occurred as a result of the wrongdoing.

Roger Sherman: To answer your first question, several years ago we changed the form of our closeout letters. We would go in, we would do an investigation, and we would end up filing that without action. That was never intended to really be a finding that there were not violations. It was simply that in the limited amount of time that we had to look at it, we determined, in the exercise of our discretion, not to take any action. What was happening is that in arbitrations, those letters were being introduced by the brokers, by the firm, as evidence that there was not a violation, which was never our intent. We clarified that in a notice to members and in the format of the letter itself, which now indicates that they are not to be introduced in arbitrations. In fact, it is conduct inconsistent with our rules for a firm or for a broker to attempt to introduce that.

On the converse side: settlements. I am not an arbitration practitioner. I do not know whether the settlements without admitting or denying find their way into arbitrations. I would suspect that they often do. I am sure that, depending upon which side of the arbitration table you are sitting on, you are either going to try to make a lot of hay out of that settlement, or you who are representing the firm are going to point out that this was done for a lot of different reasons and was done without admitting or denying.

With respect to access to our files: this is easier to obtain once a matter is closed. For an ongoing matter, you're not really going to be able to get access to our files. But again, for those of you who are involved in arbitrations, normally brokers and firms will obtain copies of their on-the-record interviews. They don't have a right to them while the investigation is pending, but certainly at the close of the investigation, if we are going to recommend charges, we're going to release those depositions and you will be able to purchase them. And you can always examine the deposition in our offices. So, this is information that I assume claimants attorneys will ask for and will have access to through sending a subpoena to the firm or particular individuals.

Joe Spiegel: Susan in the first panel mentioned that the NYSE fights subpoenas. What is the NASD's position on getting a subpoena from either a respondent or a claimant in either an arbitration or a court case for your files? Do you fight those? Do you not fight those? Where do they go?

Roger Sherman: Those go to our general counsel's office. Again, it really depends on the status of the particular matter. Obviously, if we have an ongoing interest in the matter, we are not going to voluntarily release the records. Once a matter has been closed out, depending upon the nature of what is being sought, we will respond to some of those.

Gary Saretsky: Roger, in the time that we have left, which I think is just a few minutes, can you give us an overview of what the NASD's present concerns are, what its present focus is, what the hot buttons are for us as a group?

RS: Sure. One of our hot buttons, I think much to the consternation of some in the industry, deals with fee-based accounts. The history of fee-based accounts is that this is something that was actually encouraged by the Commission and by the NASD, and it really goes all the way back to 1995. There was a blue ribbon panel put together, called the Tully Committee, after Dan Tully, the former head of Merrill Lynch, and they put together a series of best practices for the industry in an attempt to eliminate conflicts of interest that exist or to manage those conflicts of interest. One of the best practices that the Tully Committee came out with was a recommendation that firms move away from commission-based business and move to a fee-based approach, where a customer is paying a fee and that fee is based upon the amount of assets that the customer has. If the customer is not paying for each individual transaction, obviously, when you do something like that, the issue of churning should theoretically disappear because the broker has no incentive to churn an account, so in that sense it's a best practice. And it really makes sense for a lot of customers: those customers who are trying to build their account; those customers who engage in at least a minimum amount of activity. Those customers are often better off in a fee-based account than in a normal commission-based account. We don't have any problem with that at the NASD and we think that's a great idea. However, we put out a notice to members in 2003, reminding our members that they still have to supervise the area and reminding our members that these accounts are not appropriate for all investors. We brought two actions in this area, and we think these are actions that are really not close to the line. We brought an action against Morgan Stanley and we brought an action against Raymond James.

Essentially what happened in the case of Morgan Stanley was that Morgan Stanley recognized that these fee-based accounts were not appropriate for everyone and they decided internally that you had to have $50,000 to open one of these accounts, and that's because they charged a minimum of $1,000 annually, regardless of the size of the account. It could be more, but it could never be less than $1,000. What our investigation disclosed is that there was sort of a gap in Morgan Stanley's supervisory system. There were many customers – well, not many compared to the total number (this is big business at some of our firms; for example, at Morgan Stanley there are 175,000 fee-based accounts that have some $30 billion in assets, so it's big business particularly at the wirehouses) – but there were customers there that had very small accounts. This was either because somehow they were able to open the account with less than $50,000, or (we're talking now about 2001, 2002, 2003 – the market was not good) their accounts fell to $25,000. So now you have a customer that's got $25,000 in an account that's being charged $1,000 annually, which is a hefty percentage. There were other customers that Morgan Stanley had that did no trading for a period of years. Now, in the fee-based area, we are not taking the approach that simply because the customer does no trading for a period of time that it's inappropriate. Depending upon market conditions, depending upon the customer, the best advice may be, "Don't do any trading." However, there comes a time, when the customer does no trading for a sufficiently long period of time, when you need to question whether the customer would be better off back in a traditional account. We identified a group of these accounts – and altogether the accounts I'm talking about are 3,000, which is not a large number of accounts – that did no trading for two years, and we felt that Morgan Stanley really did not have a supervisory system in place to evaluate customers who were doing no trading. So we brought that case. We brought another case against Raymond James. It's an area that we continue to be concerned about, and it's a new area, so that's one issue.

Merri Jo Gillette: Let me just jump in, Roger, and add to that. This is also an area that the SEC has been looking very carefully at from a slightly different perspective. Of course, one of the other aspects of these fee-based accounts is that they may qualify a firm for an exemption from registration under the '40 Act (which is the Investment Advisers Act) if in fact the account truly is simply providing services incidental to brokerage services and not providing actual investment advice. This past year, my office in Chicago did a mini-sweep of the nine largest broker-dealers in the country that were using fee-based accounts, and took a very careful look at the operational aspects of these accounts, contrasting those of discretionary accounts versus non-discretionary accounts. The findings from that have not been made public but have been reported back to the Commission for the purpose of taking sort of a second look at whether the current exemption from registration under the '40 Act should remain in effect or perhaps needs to be modified consistent with what's going on in the industry. So this whole area of activity surrounding fee-based accounts is something that I think the regulators are visiting from a number of different perspectives.

Roger Sherman: Bill, I believe you know more about this than I do, but I think that the NASD just adopted a rule saying that a broker can no longer have discretionary authority over customer accounts. Is that correct?

William Alsover[13]**:** That's right. That has to be advisory now.

Roger Sherman: And that is simply tying right in with what Merri Jo is saying because of the issues involved with who's an investment advisor and who's a broker-dealer. So that's something that we have recently done.

Gary Saretsky: Before you stop, can you just mention variable annuities and mutual funds? Can you quickly cover those?

Roger Sherman: We certainly do an awful lot with both variable annuities and mutual funds. Very briefly, with variable annuities, for those of you who are interested in the area, I would suggest that you go onto our website and look at our Notice to Members 99-35.[14] It's probably the most important notice that we ever put out in the area of variable annuities. It set out what was, at that time, best practices. We want to codify those best practices into a rule. And that rule is proposed Conduct Rule 2821.[15] It has generated a fair amount of controversy, on both sides I might add. It is pending at the Commission right now, but, in effect, that rule would codify Notice to Members 99-35. We really don't have enough time to go into the issue, but, at least from our view at NASD, we think that variable annuities are sufficiently complex, sufficiently expensive, and pay a sufficiently high commission to the brokers selling them, that they raise particular issues of suitability and of supervision. And so we have probably brought many, many more cases in the variable annuity area than any other regulator or self-regulator. That is something that is part of our examination process.

Joe Spiegel: Merri Jo, has the SEC come out with a position on the insurance industry's objections to the regulation of pure fixed annuities, or index annuities?

Merri Jo Gillette: I don't know the answer to that – I'm sorry. I know that it's an issue that they've been looking at. Whether they've come out with a formal position or not, I'm not aware. Maybe someone else in the room could verify it one way or another. I don't think so, to my knowledge, but I'm reluctant to say it definitively.

Roger Sherman: Just let me speak briefly to that. We came out very, very recently with a Notice to Members that has also generated a fair amount of controversy, and that deals

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[13] Mr. William C. Alsover, Jr., is Chairman of the NASD Small Firm Advisory Board.
[14] Available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004395.pdf.
[15] *See* Notice to Members 04-45, available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003009.pdf.

with equity-indexed annuities.[16] Equity-indexed annuities are technically fixed annuities although there is a real question out there whether these are securities, and I guess that issue has been pending at the SEC for a number of years. But we have concerns with our members who may be selling them. If firms treat this as an outside business activity, as they have been, they run some real risks if in fact they turn out to be securities, because then you have the situation of a private securities transaction, which is serious.

Merri Jo Gillette: I think actually, generally, the industry is looking at them as if they are not securities. You may hear a little bit about this later in one of the breakout sessions because we're seeing incredible activity in this area. We are seeing people who have previously been barred from the securities industry getting into sales of these things. They are so lucrative that we are seeing registered reps who intentionally allow their registration to lapse and completely move into the selling of these securities. It is an area of great concern. The issue of whether they in fact are or aren't securities is one that is still open, but I think most selling them are taking the position they are not securities and, therefore, that they do not have to be registered to sell them.

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[16] *See* Notice to Members 05-50, available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_014821.pdf.

PANEL THREE: SEC ENFORCEMENT ISSUES FOR 2005-06

Joe Spiegel: Our next session is SEC Enforcement Issues for 2005-2006. As you know, Merri Jo Gillette is director of the SEC. Ray Henney is going to moderate, and Tom Cox is going to sit in for Clarence Pozza today.

Raymond Henney[17]: Thank you, Joe. This topic has to do with recent trends in SEC enforcement. What we'd like to do is cover a number of topics, but we'd also like to have questions. It's not often that we have a chance to speak to a regulator in a less formal setting, if you will, so to the extent that there are questions, you should feel free to raise your hand and let's try to address them as we have them.

What we'd like to cover is an overview of what's going on with the SEC on the enforcement side about a recent 11th Circuit decision about injunctions that may have some significant impact with the Commission; recent trends in enforcement on a local level; two cases that are currently pending in the Eastern District of Michigan arising out of Kmart Corporation; cooperation issues; a recent rule by the SEC defining materiality which has been long in the process; and, finally, to the extent that we have time, a favorite topic: SEC actions against attorneys. Merri Jo, can we start with the overview please?

Merri Jo Gillette: Sure, but I'll start with just a couple points, and this will be very brief, that I wanted to make to the audience. First of all, you've heard now from regulators at the NYSE and the NASD, and to the extent that you wonder how we all fit together in the puzzle, I just want to be exclusive in saying that both the stock exchanges and the NASD have jurisdiction over their members and their member firms. They do not have jurisdiction to go after members of the public who are not subject to their direct membership rules. The SEC, of course, enforces the federal securities laws, and we then also have jurisdiction to go after pretty much anybody who is in the United States or doing business with or offering some securities to investors who are located here in the United States. Similarly, with regard to state regulators, they have their own laws that they impose – and the laws vary from state to state, so I can only be very general here – but depending on how their law is written, different parameters in terms of what their jurisdiction covers. Therefore, when you wonder "How does a case end up with the SEC versus the state of Michigan versus the NYSE?" sometimes we have concurrent jurisdiction. You've heard a little bit about that already and how we try to coordinate and/or defer to one another. But there are many situations where the facts in the case or the individuals involved may encounter a regulator who doesn't have jurisdiction to bring action against them and therefore then needs to refer them to another regulator. I think it would be safe to say that the SEC probably has the broadest jurisdiction to cover the

[17] Mr. Raymond W. Henney, of Honigman Miller Schwartz & Cohn LLP in Detroit, Michigan, practices in the areas of securities, arbitration, and securities and corporate litigation. He advises brokerage firms regarding supervision and compliance issues and is a member of the National Association of Securities Dealers, Inc., the ABA Securities Arbitration Subcommittee, the Securities Industry Association, the Oakland County Circuit Court Committee and the Oakland County Chapter of American Inn of Courts. Mr. Henney earned his undergraduate degree with honors from Michigan State University (1980) and his law degree cum laude from Wayne State University Law School (1983).

broadest range of conduct that is connected with the securities laws, although I don't want to overstate that because there are certainly things that we can't reach that other regulators do reach.

Regarding the agency, I just want to point out to all of you, and I'm sure many of you are already aware of this, that the agency itself is really in a tremendous transitional phase. We have a new Chairman, Christopher Cox, who was installed this summer. He has begun certainly to focus in on enforcement efforts and to begin to communicate his views to the staff, but he does not come from an SEC enforcement and regulatory background in his recent past, so he is proceeding what I would describe as somewhat cautiously in terms of not coming in and making any wide-sweeping changes on policy issues. In addition, we have a new Commissioner, Annette Nazareth, who was formerly the director of the Division of Market Regulation, and she too is just beginning to make her views known from her position as Commissioner. Because of these changes of two of the Commissioners, there has been a shift in the dynamic among the five commissioners, and I think it still remains to be seen how that will settle out. Right now I think we're in somewhat of a honeymoon period and everyone's being exceedingly polite to one another. But as we know from the past, that may not last. We have a relatively new Director of the Division of Enforcement, Linda Chatman Thomsen; she was previously the Deputy Director, so while many of us are relatively familiar with her thinking on many subjects, you should not assume that she will approach everything in exactly the same way as Stephen Cutler did. So that is sort of an area where we will see evolution, I believe.

We currently have no division director in the Divisions of Market Regulation, Investment Management, and the Office of the Chief Accountant. So these are all key positions that do affect Commission policy in a number of areas that are vacant at the moment. In addition, two of our field offices, the Fort Worth office and the Philadelphia office, are currently without office heads, and there will be selections being made to fill those positions in the upcoming months. So there are many, many things that are sort of in flux right now at the Commission.[18] That means that there are few concrete things I can tell you.

The strategic priorities that the Commission is still announcing in the enforcement area are to continue to look at fraudulent and abusive practices in the mutual fund area, egregious financial reporting situations, with particular emphasis on disclosure of executive compensation, foreign payments, and the ongoing theme of the role of gatekeepers. Because we have oversight authority over the self-regulatory organizations, that is continuing to be named as one of our strategic priorities. Specifically, we are looking at the adequacy of the market surveillance programs by the SROs, the appropriateness of member rules, and, of course, the enforcement of rules violations by those organizations. We continue to have sort of an old time bread and butter area of priority on insider trading. Frequently we are the best or the only regulator who can bring these charges against private citizens. I will tell you that one area in which we have been

[18] A current listing of those individuals serving in key positions at the SEC is available at: http://www.sec.gov/about/concise.shtml.

seeing many new investigations opened relates to drug company and biotech stocks. We have seen a number of situations where at first pass it appears that doctors involved in some of the research testing may be passing confidential information along to analysts and to hedge funds that are trading them in advance of the public disclosure of that information. We have a renewed emphasis on microcap fraud. In this area, we are specifically focusing on increased coordination with the SROs, as well as with foreign regulators, because we find that many of the microcap manipulations are done on more than one securities market and frequently involve markets outside the U.S. as well as U.S. markets. And we have a priority to get the money that we have collected, in the past, distributed. This year, just to give you an idea of how we're doing, (our fiscal year ends September 30th so we just ended a fiscal year), we have collected and distributed approximately 65% of the disgorgement that was ordered through our enforcement actions during the past fiscal year.

A couple of other random statistics. I'm not sure what inferences you can or should draw from these, but I'll just set them out there for your consideration. I took a look at the number of criminal proceedings related to SEC investigations and cases that we were aware of being publicly announced in the past three fiscal years. In FY '03, there were 131 criminal proceedings that were related in some way to SEC cases. In FY '04, there were 159. As of the end of August (so this doesn't include the last month of the fiscal year for this past fiscal year 2005) that number had dropped to 65. I also took a look at the percentages of the parties who were settling with us versus still litigating with us at the initial filing stage of our enforcement investigations. Again, there has been a significant change or appears to have been in the past year. In FY '03, 36% of our cases were settled at the time of filing, and 64% were still in open litigation. In FY '04, 33% were settled at the time of filing, and 67% were still in litigation. In FY '05 (again, not including the last thirty days of the fiscal year), we had 61% of our enforcement actions settled at the time of filing, so a much lower percentage that were continuing in open litigation. The one thing I just want to add is that with regard to the percentages of those that were openly engaged at the time of filing, the vast majority of those still tend to settle prehearing. I don't have actual percentages on that, but it means that those cases are going further and further into the litigation process before they really are ready to settle. I guess with that we'll shift to *Smith*.

Raymond Henney: Let me introduce the topic. Recently, on August 10th, the 11th Circuit issued *SEC v. Smyth*,[19] which would have been unremarkable except for infamous footnote number 14. In footnote 14, in dictum, the 11th Circuit ruled that the longstanding practice of the Commission to obtain essentially obey-the-law injunctions—injunctions against further violations of the securities laws—is unenforceable. The Commission is not happy about this. Merri Jo, do you want to further introduce that topic?

Merri Jo Gillette: Just to round out the background. This was a case that was brought against the Richard Smyth (among others), the former president of a company that

[19] SEC v. Smyth, No. 04-11985 (11th Cir. August 10, 2005), *available at* http://www.ca11.uscourts.gov/opinions/ops/200411985.pdf.

manufactured safety equipment. He was charged with insider trading in connection with some false press releases that the company had made in a subsequent brief statement by the company. He consented to the entry of a permanent injunction without admitting or denying the allegations, but we reserved in the settlement, or partial settlement, the issue of disgorgement and the appropriate amount that he would have to pay. Thereafter, the District Court ordered disgorgement simply on paper, submitted by the parties without an evidentiary hearing, and Smith appealed that disgorgement order, arguing that he was entitled to an evidentiary hearing before the court entered a disgorgement order against him. That was how this got to the 11th Circuit. As you might notice from that description, neither party considered the issue of whether the permanent injunction, which had been entered by consent, was enforceable. Neither party raised that issue on appeal nor briefed the issue. But the Court felt inspired to comment, and I would say that the primary thrust of the court's reasoning in that footnote is that the injunction, as it read, did not comply with the requirements of Federal Rule of Civil Procedure 65(d), which requires that injunctions be fairly specific in order to be enforceable. For those of you who are not familiar with a traditional SEC injunction, it typically recites the language or tracks the language of the statutory provision and/or rule from which the defendant is being enjoined against future violations.

There are really two schools of thought on this, and it's been an issue of debate for many years, long before the *Smith* decision, among lawyers. The defense bar has wrestled with it, and we within the four walls of the Commission have had an ongoing debate on this issue. Just so you know where we stand procedurally, the SEC currently has petitioned the court for rehearing before the 11th Circuit panel that issued this decision. They basically are requesting that the court reissue the same decision but leave out footnote 14. The petition briefs two issues, and the focus of the brief is to suggest to the court that it was inappropriate for the court to issue this dictum without having been fully briefed on the issues. The two issues that are addressed in the SEC brief are whether a defendant's waiver of any objection to an injunction – in this case, the injunction that was entered – would render enforceable an otherwise unenforceable order. There is case law, both from the Supreme Court and the 11th Circuit and some other circuits that has previously held that the protections under Federal Rule of Civil Procedure 65 are waivable, although not in this particular context. The second issue that is briefed is the fact that the court did not address any of the precedent that is out there, again including some Supreme Court cases holding that there is no *pro se* prohibition against entering injunctions that track statutory language. If you take a look at the case law, to be fair, the converse is also true. There is no clear pronouncement that in every instance this would be appropriate, but the courts seem to have acknowledged that in certain situations that may be appropriate.

Raymond Henney: Let me put it into context as a practical matter. What is the significance if you represent a client who is either part of some kind of an order or who has agreed to not further violate the securities laws? The Commission has decided, "Yes, there is a violation." We don't have the niceties of a normal civil proceeding, where you have a complaint, you have discovery, you have motions to dismiss, and you have a judge who can resolve some issues but not normally ultimate issues. For instance, in a normal case, a jury gets to normally decide materiality: what a reasonable investor would think is important; what is non-public; what is in the public domain. Typically, that's a factual issue that a jury would resolve. But if you've entered into one of these orders, the Commission gets to go in and get a show cause proceeding. You, as the defense lawyer, are up against this type of proceeding and a judge who now decides this on an expedited basis, or a limited basis, and your client is in the "I'm a bad guy" posture, rather than in the normal posture where you're a civil litigant typically. So, from a defense practitioner's standpoint, the obey-the-law injunction has very significant ramifications with respect to the Commission. What I'd like, Merri Jo, for you to first address, is why are these injunctions important to the Commission, other than we know from a practical or procedural standpoint it gives some advantage to the Commission? Why does the Commission, on a more strategic basis, feel that these are important?

Merri Jo Gillette: Well, I think that to fully understand, you have to go back historically to the time when the only remedy that the Commission had available to it in the district court arena, pursuant to its statutes, was the permanent injunction. That actually wasn't that long ago. Actually, I should footnote that: I guess, at least in theory, at all times we also had certain equitable remedies available to us that were attendant to injunctive relief; however, some courts interpreted that to mean that we did not have access to those remedies, such as disgorgement, except attendant to the entry of an injunction. I think there's a split of opinion as to legally whether that is precise, but that was sort of historically how the injunctive remedy developed for the Commission. Now, in this day and age, where we have all kinds of remedies at our disposal, the importance of the injunction is less clear, although in some courts it may still be found to be necessary to allow us to get some of the other equitable relief that we frequently seek in our actions. And the point that you made, Ray, which is that with regard to recidivist conduct, if we have an injunction on the books, that allows us – if the conduct falls within the same statutory provisions – to either go back into court seeking a civil contempt proceeding (or, in some instances, criminal contempt). And our burden of proof may be lower at that time than it would be if we were to allege a whole new complaint on the new conduct. Separate from that, if we do elect to go forward and allege an initial complaint on the new conduct, we will be better postured to argue for higher sanctions, such as civil penalties, if clearly the defendant has been put on notice previously not to violate again in the future these same provisions. Now, that being said, I think the debate comes down, in that there are a number of different reasons for this, as to whether a broad injunction which tracks the language of Section 10(b) and Rule 10b-5, for example, gives meaningful notice to your average defendant as to what future conduct is prohibited by that provision. Those who argue against the enforceability of these would say that it does not. Even from the Commission's standpoint, a narrower injunction that describes very specific narrow conduct (such as insider trading – which would be a Section 10(b) violation in most instances – or false and misleading statements concerning a public company's financial situation – which would alternatively be another violation of Section 10(b) in most circumstances) may be easier to prove and enforce in a contempt proceeding later if the defendant's subsequent conduct falls within that same narrow range. Of course, on the other side, the defense bar has due process concerns because if I go out and I get a Rule 10b-5 injunction against your client this week for insider trading and next year, at this time, he's involved in the issuance of false and misleading statements in connection with a public company, I can arguably go in and just move on contempt to say that he is still in violation of this broad Section 10(b) injunction, even though the prior action had nothing to do with making false and misleading statements vis-à-vis a public company. The only thing I can say is that I think that the SEC has a lot of discretion in terms of how they would proceed on the second set of conduct, and my guess is that there would be a lot of people within the Commission who would be advocating for simply filing a new action for a number of reasons, not just this one, as opposed to just going on a contempt basis based on a prior Section 10(b) injunction based on insider trading.

Raymond Henney: Merri Jo, does the SEC still have to file disgorgement defendant-type actions, where you have a primary defendant, a company, and a president, and then you have people that may have received money or are trying to get the money from the individuals, but they're not a defendant?

Merri Jo Gillette: Yes. We refer to them either as relief defendants or nominal defendants. It is a practice that the SEC initiated a number of years ago and we do it to get jurisdiction over these individuals and/or assets that may be under their control, that we believe properly need to be brought into a disgorgement fund for distribution back to victims. Practice varies. My personal practice is that when we name people as nominal defendants that we say specifically, in the allegations in the complaint and in our press release, that these individuals are not being charged with any violations of the securities laws, because we are sensitive to the reputational damage that may have if it's misunderstood by the public.

Raymond Henney: Does this footnote 14 affect that?

Merri Jo Gillette: I haven't actually thought about that. I think not, because we do not seek injunctive relief typically against those individuals. What we're seeking is the return of assets, as I said, into typically a disgorgement fund that would then be returned to victims.

Raymond Henney: Merri Jo, what would the landscape of the SEC be like in settlements or enforcement actions if footnote 14 actually became a law and became a trend in the law? This is a long-standing practice to seek these injunctions. How would that impact how the SEC would approach civil litigants?

Tom Cox[20]**:** Actually, these have been criticized by district courts throughout the history of its usage in the past. More pointedly, how is the SEC going to put the genie back in the bottle now that the 11th Circuit has done this?

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[20] Mr. Thomas R. Cox is a principal at Miller Canfield Paddock and Stone, PLC. He has extensive experience in litigating and counseling securities and insurance industry clients with respect to market conduct and sales practice issues, including defense of securities fraud and other class actions; defense of customer claims in securities industry arbitrations; defense of regulatory and enforcement actions brought against insurance companies, broker dealers, and registered representatives; and advising and counseling of financial institution clients on conduct issues and compliance systems. Mr. Cox earned his J.D. cum laude from Wayne State University Law School and holds a M.A. and B.A. with honors from University of Wisconsin Madison.

Merri Jo Gillette: Well, we're not conceding anything yet. I have not been privy to really robust discussions within the Commission on this issue, but I know generally what the thinking has been historically. I think that we would have to revisit the question of whether we need to tailor our injunctions much more narrowly to the specific conduct, perhaps describe more details of the conduct involved and not just track the statutory language. As I said before, that is a debate that has been going on internal to the Commission, probably since I got there twenty years ago, at various points in time. There are those within the Commission who believe that we should be doing that and others who like this broader approach. I don't think that even under the worst reading of footnote 14 for the Commission we would be left with no injunctive remedy, only that we would need to think a lot more carefully. I think, in terms of what pragmatic impact that might have on the program, that it opens up a whole new area and can of worms for negotiation in the context of settlements. Instead of these *pro forma*, almost boilerplate, injunctions which we have typically used – once you get to the point without admitting or denying, the rest just falls on the paper and you put your signature on the page – you are going to have defense counsel working very hard to negotiate the narrowest and most plain vanilla injunction that they can come up with. Conversely, you may have some situations where your defendant would rather have the statutory language and not have the details set forth, and I guess that in theory at least this could impede some cases from settling that otherwise might under the current structure.

Raymond Henney: Does anybody have any questions before we move on?

Tanya Solov[21]**:** I would say that from a state perspective, usually it's defense counsel that asks for that language in the orders, because they're trying to negotiate something, and they want that "neither admit nor deny" language, they're going to offer rescission. What else can you put in the order? Often, in our situations, they say, "Can we put in the order, 'We won't violate the law in the future'?" But, on the other hand, if they violate the law, at least in Illinois, that's a criminal offense, and we tell them that, but I think people who really intend not to violate going forward would rather have that provision in there because we can't issue some kind of order that has nothing in it.

Merri Jo Gillette: I think that's a good point. From the Commission's perspective, if your client is in good faith interested in putting things right, settling with us, and going on to be a good citizen in the future, it certainly raises questions in our minds if she is overly concerned about signing off without admitting or denying under an obey-the-law injunction, which is what she was supposed to be doing anyway all along, but that's kind of getting into the dynamic of it as opposed to the legalities.

[21] Ms. Tanya Solov currently serves as the Director of the Illinois Securities Department, appointed in 1999 by the Secretary of State Jesse White. She began her career with the Securities Department in 1994 as the Senior Enforcement Attorney and later served as the Assistant Director for Enforcement. From 1989 to 1994, Ms. Solov was an Assistant Attorney General of Illinois, practicing appellate and trial litigation in State and Federal Courts. Prior to her career in government, she was a management consultant at Arthur Andersen & Co. Currently Ms. Solov is the Chair of the Broker-Dealer Section of the North American Securities Administrators Association (NASAA).

Raymond Henney: I'd like to turn to two cases that are currently pending in the Eastern District. Merri Jo can talk about the cases in only a general manner obviously. They are of local interest, certainly, but one of the two, I think, has a more interesting aspect to it. These are the SEC enforcement actions in *Conaway*[22] and in *Bixler*.[23] Conaway was a former CEO, a much maligned CEO, of Kmart against whom the SEC has recently proceeded with an enforcement action with respect to the company's books and records and financial statements. The second case, *Bixler*, is more interesting. This is against upper level management individuals at Kmart individually and vendors to Kmart, with respect to a "scheme"—in the SEC's terminology, but really some would say an understandable business practice—where the vendor would give certain credits to Kmart, for instance, for a certain volume of business. These credits were accelerated because of various business reasons, but the acceleration materially affected the books and records of the firm, according to the SEC. What's interesting about this is two-fold. One is who is involved. You have not upper management in Kmart, but you have people who are involved with vendors and credits and so forth who are being brought before the SEC for securities law violations. But you also have, in the second aspect, outside third parties who were privy to this—some very renowned companies, some who are very small, non-public companies—who are being prosecuted essentially under the aiding and abetting aspect of the SEC enforcement power. What's further interesting, from a local perspective as we're all well aware in the papers, is several of the larger suppliers are under SEC investigation. They have similar kinds of issues, although nothing has bubbled up into enforcement action, with their lower tier suppliers—Macomb County, if you will—about how they did business, how inventories were kept, and so forth. So, these have kind of a rippling effect in the community.

Merri Jo Gillette: Just to give you a little background, I'm going to actually talk about the most recent case first, because I agree with Ray that the more interesting one is the one that was filed just about a year ago now, but I do want to mention the second one so that if you're interested you can go take a look at it. Both of these cases are injunctive actions; they're pending in the Eastern District of Michigan. The most recent one was filed on August 23rd of this year against Charles Conaway, the former CEO of Kmart, and John McDonald, who is the former CFO. They were each sued for fraud, for misleading investors about Kmart's financial condition in the months preceding the company's bankruptcy. We are seeking against both of them permanent injunctions for violations of Section 10(b) and 13(a), disgorgement, civil penalties and officer and director bars. Beyond that, there's not a whole lot that I can say. The case is not settled. You can get the complaint, if you're interested, by going on the SEC's website,[24] as well as the press releases surrounding that,[25] and you can read the allegations for yourselves.

[22] SEC v. Conaway, 05 Civ. 40263 (E.D. Mich. filed Aug. 23, 2005). *See also* SEC Litigation Release No. 19344, Aug. 23, 2005, *available at* http://www.sec.gov/litigation/litreleases/lr19344.htm.
[23] SEC v. Orr, 04 Civ. 74702 (E.D. Mich. Filed Dec. 2, 2004). A helpful summary is in SEC Litigation Relese No. 18989, Dec. 2, 2004, *available at* http://www.sec.gov/litigation/litreleases/lr18989.htm.
[24] Available at: http://www.sec.gov/litigation/complaints/comp19344.pdf.
[25] *See* SEC Litigation Release, *supra* note 22.

In December of 2004, we filed our first case as a result of the investigation into the activities surrounding Kmart. We named in that case, as Ray has mentioned, some lower level folks at Kmart, but, perhaps more interestingly, we named five individuals who were connected in one way or another with four major vendors who had had relationships with Kmart, and charged them with securities fraud. The four vendors that were involved – and these are pretty much household names, so you will get an idea of the significance of this – were Eastman Kodak Company, Coca Cola Enterprises, Inc., and then two of PepsiCo, Inc.'s wholly owned subsidiaries, the Pepsi-Cola Company, and the Frito-Lay, Inc. division, which is also part of PepsiCo. The complaint alleged that these defendants had caused Kmart to prematurely recognize (from an accounting standpoint) what they called "allowances" from vendors based on false information that was provided to Kmart's accounting department. Specifically, these individuals from the various vendors had in some instances co-signed false and misleading accounting documents, executed side agreements concerning the supplying vendors, and actually had signed false third party confirms that were submitted to PricewaterHouseCoopers, the outside auditors in this case. As a result of the overall financial scheme, Kmart's net income for the fourth quarter, and the fiscal year which ended December 31, 2001, was overstated by approximately $24 million, or 10% of its total net income. I want to talk to you about the individuals named in this and what they were charged with because, from the vendor side, it is really an area where the SEC has become more aggressive. If you look at both WorldCom and Enron, there have been subsequent enforcement actions brought against third parties that were involved in some of the financial transactions that resulted in the downfall of those companies).

The first is a fellow by the name of Darrell Edquist. He was the former Vice President and General Manager for Eastman Kodak. Edquist, without admitting or denying, consented to a final judgment permanently enjoining him from violations of Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13b2-1 and 13b2-2, and from aiding and abetting violations of Sections 13(a) of the Exchange Act and Rules 13a-1 and 12b-20, and directing that he pay a $55,000 civil penalty. The second person with whom we have now settled is a fellow by the name of Randall Stone. He was the former National Account Manager for PepsiCo's Frito-Lay division. Without admitting or denying the allegations of the Complaint, Stone consented to the same permanent injunction as Edquist, and was directed to pay a $30,000 civil penalty. The third person was Thomas Taylor, former Director of Sales for Frito-Lay. As part of his settlement, he did not agree to an injunction; he instead agreed, without admitting or denying, to a cease and desist order that was issued administratively by the Commission. He was charged only to cease and desist from committing or causing Section 13(a), Rules 13a-1, 12b-20, and 13b2-1 violations, but he also agreed to pay a civil penalty through the district court action in the amount of $25,000. With regard to David Bixler, who is the former National Sales Director for PepsiCo's Pepsi-Cola division (and current Vice President and General Manager of PepsiCo), and David Kirkpatrick, who's the former National Sales Director for Coca Cola Enterprises, Inc., we are still in active litigation with them, and they are unsettled.

I think that to help put this into a context, it is interesting to take a look at the settlements that the Commission entered into with the Kmart employees, who were named in the same suit at the same time. Now these are not the highest-level officers in the suit that was just recently filed; again, these were others who were named in the December 2004 suit. We have settled with two of those individuals: Michael Frank, who was the former Divisional Vice President and General Merchandise Manager for the food and consumables division at Kmart, and Albert Abbood, who was the former Divisional Vice President for non-perishable foods in the same division. They both agreed to permanent injunctions, all with the same provisions that were agreed to by the vendor individuals. Mr. Frank also agreed to a five-year officer and director bar; he did not pay a civil penalty, but that determination was based upon a determination that he had an inability to pay a civil penalty. Mr. Abbood did not agree to an officer and director bar, but was ordered to pay a $50,000 civil penalty. So you can see—if you compare him, and he was in-house at Kmart, to, for example, Mr. Edquist, who paid $55,000—that the Commission is settling these actions with individuals both internal to the company and with the outside vendors on what at least on their face appear to be very similar settlement terms. I think this is a trend. I think it preceded the cases in Kmart. As I mentioned, we've been looking at this issue with regard to some of the other really huge financial frauds that you have heard about, and some other cases have already been filed. It's also a trend if you look at what's happening in terms of private litigation. At the beginning of this month, the Wall Street Journal reported that three pension funds had filed a private suit in Southern District of New York in connection with Delphi's recent announcements concerning the overstatement of its earnings for several past years. And as part of that lawsuit they named not only defendants at Delphi and the outside accounting firm, but they also named nine investment banks and three other companies that Delphi had done business with, again on similar albeit private theories of liability.

Tom Cox: Merri Jo, when you're talking about these lower-level individuals, what is the role of the level of scienter that might need to be shown on the part of these individuals for the SEC to settle with them? Is there concern that perhaps the requisite level of scienter is not there?

Merri Jo Gillette: Yes, I will address that. I'd like to qualify my remarks in saying that what I'm about to say is not specific to the Kmart case *per se*. However, the Kmart case, I think, falls into the parameters. As a general matter, we look very closely at scienter, and certainly, in my mind, particularly in large organizations, we typically see officers/employees that fall into three categories: the very top people who, depending upon the facts of the case and your view of where liability ought to lie, either were right in the middle of everything and directing it (or somehow were so isolated from the day-to-day acts of their subordinates that it's difficult to pin scienter on them—it tends to be one extreme or the other); then you have sort of your next level of executives—sometimes officers, sometimes not—who are the more senior people, who are really acting on behalf of the public company on a day-to-day basis (it depends again on the facts of the case what that involves); and then you may have lower-level employees who may have done something or been part and parcel, executing one piece of making the overall scheme work, but certainly didn't have any scienter in terms of planning the scheme, perhaps not even understanding that the little piece they were doing was part of a larger scheme. That latter group, of course, would be very difficult to find scienter against. So there is sort of a sliding scale that the Commission is looking at as we assess each of these. Even a lower-level employee who does something like sign a false document, knowing that the document is false, even if he doesn't understand the implications of what that might be to the larger fraud, may be someone who we would take a close look at. In this situation, in the Kmart situation at least, what was alleged involved actual conscious decisions to provide false documentation, both to the internal accounting department and, in some instances with regard to the vendors, to the outside auditors. That, from our standpoint, demonstrates a pretty high degree of scienter. Remember that our standard for scienter in the civil context is "knew or should have known," so recklessness can satisfy the scienter requirement. It doesn't mean that you have to know everything about the entire fraud and be one of the main players executing it.

Raymond Henney: There is a significant aspect to that case. It's that, according to the SEC, the outside vendors provided false information to the outside auditors with respect to these transactions. A query, though: if you don't have that fact, if you take that fact out, is it still an enforcement act? For instance, you're advising a small company. Its largest customer by far says, "Do us a favor. We have this extra inventory. Take it off our hands for a while and we'll buy it back. Here's the agreement, but the agreement doesn't say we're going to buy it back, but don't worry, we'll buy it back." Your client's getting a lot of pressure from their number one customer that they wanted to do this, it's a lot of internal pressure for them to do this, they decide they're going to do it, the transaction happens, the inventory never moves, and the SEC comes calling. You haven't lied to the outside auditor, but when you're advising that client, do they have aiding and abetting liability? It's something to think about, to the extent that you're advising a client about what I call good citizen issues, about internal issues. In a larger corporation, you talk about a compliance officer, and it has this sort of rippling effect. To the extent that you're talking about good citizen issues and practices within firms, this is certainly something you should point out: that you need to make sure your people understand that—while they're trying to accommodate a large client, they're trying to do everything they can to succeed in business—there has to be some sort of review of limitations to their practices.

I think there is a difficulty, though, for the small vendor in understanding that, because these are essentially accounting accrual and timing of transaction reporting requirements that would require the average small vendor to hire accountants and attorneys to advise it, and they may not have the incentive to do that, where they do have the incentive to make the concessions that are requested of them.

Merri Jo Gillette: I think from a pragmatic standpoint it does create some difficult issues. I just would like to point out that if you take a look at these situations—and there are more of the cases, beyond those discussed today, that the SEC has brought against third parties in connection with the public company's financial demise—that what you will see is that they are all large, major companies. However, I haven't seen a policy articulated to this effect. The names I ticked off to you for the vendors even in this case are not small vendors that are sitting someplace and that are completely dependent upon their relationship with Kmart for their own financial survival. I think that what that reflects is that, whether as a clearly articulated policy or simply intuitively as regulators, we are exercising discretion in where we go after folks when they're in this third party or vendor role.

Joe Spiegel: It's not too dissimilar from the bribery cases, where you have individuals paying off foreign countries or foreign companies to do business with an American company, where the reach of the SEC went way beyond the borders of the United States. So I think there's probably some precedent for that reach; it just never trickled down from the supply side.

Merri Jo Gillette: Also, we have a specific provision that allows us to do that under the Foreign Corrupt Practices Act.

Raymond Henney: Any questions?

Audience question: Merri Jo, you suggest that one of the Kmart divisional vice presidents, Michael Frank, was not assessed a fine based on financial wherewithal, but that in the other cases you demanded that the clients were paid by the individuals not covered, and that seems to be consistent with a practice recently. Is that an absolute in the SEC to fine?

Merri Jo Gillette: It is becoming more and more a requirement, and, at the Commission levels, staff gets its direction from the Commissioners on that point. I don't know if it's become an absolute yet. Because my office did not do the Kmart case, I don't know whether that was the case here or not – I just didn't check it, so I don't know. But there is increasing concern at the Commission level—and this actually crosses all subject areas, both entities and individuals, and not just cases involving public companies—that the civil penalty that is being assessed be meaningful for the person or entity paying it in the context of the conduct that has occurred. So if the company is just paying for an individual, then there are at least some on the Commission who feel that that is useless, and what's the point of arguing and exacting that kind of penalty? And their fix, if you will, at least up to this point in time in those instances, is to require some demonstration that it will actually come out of the individual's personal net worth.

Raymond Henney: Let's move on to cooperation with the SEC. In the last session, there was a discussion about cooperation and the effects of cooperation with the SROs, and we'd like to continue that discussion if we could.

Merri Jo Gillette: Okay. This is a topic on which you can spend an hour or more very easily. There is a lot of case law in this area, so I don't want to give you sort of my two-minute version and leave you with a feeling that you now understand this area. The area that is the tricky part is the waiver of attorney-client privilege, but let's start with the cooperation piece.

For many, many years the Commission gave no formal or explicit credit for cooperation. That's not to say that it didn't weigh into when w were deciding how to charge, when to charge, and how to sanction certain types of conduct. As many of you are probably aware, in October of 2001, we issued something called the 21(a) Report, and that was the first instance in which the Commission publicly stated factors it would consider – at least in regard to a public company – in assessing whether cooperation had occurred or not. I recommend the report to you, and if you haven't read it and you're representing such clients, you should read it.[26] Again, it applies only to public companies; however, it will give you some guidance because we do not have separately articulated factors for other types of defendants, and mostly they're relatively common sense issues, as far as I'm concerned. They could apply to anybody across the board, whether we formally said that or not.

The one thing that I want to touch on is the issue of the waiver of attorney-client privilege, because increasingly the staff of the Commission is asking public companies in particular to waive the privilege in the context of investigations, and there has been a lot of concern from the Bar whether it is necessary to waive the privilege in order to get credit for cooperation. For those of you who do criminal practice, there's something called the Thompson Memo (which was discussed also in Panel One briefly), which outlines what the Department of Justice requires for cooperation, and they clearly state that waiver of the privilege is a prerequisite to getting certain types of credit for cooperation. That is not the view of the SEC. The SEC certainly notes it in the positive column if you elect to waive the privilege, but the converse is not true. If you choose not to waive the privilege, it does not mean that you cannot get credit for cooperation, and it does not mean that you will be construed as having not cooperated. I think that, from a public policy standpoint, this is a difficult issue for the Commission because we want to encourage people to seek legal counsel advice, we want them to get counseling on many of the issues – particularly disclosure issues, which are very complex, but other issues as well – and we do not want to adopt a policy in our investigative phase that relates to waiver that would have a chilling effect on those out in the industry seeking that advice at earlier points in time, when it might be most useful to all of the investing public. That being said, we start from the position that waivers should be something we ask for as a last resort; that we should explore, as much as we can, alternate ways of obtaining the information that we think we might obtain as a result of asking for the waiver, before we go there. Obviously there is one situation where we are going to require the waiver, and that is if the defendant intends to advance an advice of or reliance on counsel defense. Two other areas where we're going to push very hard is if we believe the crime fraud exception comes into play or that there's been some other prior waiver of the privilege, and we want to get access to the same information. We try to draw a distinction between facts and work product, but along those lines, if you have corporate set-up where facts are being taken down in rote form by an attorney, and it just happens to be by an attorney but it really is just that person acting as a transcriber, we are probably going to push hard to say that should not be protected by the privilege.

[26] Available at: http://www.sec.gov/litigation/investreport/34-44969.htm.

We try to be creative in finding ways to work around defense counsel's frequently very legitimate concerns that if they release the information to us, that they will then be subject to having to release it in some other context, particularly third party litigation. Some of the alternatives that we have are not air-tight, admittedly, but provide less of a chance that you would be forced to waive the privilege. These include, first, attorney proctors to the staff rather than taking testimony directly from someone who would otherwise be asserting the privilege. Second, a verbal recitation to us of the work product of attorneys at the firm, so that without producing the actual documents, we can benefit from the information and, in effect, use it as a lead to attempt to gather the same information independently in our own evidentiary record. That is frequently done these days when an internal investigation has taken place after a corporation has discovered misconduct and conducted its own internal investigation in advance of or parallel to the staff's activities. Third, provision to us of non-privileged factual summaries that are prepared specifically for the SEC's use. Now obviously we have no ability to compel your client to do that, because that would compel the creation of a document but frequently that may be in your client's best interest if he otherwise would want to get the information into the hands of the investigators That's a mechanism that could be used. And, last, sometimes what we call "walk through" documents, where the company will bring individuals who will walk us through what we already have from prior sessions and highlight for us things that we may want to look into further, or may develop further, but they do not want to be sort of the witness on the record, giving testimony under oath to that effect for any number of reasons, and frequently privilege is one of them.

We have some other things to cover, so I don't know how much further you want me to go.

Raymond Henney: Let's see if anyone has any immediate questions with respect to cooperation. This is a large issue and unfortunately we only have a few more minutes.

Hugh Makens: I have a couple of questions. Merri Jo, regarding determining the legal rights to your settlements, because that goes to the cooperation aspect: normally in a case like a Kmart case, for illustrative purposes without understanding the case, you would see the primary motivation to get someone to provide the discounts or part with a product or to engage in a similar activity, motivated largely by the company. But in the Kmart case you had a $50,000 fine against a parent instigator and a $55,000 fine against someone who merely went along, apparently. I'm trying to reconcile those two concepts, and there must be some other aspect of that kind of case that would lead to a disproportionate sanction for the outsider rather than the insider.

Merri Jo Gillette: We're in open litigation in both pieces of litigation so I'm somewhat constrained in talking about the specifics on that case. But I'd point out that the case against the lower level individuals and the vendors who misled the outside auditors and the internal accountants was filed almost a year before the most recent case, which has now been filed against the top level people, in August of this year. Why the decision was made to go out publicly at that earlier point in time before they were ready to move with the higher-level internal people I'm not sure, and if I knew I might not be able to say anyways. But one thing I would point out, that actually highlights another issue, is that when the SEC sues somebody these days, that does not necessarily mean that is the end of the story, and if you look at our litigation release you will sometimes see a tagline at the very end which says "the investigation into this matter is continuing." That almost certainly says that the door is not closed on this, either as to the SEC or as to other regulators or both. You will not always see that, so if you do not see that you cannot automatically assume that you're home free.

Hugh Makens: On the issue of cooperation, I've often found that instead of turning over notes, and providing things that would breach the attorney-client or work-product privileges, it's often more effective to tender a witness that has been prepped and is prepared to provide testimony, who probably gives you better access than those notes are going to give you.

Merri Jo Gillette: I think that each case is different, and in each case you may have strategic considerations on your side of the table as defense counsel. I'm not here to say that one is better than the other or that in all instances we're interested in asking for waiver, just that when it does come up it can be a very difficult issue to navigate from the defense side. I will footnote that by saying that the SEC has gone to Congress on more than one occasion and sought legislative authority to allow your clients to waive the privilege as to us without it being construed as a full waiver and Congress has been reluctant to do that for lots of reasons. And I don't necessarily disagree from a jurisprudential standpoint. But know that under the current state of the law, you have to be aware that while we will make every effort to keep confidential the information provided through these means, we cannot guarantee that. There may be situations in which we're forced to disclose, and one of those situations is the *McKesson* decision.[27]

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[27] McKesson HBOC, Inc., No. 99-C-7980-3 (Ga. Ct. App. filed May 13, 2001).

KEYNOTE ADDRESS: ROGER SHERMAN

Several years ago, then Chairman of the SEC Harvey Pitt coined a phrase that was meant to challenge, inspire and perhaps scare all of us who are securities regulators. He coined a phrase "real time enforcement," and I guess, except if you are a miscreant, it is hard to have too much dispute with the term. In my remarks today, I want to tell you how we at NASD have invented and reinvented ourselves in order to try to bring cases more quickly, because I believe that's what chairman Pitt was getting at when he used that phrase.

First, by way of background, the group at NASD that I have responsibility for are about 100 people in Washington. They are attorneys, examiners, paralegals, administrative staff, but we have no routine enforcement responsibilities, as opposed to, say, some of our attorneys in our district offices. Rather, we are supposed to develop and investigate and prosecute cases of serious securities fraud: cases that affect our regional or national securities markets and that pose a threat to the investing public. First, let me start off with somewhat of a "strawman model" which is one based upon an examination program that is often routine in nature. That program is often carried out by non-attorneys, and at the end of the day may result in a written referral which would get referred to enforcement people. They would carry out a second examination, although this time we call it an investigation, and then at the end of the day you would have an enforcement action. That is kind of a traditional model. However, we at NASD in Washington operate in a very different fashion and I'm going to tell you a little bit about how we operate and how we try to bring cases more quickly.

First, let's talk a little bit about finding cases. How do we in Washington find cases? We have a dedicated group of very experienced people out there finding cases; we do not wait for referrals. There are about 800 matters that my intake group looked at last year, and they developed about 60 percent of those themselves, so they try to be proactive in looking for matters to investigate. One of the ways they are proactive is that they regularly talk to a group at NASD known as "Ahead of the Curve." These are senior people from our various divisions; with 2000 people we have a lot of divisions within NASD all of whom see things slightly differently. Out of that discussion, hot buttons will emerge: the equity-indexed annuities Notice to Members,[28] for example, came out of that group. This group will then feed ideas to people in Enforcement and we will then go out and look at it. One of the things that we do is that we often send letters to a lot of firms once we spot an issue, and these are sometimes called "sweeps." This also helps to accelerate the speed with which we are able to do investigations. I say that because if we are looking at an issue, first we are able to see if there is a problem, if any. We are then able to canvas those firms that are active in an area and we are able to rank the firms and pick the outliers, because if you want to run an effective program you want to go after the outliers first. If you don't have a tiering system—and we didn't used to—where you're looking at a large cross section of firms, you may have spotted a problem, but you may not really be dealing with the worst offenders of the problem. So, we feel that the sweep

[28] *Supra* at 24-25

approach, while it does create some burdens on our firms, also helps speed up the entire process itself.

Secondly, in terms of framing an investigation, we frame each investigation to move it more quickly. For example, as an organization we may decide that if we are going to be relevant in a certain area we would want to get a matter done within say nine or twelve months for a particular investigation. If you know that ahead of time, you are going to try to staff that investigation differently. But at a minimum we think it's important, for the people doing the investigation, to have communicated to them at least our hopes and our expectations. Obviously, an investigation has to run its own course, and the facts are going to emerge and it is going to go where it goes, but we do think some up front communication really helps speed things along. We will also, if necessary, try to narrow the time frame we are looking at and narrow the number of issues. This, of course, will also be a benefit to our member firms: there will be less of a need for on-site investigation, fewer documents that the firms need to produce and fewer people that we actually need to formally interview. So that's another thing we do to speed things along in our investigation.

Third, I'd like to talk about the way we investigate and our investigative team. At NASD in Washington, we combine investigators with attorneys. Not all regulators do that, but we do at the NASD in Washington, and our investigators typically have varied backgrounds. Some of them are recent law school graduates. Many have come from the industry itself, where they served as brokers in a compliance function or as traders. Actually, one of our most effective investigators was a former cop, a very savvy cop, and he has a way of getting people to tell the truth. I'm not sure what that is, but he has his ways. These people are very adept at manipulating large amounts of data and analyzing them, which is one of the things that we at NASD are known for. Also, we are blessed with really very fine attorneys. We draw some of them out of the SEC, out of the Justice Department, and from large law firms, and as our visibility as an organization has increased, the quality of the attorneys has just skyrocketed. I'm only half kidding by wondering whether I would be hired at the NASD if I were applying for a job today, given the qualifications of our people. But we also have another unique member of our investigative team. In all important investigations we assign a technologist—a technology investigator—to our teams. Technology is so important, so integral to our large investigations in Washington, that we want to get someone from technology assigned from the very start. That has made a huge difference. In terms of technology we pride ourselves at the NASD on being a technology driven organization, and we are really picking up our cue from our members. Our members, particularly our medium and large size members, are moving to a paperless environment. For competitive reasons, for productivity reasons, the way firms used to do business is just not there anymore. Paper order tickets are a thing of the past at most firms. Exception reports—reports that firms have that help firms supervise their brokers and supervise their various lines of business—are electronic today. We want to leverage that technology in enforcement. We want to take advantage of what the firms have already done. We think it's far less intrusive to our members to be able to do that then to have examiners in a firm for weeks on end at the copier machine; we used to get a lot of complaints about breaking the copier and tying up the firm's equipment. We are able to avoid that to a large extent when we gather information electronically.

Let me give you a good example of how we did this. It's far beyond just so-called electronic blue sheets which firms have become accustomed to over the last fifteen years or so. The example involves a series of investigations a number of years ago which involved IPO allocation abuses. What was happening at the very end of the tech boom is that all these dot.coms went public they opened extremely hot. And hedge funds, largely small hedge funds, were buying and getting these hot IPOs, and they were in effect kicking back a portion of these IPOS to a portion of our member firms. The way it happened went something like this: a hedge fund would get a dot.com IPO and would make $100,000 on that IPO; at the same time, the hedge fund would buy another security, say it would buy 100,000 shares of Disney (a very stable stock that there wasn't much risk in buying); and they would designate that they wanted a commission of 30 cents a share to go on that trade. So, they would designate some outsize commission to go out on that trade, and in that fashion the firms would recapture a portion of those IPO profits (let's say 30 cents a share on 100,000 shares) which is $30,000 and 30 percent of what the customer made on the IPO. As you can imagine, that might violate several of our rules. In these investigations, we told these firms, and we were looking at large bulge bracket firms at this point in time, to give us a download of trades, where customers bought 10,000 shares or more. We didn't want to see anything that's less because these firms do millions of trades a day. So we said, "Give us only the trades where customers bought or sold 10,000 shares, and give us only those trades where it was 10,000 shares and 20 cents or more commission per share." All of these firms had an ability to quickly give us this information. At the same time, we told the firms that we wanted a download of their IPO purchasers, so the firms gave us a download of these customers who were putting large commissions on large blocks. When you saw a lot of hits between the two lists it piqued our interest and significantly advanced the investigation itself. So that's an example of the way that we use technology in our investigations.

There is probably no more important area of technology for us, or for us as regulators as a whole today, than e-mail. And I would say that e-mail has done for securities regulation what wiretapping has done for criminal prosecutors in dealing with the mob. And I don't mean to equate the two, but what it does do is give you a window into the actual thinking, the actual thoughts and communication, of the person in the e-mail you have captured. For example, in the research analyst cases that we brought several years ago, one of the statements that we made in some of the cases is that research analysts did not believe what they were writing. Now how do you think we go about proving something like that? You take the depositions of the research analysts and you say "Did you believe what you were writing?" They're not going to confess: trust me, we've tried it, they will have a million different explanations for why they said what they said in their research reports. But, if you have their e-mail, and their private e-mail is dramatically at odds with what they are publicly stating, you have the basis for a case.

Consider Phua Young, a one-time well-recognized Merrill Lynch analyst who was covering a well-recognized company at that time, Tyco.[29] There were a series of e-mails that occurred between Mr. Young and investor relations at Tyco and I'll just read excerpts from some of them. In one of his e-mails, Mr. Young directly said, "I'm directly paid by Tyco." In another e-mail that he sent to Tyco including a proposed research report that he was going to send out, he signed it, "Your loyal Tyco employee." Recognize that these are research analysts who are purportedly objective who are purportedly reporting on these companies. There was a call that Mr. Young had with his investors. After the call he sent an e-mail to Tyco and investor relations people and said, "Did I not sound pumped-up enough?" to which Tyco responded, "You always sound pumped." And, finally, in a research report Mr. Young was predicting that Tyco would be trading at sixty to seventy dollars, when it was currently trading at about thirty-five dollars, and his valuation was all based on a proposed spin off of CIT for $8 billion. His private e-mail at that time says, "I am waiting for $10 [stock price] after tyco [sic] announces the inability to sell CIT for anything near $8 [billion]. Liquidity crunch, more distractions, the debt bomb starts to TICK, TICK, TICK . . . ." Now, Mr. Young had about two to three pages of "TICK, TICK, TICK." When we took his deposition he tried to say that this was all just a joke. As a securities regulator, as an enforcer, I would much rather have someone on the defensive trying to tell me that it's a joke, rather than not having that information at all.

Consider Jack Grubman.[30] Part of one of his e-mails said, "[T]he record shows we support our banking clients too well and too long." Another one of his e-mails in describing a target price referred to it as "extremely aggressive." Another e-mail said he didn't want to change the price target because of "optics." This is very good when you want to confront someone, asking someone what they meant by "optics" or "extremely aggressive." And you will get a lot of spin in there. But just so much of it really holds water. There was one other email that he sent internally that said, "If a senior investment banker starts up, I will lace into him. Most of our banking clients are going to zero and you know I've wanted to downgrade them months ago but got huge pushback from banking." And, of course, that is exactly what was the underpinning of our research analyst cases.

So e-mail is extraordinarily important and we ask for it in many of our investigations. We ask for it basically in one of two methodologies. Sometimes we go out and ask firms to produce e-mails that contain key words and we will pick off eight or ten key words that we are particularly interested in. The advantage to this approach is that the firm will search across all its employees and produce for us e-mail that contains those keywords.

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[29] *See* NASD News Release, "NASD Charges Former Merrill Lynch Managing Director with Issuing Misleading Research, Selectively Disclosing Material Non-Public Information and Improper Gift Giving to Tyco's CEO," (May 28, 2003), *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002906.

[30] *See* NASD News Release, "Salomon Smith Barney Fined $5 Million for Issuing Misleading Research Reports on Winstar; Charges Filed Against Jack Grubman and Christine Gochuico," (Sept. 23, 2002), *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002912.

This would tend to be an iterative process because as e-mails come back there are other buzzwords that we didn't know about and we send out additional requests. The disadvantage, of course, is that if you do not use the exact terminology, you are not going to get the e-mails you are looking for. So that's one approach. The other approach is to ask for all the e-mails for selected individuals. But, the disadvantage is that if you don't pick the right people you're not going to find out about other people who you may be interested in. We sometimes use the two together. But in any method, we tend to get a large number of e-mails. And you may be thinking, "What do you do with the e-mails when you get them?" Well, we read them. And I would say that we are still probably reading the e-mails one at a time, although we are moving away from this, which I will talk about in just a moment. I asked our people before I came here, "How many e-mails can you read in a day?" An experienced examiner, I have been told, can read about 1,000 e-mails a day. Now, unless there are some scintillating, or titillating e-mails—and yes, we've had our fair share of those—you will get a pretty disgruntled employee if he is staring at a computer screen for six weeks reading e-mails. But given the importance of it, sometimes there is no alternative.

We have started experimenting with new software. One that we have been employing at least on a pilot basis, does Boolean text searches as opposed to Outlook, which has very primitive search capabilities. Outlook, for instance, can search only one PSP file at a time. We might have an investigation where we are looking at 500 or 1000 PSP files. With this software, it can search across all PSP files and return to you the information that you want. This software also has the ability to look through attachments, which outlook does not have. And, finally, there is e-mail out there that can "de-dupe" e-mails, so that in an e-mail with fifteen CCs, you don't have to read it fifteen times; it will only produce it once. This is extremely useful for our investigators.

I recently saw a pilot of software that I can only describe as Star Wars-like, and my understanding of it is extremely limited, but I'll attempt to describe it. This software is not dependent upon key words, but through sophisticated statistical and mathematical analyses, it tries to evaluate the content of e-mail. Let me give you an example. Consider the words "review" and "examine." Sometimes those mean the same thing: they mean "to look at." However, sometimes the word "review" has a far different meaning: "a publication" or "a journal." Now, if you were to do a key word search and ask for the word "review" and "examine," you would get all the messages that contain those words. You would get a lot of false positives because if you wanted to find the word to look at you would get all these e-mails where it is also used to mean "a journal." You would also be missing other e-mails that were really talking about "to look at" but didn't use the word "review" or "examine." This application tries, again through various mathematical and analytical ways, to associate the software with what the content is, and it will produce for you e-mails regardless of the specific key words that it uses once it is able to index this according to very sophisticated algorithms. What it in effect does is that if you were to take a large number of e-mails and toss them in the air, this software is able to organize them into logical buckets as they fall to Earth. It is also able to analyze verbal communications, and I remember firms, some of them with trading desks, often take phone calls. This software is able to analyze not only e-mails but tape recordings, anything that can be digitized, and whether it is in English or Chinese it is able to form those buckets and give that information to you, which is very helpful in some of our investigations. But anyway, to make sure this wasn't all hocus pocus, as I was still not a firm believer, we took one of our cases that was closed, one of the IPO allocation abuse cases that I just described. This was a case that had 300,000 e-mails, which was 100 gigabytes. We gave it to this company and said, "We want you to index this and turn on 'Bessie' and see what happens." So, anyway, it took a while for it to index it and to go through the algorithms that it did. But when it got to actually putting e-mails in "buckets," while some of the buckets were absolute gibberish and meant nothing, there was a bucket there that the software itself labeled, and I kid you not, "IPO kickback." And in that bucket were the hot e-mails which formed the core of our case.

A final thought on e-mail. Once created it is virtually impossible to destroy. Someone, somewhere is going to have a copy of it and we are going to find it. Also, we in the securities industry have rules, and those rules require firms to retain and produce, when requested, all e-mails retained to their business, and instant messages as well for that matter. Very severe significant sanctions can flow from failure to do so. For example, in August of 2004 the Commission brought a case against Deustche Bank and fined the firm $7.5 million for failing to turn over about 200,000 e-mails during the course of an investigation into research analysts. Now, if your clients are hell-bent on committing securities fraud, it would be wise to advise them not to use e-mail. I say this to you because I am sure that your clients will not follow your advice, since e-mail is so ingrained into our culture, and into the way firms do business. I think the best example of this comes again from these IPO allocation cases that we did at the NASD. The 65 percent figure that I'm going to read to you refers to the percentage of the IPO that the customer was supposed to return in terms of other trades. Here goes: one trader to a second trader says, "A hedge fund costumer voluntarily shut themselves down after a supervisor at the firm got on the phone with them. The supervisor was a total prick and the customer just said they don't want to do business anymore." Also, the first trader says, and I am serious, "Is this 65% thing illegal?" The second trader back to the first, "I don't know, it probably would not look so good to anyone making an inquiry though." So all I can say is, thank God the bad guys are not that smart. That concludes my formal remarks.