PROCEEDINGS OF THE 2007
MIDWEST SECURITIES LAW INSTITUTE SYMPOSIUM[*]

8 J. BUS. & SEC. L. 59

TABLE OF CONTENTS

---

[*] **Note from the Editor and Disclaimer:**
The following is a minimally-edited transcript of the panel speakers from the 2007 Midwest Securities Law Institute (MWSLI) Symposium, an annual one-day gathering of securities lawyers held at Michigan State University College of Law on October 12, 2007. Biographies of the speakers are footnoted throughout.

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

INTRODUCTION

Elliot Spoon: Good morning! I'm Elliot Spoon[1], Professor and Assistant Dean at MSU College of Law. I want to welcome you to the MSU College of Law, and to the 2007 Midwest Securities Law Institute. It's a great pleasure for the school to host this conference and we have a wide variety of expert speakers on a wide variety of topics. I think there's something for everybody today…. Those of you who need [Continued Legal Education] credit, that is, those of you who are members of bars other than the state of Michigan, we do have a CLE sign up and we have procured prior approval for several states. If we don't have your state then we will endeavor to get approval after the fact…. It is my pleasure now to introduce my co-chair in the conference, Joe Spiegel[2].

CURRENT COMPLIANCE ISSUES WITH BROKER-DEALERS AND INVESTMENT ADVISORS

Elliot Spoon: Now, our first panel, as Joe indicated, is dealing with current compliance issues for broker dealers and investment advisors. John Walsh, is from the SEC where he is the Associate Director - Chief Counsel of the Office of Compliance Inspections and Examinations. Clarence "Rocky" Pozza from Miller Canfield, and Hugh Makens from Warner, Norcross and Judd.

John Walsh: Thank you, good morning! The first thing I want to do is give you the standard disclaimer. The Commission requires all of its staff, and actually the Commissioners as well, to give this disclaimer when their statements have not been approved by the Commission, which happens very rarely. The views I am about to express are my own and not necessarily those of the Commission, the Commissioners, or my colleagues on the Commission staff. Though, I always like to say that I hope I'm not too far a field of what the

---

[1] Elliot A. Spoon graduated *cum laude* from the University of Michigan, where he was on the staff of the *Journal of Law Reform*. He joined Butzel, Keidan, Simon, Myers & Graham and later chaired the firm's corporate department and was a member of its management committee. Prior to his current appointment at MSU College of Law, Professor Spoon taught at the Law College on an adjunct basis. He also chaired the Business Transactions Practice Group and was a member of the Executive Committee for Jaffe, Raitt, Heuer & Weiss. He has lectured widely on various mortgage banking and corporate topics. Professor Spoon teaches Contracts, Corporate Finance, Mortgage Banking, Accounting for Lawyers, and Securities and Michigan State University – College of Law. He is co-chair of the Law College's Corporate Law concentration and faculty advisor to the Business Law Society and the *Journal of Business and Securities Law.*

[2] Joseph H. Spiegel, of Joseph H. Spiegel PC, has extensive experience in drafting corporate and partnership documentation, including shareholder agreements, employment contracts, buy/sell agreements, private placement memorandums, and general and limited partnership agreements. He specializes in federal and state securities law in corporate finance and broker/dealer areas, commodities law on the federal and exchange levels, and general corporate and partnership law. He has lectured in the areas of securities and commodities law, and federal civil procedure, and has co-authored many articles including "The In Pari Delicto Defense and Attorney Misconduct, or It Is Time to Get Rid of the "Law-Free Zone", Michigan State University Journal of Business and Securities Law, 2005 J. Bus. & Se. L. 65, Spring 2005. Mr. Spiegel received his B.A. in History from Cornell College in 1968, and his J.D. from John Marshall Law School in 1974.

Commission would like me to say, particularly now that I have heard I am being recorded….

What I would like to do today is to talk about compliance and particularly about examinations which are an important part of the structure of compliance. They are also a growing legal practice area. Examinations are becoming a more important practice area for several different reasons.

One is that the profile of examinations has gotten much higher. There was a time, not that many years ago, when we would end an examination, we would hand the result to the firm, the firm would make the necessary corrections, and that would be it. It would be over. No one else would ever hear of it and nothing else would ever come of it. Well, those days are long gone. People have caught on to the fact that we do these exams. They've caught on to the fact that our letters to the firms contain a lot of good information. Now in our hands, examinations are not public and it is very rare to read about an examination in the newspaper. However, it is very common for us to conclude an examination with what we call a deficiency letter, which describes the problems that we identified at the firm. People who do business with registered entities have decided that they want to see these letters.

It's very common now for a firm to be asked for its most recent deficiency letter by potential business partners, by potential institutional clients, and by consultants who screen financial service providers to decide which ones to recommend to their clients. Mutual fund complexes now frequently ask for the last deficiency letter before they will take on a sub-advisor. Firms will ask for the last deficiency letter before they hire a transfer agent. So there's this whole 'secondary market' now in our letters and business decisions are being made on the basis of them. As a result of this firms are getting their lawyers, inside and outside, much more involved in the examination process because they can see a real world impact from what goes into that letter.

There's a second issue as well that is fostering the growth of examinations as a legal practice area, and that's the number of examinations we are doing. Last year, 2006, we did 2,600 examinations. By way of comparison, the Division of Enforcement brought about 800 enforcement actions. So you can see that we're doing more than three times as many examinations. They're also scattered around the country. We have eleven regional offices including a very fine office down in Chicago. Most of the exams that are done in this area are done by the Chicago office. So there are examinations in progress all around the country.

With all of this going on, attorneys, whether in-house or outside counsel, are making more appearances in examinations. I think that's great, I am glad to see it. If there are folks in this room who are wondering, "is there a role for me in an examination," I think the answer is yes, absolutely. However, I would add that it is very important to keep in mind that examinations are not litigation. They are different. If you want to make a successful appearance, if you want to do well for your client, it is very important that you be mindful of the differences.

What I would like to do at the beginning, with my co-panelist's indulgence, is to start with a quick briefing on the examination program and what it does, and then turn to some practice pointers. I have seven of them. If you have a litigation practice, or an arbitration practice, and you're thinking of making an appearance in an examination, or developing an examination practice, what are some of the pitfalls you need to be aware of as you transition into this new area?

Let me invite my co-panelists, and everybody here, if you have a comment or a question at any point, to raise your hand or shout it out. I will be happy to entertain it.

Hugh Makens: John I'll have some observations from the standpoint of counsel when you finish, and maybe we can talk to some of those questions as we go along and walk you though some of the experiences that are similar.

John Walsh: Great! If something seems particularly apt as I am talking that is fine, you can bring it up then.

Okay, briefing on the examination program—what is an examination? The closest analogy is an audit, though it is closer to an internal audit in its mechanisms because we are not working toward an opinion. We are not going to conclude it by saying: "We find that you're compliant." Instead we are looking at your control structure and looking for specific breakdowns that may show (a) that your firm is out of control and likely to have problems in the future, or (b) that your firm has actually had compliance problems.

We will usually send you a letter at the beginning announcing the examination. On the other hand, sometimes we will show up by surprise. That is always exciting. I have done a number of surprise examinations and it is exciting for the firm and us too. I always like to say that there is a bell shaped curve of human behavior, and when you walk into somebody's office one morning and say "Good morning, I am here from the federal government and I am here to examine you," you see behavior from every point on that bell shaped curve. You never know what is going to happen.

When we walk into a firm by surprise we are usually doing it for specific reasons. Either we've never been there before and we want to get a candid look at the firm, or we think it has serious problems and we are worried that records may be destroyed. A third reason I should mention, is that if the examination is of a sales office, a lot of times a candid look, even just at the waiting room or reception area, will tell you more about that firm than the whole rest of the examination.

Not to tell war stories, but I actually had an examination where we called the day before, so it was short notice. It was late in the afternoon and we said, “We are coming and see you first thing tomorrow morning.” We walked in and it was an office where once you walk in you take a left, and go up a flight of stairs to the office area. We walked in the door and, examiners are always watching for everything, there was a little alcove on the steps with a display of pamphlets, so I just took one of each. We went up stairs and we started the entrance interview and I said: “Sir, I see you have some pamphlets about products you are offering and I would like to ask you a few questions about them.” He looked at me and he said, “What are you doing with those? I thought I put all of those away!” I said: “Sir, you forgot the alcove by the front door.”

At the end of an examination, there are three possible outcomes. One, we give the firm a letter that is called a “no further action letter.” In a no further action letter we basically say, “We came, we saw, we have no findings.” The second outcome is a letter that is called a “deficiency letter.” In a deficiency letter we describe problems that we identified at the firm. The third outcome is an enforcement referral.

Let me give you a couple of statistics that will show how our program operates. Last year, in 2006, for investment advisors, 81% of our examinations resulted in a deficiency letter, 12% in a no further action letter, 6% in an enforcement referral, and 1% in a category called “other.” For funds, 73% resulted in a deficiency letter, 18% in a no further action letter, 8% in an enforcement referral, and again 1% other. And then finally for brokers, 57% in a deficiency letter, 16% in a close-out letter, 10% in an enforcement referral, and 17% in a referral to one of the Self-Regulatory Organizations for broker-dealers (hereinafter “SROs”). So depending on what kind of firm you are with, or that you represent, your chance of having an examination result in an enforcement referral, last year ranged from 6-10%.

The statistics are important because the relatively low number of enforcement referrals demonstrates that we are not simply an adjunct to the enforcement program. Compliance is different. Examinations are different. I always like to describe it as a matter of personal biography. When I got out of law school I went to work for a litigation firm in New York and did securities defense work. I left that firm and went to the SEC and worked in the Division of Enforcement. Now I’m working in the compliance office. I always like to tell people that when I was doing securities defense work I helped people who had gotten into trouble. Then I went to Enforcement and helped look for people who should be in trouble. Now that I am doing compliance work, I help people stay out of trouble. That is what we are trying to do with our examinations.

How many examinations do we conduct each year? For broker dealers 600-700, for advisors 1,300-1,400, investment companies we examine by the complex, not by the fund, and we conduct somewhere around 200 or so. Transfer agents, clearing agencies, SROs, and all the others make up the rest of the total.

A colleague of mine is here from the Division of Corporation Finance, and just to clear up some ambiguity that people bump into, through historical happenstance, the individuals who review filings in Corporation Finance are called "examiners." We are called examiners too, but the two functions are not related. I have received calls from people who tell me they have an "examination question," and as they describe it, it turns out to be a Corporation Finance question. So, unfortunately we have the same name for two different functions.

Next question, how do we decide who we are going to examine? This is really where the rubber starts to hit the road. How do we figure out who we are going to visit? At this point, when you're representing a client, in your retainer letter the client says you will represent it during any examination. You may be here today trying to figure out what is the likelihood that your clients will actually be examined. It is not an easy calculation to make these days. Even just a few years ago it would have been fairly straightforward, certainly for advisers, because we had a five year cycle in which we committed to seeing all advisors at least once every five years. Broker-dealers have always been treated a little differently because we can rely on their SROs to provide front-line oversight.

Today everything we do is risk based. There are several different risk selection processes. For advisors, we take your registration information, run it through an algorithm in which we take each piece of data, weigh it and then score each answer. We then roll the firm's scores together and get a single score. We then take the high 10%, the ten percent that appear to be the most risky, and we visit those firms on a regular basis. We call those our regular examinations. We have committed to visit those firms at least once every three years, although usually we see them more often than that. For broker-dealers we generally look at systemic risk, that is, while we will respond to problems, the firms we pick out for regular oversight, particularly of their internal controls, are the firms that are big enough in a particular market segment that if they have a problem there could be significant collateral consequences.

Another way we assess risk is through a new tool called RADAR.[3] If you are familiar with risk management at most big firms, most big financial institutions, it is similar to the processes that they often use. All examiners, and we have over 800 of them, so we have a lot of participants, all examiners identify the risks that they have seen or that they worry about and put them into the RADAR database. In their input they identify the risk itself, the likelihood of occurrence (that could range from happening now and frequently to not happening yet), the significance of the risk (from catastrophic through background noise that could grow), and then we have two risk managers in our office who assess this data and prepare reports. Much of what we do is driven by these risk assessments.

Finally, we are procuring commercial databases. Those of you who are law students, I had a chance to look at your law library and it looks like a really fine library. You probably have a lot of commercial databases available to you there. If I were you I would use every opportunity you have while someone else is paying for those databases to learn about them and to become skilled in them. There are commercial databases that are wonderful tools until you get the bill. We have some of them and we use them and we have people who have become very skilled at them. But it's a great skill to have. We use the databases as a check on our other risk processes. For example, we can use them to ask "Who are the outliers in performance? Who has performance that is consistently higher or consistently lower than everybody else?"

As you can see from all of this, if you are sitting there with your client and your client says "Give me the bottom line. What is the likelihood that an examination team is going to show up at my front door anytime soon?" You will have to raise your hands and say, "I have no idea." To tell you the truth, if you were to ask me I would raise my hands and say, "I have no idea either."

We have a lot more flexibility, we have a lot more ability to respond to emerging issues but the predictability factor is much, much lower. We are trying to make sure that no one escapes oversight for too many years. That is something we are looking at. But at the same time, one of the methods we use to test our risk processes is to select firms randomly for examination. Our colleagues in the Office of Economic Analysis use random sampling techniques to select low risk advisers for examination. With these random selection techniques even we cannot predict who we will select.

Let me give you a couple of the most common deficiencies.

[3] Risk Assessment Database for Analysis and Reporting

Audience Member: What percentage of your examinations originate in referrals from some other source, be it agencies within the SEC and other agencies or SROs?

John Walsh: I cannot give you a hard number, but we have a fairly large referral system.

We do a number of things with the SROs and we also oversee the SROs. The statutory authority for examining SROs is identical to the authority for examining broker-dealers. In fact, it is the same section of the Securities Exchange Act. We call our examinations of SROs “inspections.” The office I am with is the Office of Compliance Inspections and Examinations. People ask: “what the difference is between an inspection and an examination?” The answer is none. The controlling legal term is examination, but when we examine SROs or funds, as a historical matter we call those examinations inspections.

We actively oversee the SROs’ programs. I understand arbitration is going to be a topic of discussion today. We inspect the arbitration programs. If in your arbitration practice you encounter issues that you think should be brought to the SROs’ regulator, don’t hesitate to give me a call. In answer to your question about referrals, I would consider that a referral from a practitioner, and we can get those.

We also get referrals from other agencies. We’ve been working really hard in recent years to build better information sharing relationships, for example, with the bank regulators. We have gotten to the point with the Federal Reserve that we now share information with them very regularly. We have conducted joint examinations with them. Recently, we engaged in joint rule making with them. So I think that relationship is getting very good and there has been a good flow of information back and forth.

We get information from foreign regulators. We share information with the Labor Department. With the Defense Department we have an initiative looking at sales of securities to the military. We have had contracts with the Defense Department’s Inspector General’s Office. We give information back as well. For example, we may give information to the insurance regulators saying, here is something that we cannot do anything about, perhaps you could take a look at it? Information like that is flowing much better than it used to.

Let me give you a couple of the top deficiencies and then move on to the practice pointers. The deficiencies for advisors- let me give you the top five. They are fairly general categories as you will see.

Number one is information disclosure, reporting and, filings. It's a pretty unusual examination of an advisor not to find something wrong in the brochure, in the registration data, or something like that.

Number two, a relatively new one, is the Compliance Rule. The compliance rule went into effect a few years ago. The Commission has brought very few enforcement actions under the Compliance Rule. By my count, two, and one came out just two weeks ago. But we are writing a lot of deficiencies. So this is an area where right now I think the agency is proceeding mostly by examination.

Number three- personal trading- this is always a critical issue.

Number four is performance advertising and marketing.

Number five is another new one- information processing and protection. In the electronic marketplace, the electronic world we live in, protecting information, safeguarding it, making sure it can't be changed after the fact, issues like that have become very important.

For funds, you can take pretty much the same list and throw in corporate governance and you have a pretty good list of leading deficiencies.

The deficiencies for broker-dealers: Number one is supervision. No surprise, that always a concern to us and to the SROs as well.

Number two is books and records.

Number three is AML. AML has become the third largest deficiency so this is really a critical area. This is relatively new. At the very beginning when AML was first rolled out, all the regulators, the NASD, the New York Stock Exchange, the SEC approached this almost in a didactic way. We understood it was new for you. A lot of services were provided to help the firms learn about this area. Enough years went by and we kept finding deficiencies, and recently the Commission brought its first AML enforcement action. So I would tell your clients that if they are coasting on the fact that we are taking a sort of user friendly, let's work through this together kind of approach to AML, it is past time to get serious and make sure they really have their systems in place.

Number four is net capital computation errors.

Number five is suitability and misrepresentation.

Ok, shall I jump into practice pointers for examinations? I have seven of them.

Elliot Spoon: Fire Away.

John Walsh: Ok, number one: an examination is not litigation. I have seen very skilled litigators, people that I respect a lot as litigators, get involved in an examination and mishandle it badly. There are several reasons for this. The starting point is the deficiency letter.

You have to remember that a deficiency letter -- the letter we give you at the end of the examination telling you about your problems -- is not an enforceable judgment. In fact, as a legal matter, you could put it in the category of a letter from your regulator saying, "would you please do this." It is voluntary. There are no sanctions for ignoring it. It is basically us telling you that you are on notice, that we think you have the following problems. Now let us suppose you get this letter and you say: "forget it, I am not going to do anything." Well, a couple of things could happen. If the problems rise to the level of possible violations, and we write deficiency letters all the time where the problems could rise to the level of violations; if you choose to ignore our letter the Division of Enforcement could come in and the Commission could bring an action against you. Or alternatively, if the problems are control weaknesses and you do not do anything to fix them and they eventually lead to violations, well – this is similar to old-fashioned tort law- you were on notice because of our letter that you had weaknesses in that area. Because of that notice, when you fail to take corrective action, you are going to have a hard time later arguing good faith or arguing that you did everything you could to prevent the eventual problem.

Hugh Makens: You may absolutely with 100% certainty, know that on you're next inspection; their checklist for the visit begins with that letter.

John Walsh: Yes, there are a lot of things we do not know. But one thing we do know is what we told you in our last deficiency letter.

Also, because of firms' interest in using our letters in a marketing context, we are looking very carefully not only at what you have done to respond to the problems we identified, but also at how you are characterizing our letter. Last year the Commission brought a case against a firm where we had written a deficiency letter for several problems and the firm was telling consultants and putting into requests for bids that they had had a clean letter. The Commission brought an enforcement action against them, saying that this was a false representation. If you are going to make things up, don't make them up about the deficiency letter because we will see that one for sure.

Clarence Pozza: John, if I could – Don't if you get the deficiency, whether if it's from the SEC or FINRA, whomever, says yes, we're going to take steps and I will personally make sure that we inspect this office- I assure you it will be done the next year. It hadn't been done, so the vice president manager said I assure you I will do it this year, didn't do it, and by year three there was a major regulatory issue and when the litigation flowed in it took a lot of work to undo these assurances and lack of follow through. I think a broker-dealer or an advisor, really it's the most important thing to follow up on the deficiencies and keep a careful record of what has been done, and a common sense approach to the deficiency, not a legal one, a common sense approach.

John Walsh: I think that is right. Put yourself in an examiner's shoes. Ultimately the decision the examiner has to make is: can this firm be trusted to fix the problem voluntarily? If I give the firm this letter and leave; is it going to fix it; or will it take a binding order of the Commission to get it to fix the problem? A lot of times that is the thought process an examiner goes through when he or she is contemplating an enforcement referral. Going back to the earlier point that an examination is not litigation, well, if you take the approach, we are going to stonewall, we are going to scorch earth, we are going to deny everything, and fight to the last trench to avoid having to face this problem, well, an examiner in that situation could say: "I think this has to go to Enforcement because that is the only way to get the firm to pay any attention to the problem." It is an old saying and I think it is true- one of the best ways to turn an examination into litigation is to act like it already is litigation.

Hugh Makens: A couple of observations on your letters. First, the SEC, FINRA, make mistakes when they conduct inspections.

John Walsh: We are not always right.

Hugh Makens: Everybody is human. They may end up talking to the wrong person. They may end up misinterpreting data. The may not be provided complete sets of data from the firm. There may be information that's important by way of background from someone who is not in the office at the time the inspection occurs. There are 101 different things that can cause those letters to be either incorrect, misinterpreted, or which can cause you problems later on down into the litigation trail. Therefore, it's important to do several things. Number one- respond internally to the letter immediately, don't put it off. Secondly, once you've started going through the letter, look at each of the items in detail and prepare a response back to the SEC that says thank you very much for your letter, we appreciate your inspection, in response to your comments we have done the following things. Next, if there is a misapprehension or an error, discuss in the letter you noted the following; however, we have the following additional information which we think will be valuable in your evaluation of the information. So when they come in next time, they don't start with the bad information, they start with the corrected information. If you have a disagreement on something, and back to your point Rocky, it's something the firm is going to correct, but hasn't corrected right away, or that you don't feel needs to be corrected, take a look at your systems and your disclosures and see if there's something you could do that would be a significant step toward resolving the issue in the minds of the regulators and protecting your client and yet at the same time, if you don't feel that the entire baby needs to be tossed out with the bath water, keep the baby, throw out the bath water.

John Walsh: I agree with everything Hugh has said. I would only add one layer to it. We agree so completely with everything he has said that we have instituted a new practice, which is a mandatory exit interview. The reason we did this is we want everything he described to happen, but we would like it to happen before we have written a formal letter. We would like it to happen before the letter is finalized. So, other than in fairly exceptional circumstances, and they run maybe three, four, five percent a year, something like that; in almost every examination we will have an exit interview or an exit conference with you in which we will tell you orally everything that we are going to put into the letter.

Many examination teams will read you a draft of the letter. I think that is great because then you not only hear what will be in the letter, you can hear the tone or tenor as well. As Hugh said, you should not hesitate to say: well wait a second here, I think you have that wrong; or you did not talk with this person; or you must not have seen this report; or yes we agree it happened but we think it should not be described under a fraud standard. We tell our examiners: do not negotiate, but listen very carefully and go back to the office and respond to what you heard. So a lot of those issues hopefully will be resolved before you receive the deficiency letter. Once that letter is out there, it is a lot harder for the firm to explain things. It is also harder for us too, human nature being what it is, to say oops, we made a mistake and not only that, darn, we put it in writing too. The mandatory exit interview provides good quality control for both of us.

Hugh Makens: A couple of other comments on that process. The states will not necessarily have the same exit interview process. Some states will give you an exit interview, some states will leave, send you a letter back afterwards and some states will leave and you don't really know what's going to happen for the next five years. Those you need to push a little bit more if you can to see if something is coming up. FINRA will usually give you an exit interview, but there will be circumstances where there will be open items and that's something we didn't discuss. There may be open items because they may take documents back with them and analyze them back in the office rather than on site. So those documents can lead to additional comments or conversations and the extent to which you can stay in touch with your examiners during the period of that evaluation– it's often helpful to cut again off misapprehensions.

John Walsh: It is very common for us to take things back to the office. We may give you an exit interview as we're leaving your offices, but with warnings that what we say is contingent on further review in the office. Usually the dispositive exit interview is done a few weeks later, after we have completed the in-office review.

We also -- and again Hugh, you're right on the money here -- another problem we used to have was that examiners would leave the firm and leave it wondering: "whatever happened to that examination." Months and months could go by. So we now have a procedure where at 120 days out from the examination, if we have not resolved it, then we will contact you, give you a status report, and talk with you about our expectations for how we are going to resolve it. Most examinations are resolved within 90 days, more or less, so by 120 days we are not going to have that many still open. But there are always those situations where a lot of time will go by.

I would like to note one exception. If you were examined during the market timing days, back in 2004, 2005, we made a decision to treat those differently, with no close out interviews. So if you have what you think is a pending market timing examination from 2004, I can tell you that all of our market timing examinations are closed. Please note that I do not speak for the Division of Enforcement.

Hugh Makens: I got involved in representing the bank . . . that did much of the trading. So we saw all those correspondence with the funds and spent a good deal of time with your Los Angeles office.

John Walsh: Quality time.

Hugh Makens: Quality time. A couple of other things to note. The single most important time for the attorney to be involved is at that exit interview time. You don't need to be at all of them but there's a good opportunity to ask questions and help prepare that follow up letter. There is no better opportunity than to be present during the exit interview, which may be a phone interview. If your client doesn't expect any significant, fine, no reason to be there. But if there are significant problems identified, you may even ask the examiners, would you mind if I called my attorney and tried to involve him or her in the conversations so that they can get the background of what's going on.

John Walsh: Attorneys ask: "will you hold it against my client if I make an appearance in the examination?" The answer is: absolutely not. It is entirely up to the firm if it wants to have the advice of counsel during the examination. So when do we usually see counsel appearing during an examination? Certainly at the exit conference, that is fairly common. Next we see them at interviews, particularly if the examination team needs to interview the CEO or someone like that. The higher up you go in the organization, the more likely that counsel will be sitting there. In some cases I think it is mostly a relationship issue between the counsel and the firm. Least common of all is to have counsel sitting there day-in-and-day-out, while the firm produces records and we review them. But again, that is the firm's choice if it wants to do that. Of course, the examiners might start to wonder: "Gosh this has got to be incredibly expensive for the firm, why are they doing this?"

Another question that comes up in this regard: can you assert the attorney-client privilege in an examination? Yes, you can. We respect and support the attorney-client privilege. Some regulators have suggested that their statutory examination authority trumps the common law attorney-client privilege. As a lawyer, I state no view on that. I state no opinion of law on whether that is a correct legal analysis. Simply as a practical matter, putting the legal issue aside, we want firms to get good legal advice. So if the privilege comes up in an examination, we will respect it. We will ask you to create a privilege log, which is standard practice, identifying the records that you believe are privileged. And if we are interviewing someone and you say I would like to assert the attorney-client privilege, or step out of the room, of course, that is acceptable as well.

Clarence Pozza: John, Hugh, if I can. Hugh, one thing I strongly disagree – a lawyer should always be present; the client should have a lawyer in that room because you never know what's going to happen. If it's appropriate of course. But, we need to get retained since that bear market ended. Secondly, on the attorney being present- if at the exit interview, certain issues can be headed off and the lawyer can then interact with the client and say look, you may not want to do this but it would be better if we get this resolved right now so that it doesn't come out in the letter. The lawyer of course seeing what is out there in terms of the icebergs and the minefields that may be down litigation wise. It's much better, as has been noted, if it's taken care of before the final letter comes out. On the privilege, from my perspective there are a great many clients who feel that, in general, not singling out any regulator, that if they assert the attorney-client privilege, especially with younger regulators, that they are kind of being branded as someone trying to hide something or scofflaws. There is this feeling out there and I've seen it for a long time.

John Walsh: I think that depends on what you are asserting the attorney-client privilege over. We have seen firms that have taken institutional steps, like handing all compliance reports to legal or handing all internal audit reports to legal and — as far as we can determine, it is simply adding a dotted line on an organizational chart — and then saying that everything that happens in Compliance or Internal Audit is now privileged. We have seen privilege logs where communications are from a business person to a long line of business people and CC'd to a lawyer, and the firm says because a lawyer was CC'd on the communication it is privileged. These types of situations can make us skeptical about some assertions of privilege. You can expect us to ask questions about them. On the other hand, if you are carefully choosing your communications and you are giving us a good privilege log that shows the basis for the privilege, then we should be backing off; we should not be pushing you.

We do not adjudicate whether or not a record is privileged. This is true even when you accidentally give us something that you later say is privileged. We have a procedure for that. If you timely contact us and say "we accidentally gave you something, can we have it back," we will generally ask you to give us a letter explaining why you still believe it is still privileged, and we will ask you to sign a letter agreement. It is a standard letter that basically says we are giving it back to you and in return you will not assert any fruit of the poisonous tree against us. And we've actually done that several times. We have also said no. Usually the reason we say no is somebody waits five or six months before they call up and say "we gave you something by accident and we want it back." At that point, we say, we cannot unscramble the omelet.

All of this goes to our respect for the privilege. Let me give you my phone number. It is (202) 551-6471. That rings on my desk and only my desk. We also have an Examination Hotline and its (202) 551-EXAM. The Hotline gives you an alternative of the Inspector General or me and a group of attorneys who sit around me. We are open to hearing from you if there is a problem. If you believe an examiner is putting pressure on you to waive a valid assertion of the privilege, give me a call.

Hugh Makens: John, could we get your home phone too?

John Walsh: That is funny because we created the Examination Hotline a couple of years ago and advertised that if you have a problem on an examination, call the Hotline. But I like to give out my own number too. By the way, if you are really in a hurry call the Hotline because I am out of the office a lot. But almost invariably, the Hotline-type issues I get, I get either in person at a conference like this or on my direct dial. People call me up and they say: "You know, I have an issue that I think may be a Hotline issue, and I am thinking of calling the Hotline." I say: "Don't worry about it. The only difference between this line and the Hotline is that the Hotline is two buttons down on my phone. What do you have for me?"

Hugh Makens: I have one observation on the attorney-client privilege issue. There is a tremendous amount of material that has been written on this in the last two years. American Bar Task Force reports, the Justice Department . . . versus Thompson memo, the McNulty memo, then defenses of the Thompson and

McNulty memo as they evolved over time, a lot of independent academic writing, so there is a wealth of information out there. I'll give you a forecast. What I think is going to happen is that there's going to be a significant backing off on the regulatory side for demands of waiver of the attorney-client privilege. But, the trade off for that I believe is going to be that we are going to see a much tighter definition of what's actually privileged and what's not and we're going to see the regulators attacking claims of privilege that are essentially spurious. You're right on the quality of the claim. I think John is exactly where this stuff is going and ought to go.

John Walsh: Just a process issue- very few examiners are attorneys. I am an attorney. Certain areas of the program, for example, our oversight of SROs, tend to have more attorneys. I am glad to say we are getting more attorneys in the other areas of the program as well. People who want to have a legal and a compliance practice and for those of you here in the law school, it is a great career track. I am not here to recruit, but if you are thinking about government, let me urge you to think about coming to the examination program because you go through both compliance and law.

But having said all that, because so many of our examiners are not attorneys, we disavow any responsibility of telling you that you have given us a privileged document. That is up to you. And we will not ask you to waive the privilege. But we may ask you for things that you think are privileged. It is really up to you at that point to say that is privileged.

So it is very important, I think Hugh, you said it, to speak up. Do not be shy. Let the examiners know that there is an issue. I get calls from people who will say: "An examiner asked for X and I gave it to him. Then the examiner asked for Y, and Y is plainly privileged." I may say, "It sounds like you are right." In those situations you should tell the examiner. It may be a great line of inquiry, but if it is privileged, we should back off. And we do.

Hugh Makens: One other place where you will play a role during the examination. The examiners, if there is a significant weak spot in their background, is in the area of product knowledge and particularly in the area of private offerings. So often examiners will ask questions, they will jump to the conclusion that because there is a POP there, a public offering procedure, that that same procedure is going to apply for private offerings. This is particularly true if you're doing institutional or highly sophisticated investor placements and I've been called on several occasions to come in and get on the phone with the examiner and just explain to the examiner why this was done in this way, what the legal basis was for documenting in that fashion. Why they don't have full written prospectus and instead end up with this pile of documents and a letter on top it's a process that you can provide a good deal of assistance in and alert your clients if in fact they're involved in private offerings, and the examiner's got questions, bring you in earlier rather than later.

John Walsh: We actually have a very well defined training program, where we have different levels of training. It is like a graduate school in securities compliance. We have general and focused training programs and they go on all the time.

But even with that, there is no question that examiners or an examination team will walk into a shop and will need help from you to understand what you are doing, what your business is. But I have to tell you, it may annoy you that you have to spend your time educating examiners, but that is preferable to having them walk into your shop with all kinds of preconceived notions. You do not want examiners walking in your door and saying: "I already understand your business and I am going to tell you how you should run it." It is much better for them to come in and say: "I need to learn about this."

Just as an aside by the way, Mr. Kennedy, our first chairman, and father of the president, was a very famous financier. Very few people know that he actually learned the trade as a bank examiner up in Massachusetts. He got out of school and worked for several years as a bank examiner. Apparently he used to say that everything he needed to know about finance he learned as an examiner. And part of the reason why our examiners end up with the knowledge and expertise that they do is because they get the opportunity to talk with firms and with people like the people in this room.

Hugh Makens: We should also bear in mind of course that when President Roosevelt appointed Kennedy as the first chairman of the SEC, the truth of this I won't represent, but that supposedly, Kennedy by the way was regarded as one of the great rascals of his time- he was a manipulator and he was asked by one of the members of the press, in informal conference, or off the record conference, how could you put someone like that in charge of the SEC, and his response supposedly was it takes a crook to catch a crook.

John Walsh: I have to tell you I have been in this long enough that every once in a while when we encounter a new scheme, and it is a fraud, it is horrible, and I will say "Wow. That is a neat scheme. That is really cleaver. How did they come up with that?"

Well, a lot of the practice points I was going to talk about have been covered. There are just a few others I would like to toss in.

Actually Rocky, you said this. Let me just reiterate. Maybe I can do it with a war story. I was on an examination. We were conducting an interview and the interview went really badly in a completely unexpected way. By the end of the interview, the people with the firm and the attorney that was the examination facilitator got up and left. We were looking at each other, saying that none of us had expected this development, that the tone of the examination had to change, and we started making plans on what we were going to do. Within minutes the attorney who was representing the firm in the interview came in with the General Counsel of the firm. This was a pretty big firm, and its General Counsel was a pretty serious position. They said we understand what just happened and we are very surprised by it and from the looks on your faces, you were surprised as well. We are going to set up an action team as soon as we leave this room to look into what happened. And the General Counsel, going back to the comment that Rocky made, the General Counsel said: "I personally commit to you by the time you leave our offices at the end of the week we will have a report to you on what is going on here. We're going to find out how wide-spread it is and what the issues are." They did that. They made that report. Actually, by the time they were finished and we were finished it did not even have to go into the deficiency letter. We decided by the end, that it did not even warrant writing it up.

To me, that really reflects where the attorney can play the most positive role. That is in getting out ahead of trouble and fixing it. Again, going back to the underlying concept, we ask: Can we trust you to fix the problem or have you convinced us that the only way you are going to fix the problem is to have the Division of Enforcement and the Commission compel you to do so.

One final practice point: record production must be prompt. That is the regulatory standard. If you bring a litigation mindset into an examination, where subpoenas are not instruments of discovery, but instruments of dispute, you are going to get yourself into trouble and your client into trouble very quickly. If there is some reason why you cannot produce something quickly, let us know. We are happy to work with you. We have a practice called a "rolling production," where we ask for a certain number of records and you produce them with a rolling schedule. On the other hand, if you are in there fighting over every request, dragging it out, stonewalling, that's going to be a problem.

By the way as a legal matter, we have authority for broker-dealers, SROs, and advisors to see quote "all" of their records. This is probably the single most misunderstood part of the examination program. People think we only have authority to see required records. The law was changed in 1975 to all records. In our reviews we never ask for all of a firm's records. But the intent is that we do not get tangled up in relevance issues. If we ask for it we should get it.

Audience Member: Do you go in take a picture of the computer then leave? Are you being given accesses to the computer to the emails to the native document sent in native form etc. and what is your position on that?

John Walsh: In terms of taking an image of a computer we do not do that. There are experts in the Division of Enforcement who take images of web sites, or do other forensic work, but in the examination program we generally do not.

In regards to access, we do not want production access to your system. I have been on joint examinations with other regulators who may obtain access to the registrant's systems. We do not. I do not want an SEC examiner in the chain-of-custody when you have to explain who had access to the record.

As for emails, we do ask for emails. If they fall within the scope of the communication rules for broker-dealers or investment advisers, they are required records and you should have them. In 2004, in the immediate aftermath of the market timing crisis, we encountered problems in unexpected places. To put it in risk management terms, we realized that we needed to reassess or risk assumptions from the ground up. One of the ways we did this was to ask for blanket email production. We were very up-front about this. We said that our goal was to determine firms' corporate cultures of compliance. Now the risk assessment system is much more formalized and our email requests have become much more targeted. For example, a typical request today would be for all e-mails between the people creating advertising and the people reviewing it within a certain period of time, something like that.

Your final question was on native format. We take the view that how you keep a record is how we should get it. If your way of keeping it is printing it out and keeping it in hard copy then that is how we should get it. We always get worried when you start changing a document for purposes of producing it. So if you're going into a document and stripping out the meta-data, I would advise you to be extremely careful. I realize that metadata is an issue bars around the country are wrestling with. My concern is that if you are reaching into a document and changing it solely for the purpose of producing it for us, that is extremely worrisome and I would urge you to be very careful. There is probably no better way to turn a problem in an examination into an enforcement referral, then by backdating or falsifying documents, or tampering with documents.

Audience Member: What about e-mails that are accidentally not turned over?

John Walsh: I am not allowed to give legal advice but my practical advice to the firm would be to call up the examination team and tell them: "we just found more." The Commission has brought an action against a firm that claimed its production was complete, and then later found copies of records they had claimed were missing. In its order the Commission talked about how the firm took no steps to bring the records to the Commission's attention.

The accidental production procedures that I talked about were developed at about the time we really started to get into e-mail production. We recognize that when you produce e-mail, accidents can happen. We made sure we had a system set up so that when there is a glitch in the production system and accidentally produce e-mails that were – say, to and from outside counsel -- there is a mechanism in place to get those back.

Audience Member: Back in the old days we didn't Bates Stamp anything and that was thought to be good, but today we have to do almost the exact opposite.

John Walsh: The Commission has issued new guidelines on FOIA requests. Our records from examinations are exempt from production under FOIA. That is Exemption 8 if you want to look it up. Nonetheless, the new procedures say you should Bates Stamp all the pages of the documents you produce when you want to claim confidential treatment. There was some real groaning about that. Well, in the event I think the new procedure has been good for both the firms and us. It helps us manage the documents when they are all numbered like that. It also helps the firm keep track of what it has given us. I have no problem if you make sure you produce your files in a way that helps you keep track of what you have given us.

We have also found that the FOIA procedures help us when someone tries to subpoena the records you have given us. We then have an argument that you carefully complied with the confidential treatment rules under FOIA. I am aware of a situation where an ALJ dropped the whole thing and said "I'm not going to issue a subpoena." I think it was very helpful that the firms had complied with the FOIA procedures.

Audience Member: Hedge funds--what has happened with the hedge fund situation, maybe they can create a financial system crisis because there is so much in the security and dollar amount assets that are not really transparent or subjection to regulation. Also, *State Administrators v. SEC*—is there a divergence? What about the poncy fraud situation?

John Walsh: On hedge funds: I want to be very prudent in what I say. The Commission adopted a rule regulating hedge fund advisors. It was a highly controversial rule. The Commission split. Two Commissioners wrote a very strong dissent on the rule. I work for the Commission. So I am not going to go back and comment on that rule making one-way or the other. Other than to say, in regards to the transparency issue that you raised, we do not really know what is out there.

Secondly, the Commission has taken steps to address the decision that vacated the hedge fund adviser registration rule, Goldstein v. SEC. It was a very broad decision. One of the issues that came out of it was that you could read it…..I am going to put my lawyer hat on and say I am not personally advocating this reading, I am merely saying one could read it to say this….one could read it to say that the existing anti-fraud protections of the Advisers Act protected the fund, but not the individuals who were invested in the fund. Under this reading, defrauded investors would not be protected. In the words of the Commission, the decision left this "unclear." The Commission has recently adopted a rule to fix this. The rule prohibits advisers from defrauding investors in hedge funds. But what will happen on the larger field in general I do not know.

In terms of Ponzi schemes, we have seen a number of them. I heard someone say once, and I think it's a great line, that he thought Mr. Ponzi's first name was "Classic." It is always a "classic" Ponzi scheme. There are a number of them out there. One area where there seems to be tremendous growth in this field is internationally. Cases include a firm that claimed it was located in Uruguay and had business all around the world. In fact, it was boiler room in Spain and that was about it. Nonetheless it was able to raise money from people in 20 different countries. This kind of growth activity is significant.

We have a new initiative called the PAUSE Initiative.[4] The goal is to try and figure out what we can say in a real time setting if we think one of these global Ponzi schemes is going on. We cannot publish unajudicated facts. We cannot say: "this is a boiler room in Paraguay." On the other hand if we think someone is operating a Ponzi scheme we can quickly disclose their registered status or whether they are affiliated with an international organization. That is something we can disclose immediately.

Many of these schemes claim to be U.S. securities firms or to be approved by some international organization, often an organization that does not exist and has been made up. We can quickly say that we have no evidence of their registration.

Audience Member: Is PAUSE a website?

John Walsh: Yes, correct, it will be. You know the government, we love acronyms.

[4] "Public Alert: Unregistered Soliciting Entities" Initiative

Again, what are the facts that we can state accurately from our own records without adjudication? Are they registered yes or no? Are they registered as a broker dealer?

Ponzi schemes, "Classic" Ponzi schemes are a huge issue.

Are there any more questions, we are about out of time; I realize there are only about 42 different subjects we didn't get to today.

Audience Member: How much power does the SEC have over the SRO, or is it a voluntary relationship?

John Walsh: Actually the answer is: both.

We have power to oversee and examine SROs the same way we have to examine broker-dealers. We have a very active inspection program. There are some inspection programs we do on a regular basis, and others that we review less frequently. We are very active in reviewing them. We have a staff that works mostly out of Washington DC that specializes in SRO oversight. We actually have two groups. One that looks at the SROs as self-regulators, the other that looks at them as market places. So in that regard our oversight is very formal.

In another sense we are colleagues, we are both interested in the same things and we recognize that there are a lot of benefits from working together. There are a number of areas where we want to work in the same direction: sales to seniors or sales to the military, things like that. We work to make sure we are really in synch. We talk to them regularly and we draw up consolidated approaches to how we are going to deal with these issues. We even get down to the level of preparing lists of possible firms to examine and we say we will take these, and they say that they will take those. And then we get together at the end and compare notes.

It could be an awkward situation, I know, because we work together and then we also oversee and examine them. But it works.

Audience Member: Does the SEC have any say in the structure of the governance of an SRO?

John Walsh: The Commission is very interested in working with the SROs in making sure that they comply with the Exchange Act in their governance and other issues as appropriate. In the examination program we go in to see how the existing structures are working. So yes, from an examination perspective we are interested to the extent it relates to our oversight. But as to the review that the Commission gives SRO governance when they go public, or merge, or engage in transactions like that, I am not really in the best position to answer that.

Audience Member: A gentleman has active trading strategies, and he is concerned about some hostility to that particular strategy and asks what particular compliance issues he might face.

John Walsh: I have no problem with any lawful trading strategy so long as you are disclosing it to your clients and they know what they are getting into. The only time we have concern is when you're not making that disclosure. Market timers for example, it is very important to remember that some forms of market timing were legal. There were legitimate market timers and there were funds that held themselves out as available for timing. That could be fully disclosed and fully appropriate. It was the ones that were doing it surreptitiously and secretly that caused the trouble.

What kind of special compliance issues might you face? That is probably a bit more than we have time for, but I would start by saying: take a look at your disclosure and what you are telling your clients. Will they get the full picture; do they understand what you are doing? If you think there is something about what you are doing that is counter-cyclical or against the conventional wisdom -- and from your question you seem to suggest that -- it might be a good thing to make sure they understand. Flag it for them and tell them why you think it is still a good idea.

Audience Member: Could you quickly recap proactive pointers?

John Walsh: Sure. (1) An examination is not litigation. (2) Record production must be prompt. (3) In interviews you should tell your clients to do more than just answer the questions. (4) As counsel you have a positive role as a facilitator rather than adversary. (5) An exit interview is not a settlement conference; it is a form of quality control. (6) You have appeals available; don't be afraid to use them. (7) Attorneys really earn their fee during the enforcement referral part of the examination process. Thank you.

Elliot Spoon: Just a few things, one, we have a ten minute break. There's food and drink in the corridor outside because the next section will go right until lunch. Secondly, I want to particularly thank John Walsh for coming here from Washington and note that my former student, a 2005 grad is on the staff and that may have had something to do with him being here.

SECURITIES & EXCHANGE COMMISSION (SEC) ENFORCEMENT ISSUES

Joseph Spiegel: Our next segment flows from the information you just received concerning inspections and compliance issues. What you're going to hear about next is the "oops, we didn't fix it" problem. Steve Klawans is the branch chief, who you hope you never see, of the US Securities and Exchange Commission. He's been there since 2002 in his practice as a staff attorney with the SEC in the Chicago Office. Dennis Egan is a partner and has been doing this work with Butzel for many, many years. And Bradley Schram with Hertz, Schram has also been doing enforcement work for many, many years. I'm going to turn this panel over to this incredibly well qualified group to get some insights on SEC enforcement issues. Gentlemen.

Dennis Egan[5]: This is essentially the next step. You've heard about the examinations phase. Now we're going to move to the stage where we're actually dealing with the enforcement people, not the examiners and that can happen as a result of an examination. It can also happen as a result of other things.

So, I think we sort of work with a bit of a situation, you get a phone call in your office, you have a client who has gotten a phone call from the SEC office and/or even maybe [you've] gotten a subpoena or perhaps a letter asking them for information and the client is going to say "What should I do?" So one of the early decisions you have is to what extent does your client want to and should cooperate with the SEC and if there's a problem down the road, what points will you get in terms of negotiation with the SEC by cooperating?

And I think Steve can at least start off talking about the universe of issues. So the subpoena or letter has come in, you now have a lawyer call you and how does this work and what's your reaction on your side?

Steven Klawans[6]: Thanks, Dennis. First, let me just give you the same disclaimer you heard earlier today that the views I express today are my own and not necessarily that of the Commission or my colleagues on the Commission staff.

---

[5] Mr. Dennis K. Egan is a shareholder practicing in Butzel Long's Bloomfield Hills office. 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). Mr. Egan 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. He also has experience in defending parties in class actions, and the representation of mortgage bankers and lenders. Mr. Egan is Vice Chairman of the Epilepsy Foundation of Michigan and is the president of the Mercy High School Dads' Club.

[6] Steven Klawans has served as Branch Chief since 2002 and practiced as a staff attorney for the SEC in the Chicago office since 2000. Steven has directed the investigation and litigation of complex federal securities cases, including financial statement fraud, disclosure failure, internal control deficiencies, record-keeping and reporting violations, corporate governance issues, insider trading, market manipulation and offering schemes.

Dennis Egan: And my views aren't even my own. [laughter]

Steven Klawans: SEC enforcement process. Let me give a quick primer on how we go about investigating our cases.

The initial stage of the investigation would be called an inquiry and you'll see that language typically in the letter. If it's a subpoena that means we have formal order authority from the Commission. Most typically, the first communication you get from the SEC enforcement staff will be a letter, not a subpoena and it will be an informal inquiry which we don't have subpoena power for.

We are seeking voluntary information, unless, of course, the letter is sent to a regulated entity, in which case the staff should provide, the rules provide that those entities - investment advisory reports for dealers, investment companies, transfer agents - they are required to produce documents to us. However, if you are not one of those regulated entities, any information you provide us with will be on a voluntary basis.

And then from that point, once it's decided on your part whether to provide information, we will, at our level, assess the information based on the allegations and theories that we're working with at that time to determine what securities law violations there may be. And then, if we feel that the case warrants or requires additional information that we can only obtain through subpoena power, such as bank records or we may require testimony, which is also our version of a deposition, we will get the Commission, and recommend to the Commission that they provide to us and authorize us to have subpoena power. In which case subpoenas will be issued, the investigation will follow, getting documents, talking to the witnesses through our subpoena power.

And then we reach a point in which we have to determine whether there is a violation or not, who committed the violation, and what we think we should do about it from a matter of discretion. Even if there is a violation, should this be something that the Commission should recommend an enforcement action for?

Steven has lead investigations of Fortune 500 companies in the pharmaceutical, retail, telecommunications, and financial services industries. His case work involves analyzing financial statements, interviewing witnesses, drafting lengthy recommendation memoranda, negotiating settlements, conducting presentations before SEC commissioners, and litigating actions in federal court. Mr. Klawans has received the SEC Chairman's Award for Excellence in Enforcement and five SEC Special Act Awards for outstanding work. Prior to joining the SEC, Mr. Klawans was a litigation associate at Cassidy Schade LLP and an Assistant State's Attorney in the Cook County State's Attorney's Office where he tried six criminal jury trials and hundreds of criminal and civil bench trials. Mr. Klawans received his J.D. in 1995 from DePaul University College of Law in Chicago where he was a member of the Appellate moot court team and has taught as a adjunct professor. He received his B.A. in 1992 from Indiana University.

So that's basically, in a nutshell, the process and perhaps you can talk about the defense perspective on when you receive a subpoena, when you receive a letter and then I think we should go into once the investigation is complete, what happens with the negotiations of settlement.

Dennis Egan: Steve, from the practitioner's standpoint, client receives the inquiry, typically in our environment here, we have a small local broker dealer, a small R.I.A., possibly a regional broker dealer. The first question of course is "What does this mean?" and "Can you gather any information before we go any further to determine to what extent our exposure is and whether we should be trying to preempt the problem that's occurring?" And as we practitioners try to make that inquiry, what is the position that you give your staff and others regarding discussions about that?

Steven Klawans: Let me first just mention the fact that when we go through our investigations, something that is brought forth in terms of cooperation, we get varying degree of responses to our letters. Sometimes we get folks who will readily make everything they have available, including privileged materials, which touches on the attorney-client privilege issues that we talked about this morning, which I think we'll get into a little bit later, and other times we will receive no response at all from a recipient of our letter or our subpoena, in which case, if it's a subpoena that's being ignored, then we have the ability to go in to court, even though at this stage of the game, obviously in our investigations, we're not in court but we can file an action in federal court to enforce our subpoenas.

Dennis Egan: Certainly the process is the lawyers, you as the lawyer, you got an inquiry letter, you can try to figure out what they're looking for and there is certainly nothing wring with calling the SEC staff member who sent it out, who signed the letter, and ask them what this is all about. I think most of the time they'll tell you if they can't give you all of the information necessarily but they'll work pretty hard to help you figure out what the nature of the item is and what they're concerned your client's role might be. You then have to sit down with your client and find out what happened and hope you get all the information, you need to have them gather documents because I think the one thing that is the most important as counsel, you have to have absolute credibility with the SEC staff lawyer. It means if you've said something happened you've got to be comfortable that it did happen and that the SEC staff lawyer will not find out later that what you said wasn't true. And that includes when you are saying "I don't know." under certain circumstances you investigate. But if you can get a degree of trust with the staff person that will go a long way. So the first thing you've got to do is get an investigation put together, find out what the issues are because only then can you make an intelligent decision as to what to do and what the response to the inquiry should be. Brad, do you have anything to add?

Bradley Schram[7]: No, I agree with that. The difficulty, of course, is in the detail and the circumstances and frequently there will be a multi-faceted investigation where we're not certain whether the inquiry is really targeting our client or whether they are really being used for more informational purposes as a witness.

And the difficulty becomes, as you've just explained, Dennis, in trying to be as forthright and cooperative as possible to create the proper relationship with the staff member at the same time without giving away too much information because we're not sure exactly in which direction this is going. And it may be a problem for us if we're not certain and we tend to lead it in a different direction where we may feel, because of discussions with the client, there may be some exposure but it's not at all the area that the SEC is looking at in this particular instance.

Dennis Egan: And I think at this stage, and I would like to comment at least a little bit on the relationship between his group and the U.S. Attorney's Office. You need to figure out is there a potentially parallel criminal action out there that might affect your client. Sometimes you know. I had one recently that the FBI had already called the client and asked them some questions before I was retained. And it turns out the client really isn't the focus of it but the mere fact that the FBI had called, obviously that means that the federal police and the U.S. Attorney's Office was involved. If you have a situation that might involve criminal exposure, I, at the earliest possible point, want to get somebody, another lawyer involved with that kind of experience. At my firm, we've got some ex-assistant U.S. Attorneys. If you don't have someone in your firm, find somebody who does because there will be Fifth Amendment issues, there will be, all of which will impact to the extent you want to cooperate and unless you are conversant in criminal procedure and have experience in handling criminal matters, you would hate to, as a civil lawyer, be responding to this investigation and find out later that what you did now opened your client up to a criminal investigation and the client didn't realize it.

Bradley Schram: The other side of that, Dennis, can be played both ways because, if in fact then a call comes in from the FBI, that there is a little bit of cat and mouse

[7] Bradley J. Schram established the law firm of Hertz and Schram in 1979 and has served as its President since its incorporation in 1981. As local and regional counsel for several securities firms and developers, Mr. Schram has developed an expertise in the analysis and structuring of private placement transactions that meld the venture capital needs of developers and the protection of the individual and institutional investors. Mr. Schram attended the University of Michigan Honors College, where he received a political science degree with highest distinction. He then spent six months in South America as a photojournalist for several US newspapers before attending Georgetown University Law Center in Washington, D.C. There, he received his Juris Doctorate degree in 1976 and served as Senior Managing Editor for the Georgetown Law Weekly.

going on and it may provide you the opportunity where you're not able to get it from enforcement side, to have a better idea of where it actually is going so you have a better perspective of how to handle it from both ends.

Steven Klawans: You know, one of the issues that I know that defense counsel have, especially early on in the investigation, is to figure out, what, when I get this letter or subpoena, what is my client's role? What is their potential culpability? What is the SEC looking for? And the problem, from our perspective is, when we at the SEC get asked those questions, we're very limited in what we can say. It's a nonpublic investigation. The information, as I often say to defense counsel, is one way.

But not completely. And what I find that effective defense counsel do in our investigations is that they will negotiate the document production. And there's two reasons why they do that. One, obviously, is they want to save their clients the costs of producing a truckload of documents. They also want to narrow the scope of what the issues are. Through that negotiation they can often figure out where their client fits in…. Not every SEC lawyer negotiates the terms of these documents requests. But I often see there's utility on our part to do that because we also don't want a truckload of documents; we want what we need, not everything that's called for by the request often times because we don't know what the client's business is, we don't understand exactly how they collect and store their documents and so I would encourage defense counsel to, if they feel it's appropriate, to negotiate those requests with us.

Dennis Egan: And as Steve pointed out before, sometimes the inquiry letter they get no response, sometimes they'll get a truckload of documents. I actually think ninety percent of the time you do give a response, you negotiate and work out so you can present the documents that you want to present, hoping that that will end the inquiry and not result in formal subpoenas or in escalation. So you have to think through what you're going to offer.

Another issue that certainly has come up and was touched on a bit this morning is obviously electronic discovery. Now the federal rules were amended late last year to formulize production and retention of e-mails and all other types of electronic data. The fact is, in our business, in the securities and a regulated market, we've always had document retention requirements. The thing is now everyone's opened up to the fact that that's not jut pieces of paper, it's electronic data. I think, depending again on the investigation and how serious you think it is, you need to immediately take some action, even if you're just at the inquiry stage, to say "don't destroy anything" because the last thing you want to be in is a position is, yes, even though the federal rules aren't impacted yet because there's no lawsuit in federal court, but I don't want to be in a position that I have to tell the SEC that ten thousand emails were destroyed in between the time that the inquiry letter came in and the time that a court proceeding was started.

They mentioned this morning meta-data. Does anybody here not know what meta-data is? Meta-data is, if you do a Word document, just type up a memo. If you then hit the properties section of your document, you will see that the data was created, it will show who's worked on it, it will show how long they've worked on it, everything from word count to keystrokes. The key information is it shows who prepared it and when they prepared it. You have to be conscious that if you're going to have case where you need to preserve emails, for example, and other types of documents, it's more other types documents, the very fact of having your client's IT department access material for you to look at can change the meta-data because it's now been accessed today and there's less information available. If you're in a situation where you're really are going to feel that we better preserve this material and in the format that it originally was, including the meta-data, you might have to engage a vendor, because there are vendors out there with the e-discovery practice forthright that have the technology to preserve emails without changing the meta-data so that when you do then have to produce it or you need to use it in litigation, you've got the actual meta-data still there.

I'm part of the e-discovery group at our firm and if you're at a smaller firm and you're in one of these situations, give me a call because we've sort of sorted through a lot of the vendors out there to come up with people that are competent because you really have to make sure now and the courts are expecting you to preserve documents even in electronic form.

Bradley Schram: But that practice has changed so much, Dennis. I'm involved in a case right now and the other side is a thousand number law firm and they have actually retained a firm out of Minneapolis that does nothing but e-discovery. Within their thousand lawyer group, they didn't feel confident enough, they had to go to a specialized firm. So it has completely changed over the years.

So anyway, you have gotten the inquiry letter, you've met with the client and you think you know what's going on. You determine whether or not you need to have criminal counsel involved and you've made a decision one way or another. And let's assume you've decided, for the moment, that although there may be some civil exposure, you don't think that the FBI or the assistant U.S. Attorneys are looking at your client in any way and it's unlikely that they will. So now, the question is in dealing with Steve's office, you have to make a decision on cooperation. Cooperation is codified in a number of places, for example the federal sentencing guidelines have them; the fact is the SEC, and Steven can touch on this a little more, gives you credit for cooperating. And you have to sit down with the client early on and explain to them the pros and cons. I had an investigation a couple of years ago, these two guys got caught up in something, they really weren't at all behind it but they got caught up in it and I sat down with one of my partners who was a former assistant U.S. Attorney and we went through here's what could happen if we cooperate, everything they say, everything you say can and will be used against you. You have to go through it and then discuss with them that if, for example, you just decide to take the fifth and not cooperate, here's what might happen. I mean these clients made the decision to cooperate and they were the only people being looked at who didn't take the fifth and who actually answered questions voluntarily. That will ultimately help them. Comments on that Steve?

Steven Klawans: Yeah. You know, I think there are a couple of issues to keep in mind. One is how, if you're inclined to cooperate, what are the ways in which you can cooperate? What do we mean when we say cooperation, especially in the SEC enforcement context? Well, if we're talking about an entity, or I guess an individual as well, you're talking about perhaps self-reporting the misconduct. We have companies on a fairly frequent basis that will literally pick up the phone and call us in Washington or in the Chicago office and say "we've uncovered some misconduct which we think may be a securities law violation and we want to get out in front of it and tell you about it." That kind of cooperation is obviously very helpful to the SEC enforcement process and that's the kind of cooperation that will be recognized by the staff.

Secondly, there may be, within the entity context, the need to terminate employees. If you find an employee that's responsible for misconduct, termination of that employee will also count as cooperation.

We've also got a situation in which you have some sense of some misconduct, you're not sure, maybe it's a whistleblower complaint, conduct an internal investigation of this whistleblower complaint or alleged misconduct within your firm or within the company. Then there's the issue of once you conduct an internal investigation, what do you do with that information? And we often have companies that are willing to provide to us the results of that internal investigation and not assert the various privileges that may apply to that.

I'll get to that in a bit but continuing on with some other forms of cooperation there's also remedial measures and that's critical. If a company, in … cooperation, they've identified the misconduct and they've reported to us what that misconduct was, what do they do about it? Well, you're talking about firing employees, you're talking about changing policies and procedures, and you're talking about training other employees in similar situated positions within the company. You may hire additional personnel. These are all the kinds of the things the Commission looks at when it assesses cooperation.

Brad Schram: On the other side of that, representing the respondents in this instance the kind of broker dealers or the IRA's to frequently closely held entities – few employees, several key employees. The allegations are against friends, family members, key employees. You're looking at situations where they may completely deny what's going on anywhere in the broker-dealer context or the ED context we have CRD or ADD reporting issues where firms may then look at forms of defamation, U-5 issues. So we have to balance that with all of this cooperation at the same time.

Steven Klawans: And I think that the enforcement staff is sensitive to those issues. Their sensitive to the waiver of the privilege issue as well. I can speak for myself and I think generally what I see is that the commission being so sensitive to these issues does not use the lack of cooperation necessarily as a sword. What I mean is if we have an entity or an individual that is purposely thwarting an SEC investigation, not cooperating, that's going to be held against that person or that entity. However, if there is no termination of employees, there's no internal investigation, there is no remedial measures but if at the same time you have prompt responses to our subpoenas, production of witnesses for testimonies, we're requesting information and they're giving us information but nothing more, that will not be perceived as a lack of cooperation and used as a sword against them because we are sensitive some of the issues that you raised.

Dennis Egan: Steve, you have used termination three times. I would assume that the entity could also suspend or cordon off because very often you get faced with a situation if you terminate, you then get the employee lawsuit or there are issues there but some type of cordoning off would be a good substitute given the appropriate circumstances.

Steven Klawans: Those are all forms of cooperation. It's appropriate in those situations.

Dean Elliot: Steve could you repeat the comment?

Steven Klawans: The question was whether instead of going to the length of terminating an employee, would cooperation also constitute cordoning off or demoting an employee or removing that employee from a particular job that person was in. The answer is yes. It makes sense in that situation to resolve some of the issues and the risks in terms of this conduct. Then yes that would be considered cooperation.

Brad Schram: Dennis, the next part of the process to me which is frequently the most difficult is once discussions begin regarding cooperation there may be an investigator, there may be a staff attorney, there may be two or three staff attorneys and then a senior trial attorney as well as the chief of enforcement – all of whom who have varying opinions and their politics within the office is frequently difficult for the attorney to try to decipher those tea leaves to determine exactly what direction its going. Remember, we have a client who really has bet his business on this investigation and in many instances it is the difference between continuity of the business or perhaps the end of a business depending on the consequences that occur here. We have our clients on the phone daily with us trying to help us give them insight into what's gone on. My experience has been, and not in all instances, but sometimes it is difficult to determine who really is carrying the message and whether the conversations and discussions concerning cooperation bring with them the enforceability of the organization itself.

Steven Klawans: I think we're cognizant of those issues. Obviously as I said before, often times the flow of information is one way for folks out in the industry who are witnesses of a particular case and fed us information but not necessarily divulging information such as that. However, SEC staff typically does not comment about cooperation as the investigation is going unless there is a severe deviation from what the normal reasonable standard of cooperation would be. The question is where the client wants to know where do I stand in terms of cooperation, what does the SEC think what I have done? During the course of the investigation it's typically not something that we're really going to discuss. I think one of the reasons is the case isn't over. You can't assess cooperation until the commission has spoken because as any of you realize our investigations our findings or our recommendations to the Commission as far as what action to take is only that – it is a recommendation to the commission that ultimately the commission decides whether there is actionable activity, who should be sued and also what statements to make. For example, in a press release with regard to cooperation, the staff has a lot to say with it but the Commission often times weighs in on that issue.

Dennis Egan: So let's talk about that. The decision has been made. There's an order instituting proceedings. How do the dynamics change at that point?

Steven Klawans: This is another area where I know in speaking to defense counsel over the years can be particularly frustrating. We decide, for example, at the Chicago office, that Brad's client should be charged with violations of securities laws. We will then, at the conclusion of the investigation, make a Wells Notice to the client and in the Wells Notice explain to the client that we decided to recommend securities law charges that the Commission should bring such an action against this individual. From there a negotiation will often take place. It's possible that Brad will say no let's go to trial on this. We're not going to negotiate. Let's say for the sake of argument that Brad's advice that we should negotiate a settlement here. Settlement negotiations take place and we've reached a settlement in principle. Who have you reached a settlement in principle with? Is it with me because you're talking to me? Is it with my boss? Is it with the regional director of the Chicago office? Is it with the Commission. At that stage, and I can't speak for every SEC office, a typical practice, particularly in Chicago is that the principle is going to be approved by the Chicago office, the regional office. Then often times its logical, I can see for a defense counsel who may not be well versed in our process, to say well ok we're done. We got the settlement papers, we've signed off on the offer of settlement or on the consent to enter the injunction, and we're done. Thanks Brad. Appreciate the help and the great counsel you gave us. That's not the end of the story because we have multiple levels of review. Once the consent for the offer of settlement is signed off on, we in the Chicago office will send that recommendation in the form of what we call the action memo. It's basically a 30 odd page document explaining what happened, explaining our recommendation, explaining why the Commission should accept the settlement. We'll attach the consent of the offer of settlement with it – send it off to Washington. What happens? Well, a lot of people weigh in on it. You have the division of corporate finance who will weigh in on issues regarding public confidence. You have the division of market regulation who will comment on the issues with regard to broker-dealers. You have the division of investment management which will weigh in on issues regarding the advisors act, the investment company act. It goes on and on. All of these folks will have the opportunity to weigh in on our recommendation. It's not that uncommon that they will tell us, we suggest that you add this charge, or don't seek that charge. That's how substantive some of these comments can be. It's not add a period here in your recommendation or add a paragraph about this. It can be very substantive in terms of what the changes are. Then you go back to Brad and you say you have to sign a new consent. You have new charges. That shouldn't be a surprise because if the defense counsel is doing your job they have to ask the SEC staff where the memo or the recommendation is in the process. That is critical. You have to ask ask. I'm not saying that every SEC staff attorney will tell you that information but I make it a personal practice to share what information I can because I think it benefits the staff as well if the client is managed properly as to where the recommendation is and explain it as best I can why the recommendation has changed to the extent that I can do that because we also by doing that will get quicker turnarounds on negotiating the second or revised settlement with quicker turnaround executing that document and get this thing through the Commission and done. I guess the bottom line is that defense counsel has to ask the right questions – know where the recommendation is in the process. After the second and revised version of the recommendation there could even be a third or a fourth. The **c**ommissioner's themselves may have a problem with it and cause a revision to remain. You have to know where things stand in the process. As best you can encourage SEC staff. I'm not asking you to tell me state secrets, just tell me where the recommendation is in the process and I think most SEC staff will provide that kind of information.

Dennis Egan: I think the most difficult stage is the initial stage. Most lawyers understand the bigger pictures you've just described. The most difficult time when you're dealing with the staff – the charges have just come out, we're trying to resolve it and there's a question whether under, for example, section 203 of the 1940 Act an investment advisor context that we're looking for a scienter phase consent where the word fraud will be included instead of the non-scienter what many clients would describe as a parking infraction. You're negotiating with the staff member who may be very much involved in the personalities of the case because of the interview process as well as the on the record interview process. There may be personality issues there. That staff member may not like my particular client. It's my job to try to smooth that out and if I can negotiate with this particular staff member, the resolution that I need to save the day for my guy or company because it's a small company and their referrals, they may only have 3, 4, 500 million dollars under assets that are all referrals and if it comes out in the paper, because it will, as soon as they charge them there's a release, and its on page 1 to page 3 of the business section that they're being charged with fraud, that the next stage we can't negotiate that fraud charge out, I'm going to try to go up the chain. I'm going to try to go to the senior person to that staff person and if that doesn't work, I'm going to try to go to the senior trial guy that's going to do it, and if that doesn't work I'm going to try to knock on your door before we get to the next stage you were describing to try to resolve as best as I can. Within that level the communication needs to be very well understood because that's when your client is most vulnerable.

Brad Schram: You also have to manage client expectations. In an auto negligence case, if the lawyer on the other side and you agree to a $100,000 settlement, that's it – it's a $100,000 settlement and its over. Whether you're dealing with the SEC or FINRA if you in fact think you worked out a deal that would resolve the matter you have to tell the client, this is a probable deal that may go through but the point is it has to be approved by someone else and they may not approve it. They may come back to us. I had an NASD investigation a number of years ago and negotiated a fine and a very short suspension. It was put into a settlement document. The enforcement lawyer called me back and said his boss wouldn't approve it. Ultimately his boss did approve it, but he wasn't making it up. He had to go get the approval so the clients need to understand that it's possible that the terms of this settlement may change until there's a final approval of it either by, in the case of FINRA the person that has to approve it or by the SEC in Washington. I think that if clients understand that then they won't be angry with you. If you told them you have a deal and they don't they're going to get upset with you. This way they can get upset with the regulator but at least you told them upfront that this is how it works.

Audience Member: Steve, what sanction guidelines can you talk about that the SEC has as opposed to NASD and FINRA.

Steven Klawans: Well I can speak to the sanctions that the SEC has the authority to impose. We will impose most typically an injunction action in district court. The other forms of relief that we can see are disgorgement of illegally obtained profits. We can assess civil penalties. We can do what we would call officer and director bars, essentially barring somebody serving as an officer or director from serving in that capacity for some period or permanently. We can bar somebody from associating themselves with the broker or dealer or investment advisor. We can prohibit somebody from being involved in the trading of penny stocks which is helpful in our never-ceasing effort to stop micro-cap fraud. Those I think would be the highlights of what we can do.

Audience Member: There are no published guidelines. Is there any effort that you are aware of to publish guidelines as the NASD is published?

Steven Klawans: I'm not aware of the specific publication that outlines the sanctions that I have talked about. Certainly within areas of the federal securities acts, the '34 Act, the Investment Advisors Act, etc., it does provide for these sanctions.

Dennis Egan: Steve, what might be helpful also to the group – could you explain to the group the concept of relief defendant? When you see this formal action come in there's often two different sets of defendants and some of them are relief defendants.

Steven Klawans: A relief defendant is essentially a way for us to get at illegally obtained proceeds from folks who we are not charging with violating securities laws. So for example, if you have, and this often comes up in an offering fraud context or ponzi scheme context in which the main perpetrator of the scheme took in X millions of dollars and he had sent some of that money over to a business associate of his who had no knowledge of the underlying fraud. Nonetheless, he received these illegally obtained profits. The second prong is that his business associate had no legitimate claims to the funds – didn't do any work for the perpetrator, didn't essentially earn fees to justify this transfer. We have illegally obtained profits in the hands of somebody who has no legitimate claims to those proceeds then we will typically name the person as a relief defendant – especially if it's a sizable amount of money that can be used to then distribute back to investors.

Dennis Egan: And you'll do that in the business context as well where those funds have been used by that person to possibly go into a legitimate business using another promoter or another entrepreneur where you can in turn name that entity or those individuals as relief defendants as well to try to reclaim that money?

Steven Klawans: If the proposed relief defendant had no legitimate claims to the funds but used the funds in a legitimate way. It doesn't matter what they did with this. They could use it legitimately. They could go to Vegas. They could put it under their mattress. It doesn't matter. If they received it, if it was illegally obtained funds with no legitimate claim to it they have to disgorge it back now. Of course there's the matter of discretion. Do we want to go through the litigation process against your relief defendant when perhaps the money that they have received is gone? It wasn't frozen at the temporary restraining order stage. Then the SEC may consider well it's not worth our time and resources to go after and then default. We don't charge relief defendants in every case. It's probably more the exception to the rule.

Elliot Spoon: Steve, what about a relief defendant that is given value for the proceeds. If there is some exchange made, and they did not have knowledge of the way which the proceeds were obtained?

Steven Klawans: The question is whether the relief defendant was not aware of how the funds that they were received were originally obtained. Again, it's often an issue that is litigated related to that context. The law in most jurisdictions is that if we can show that the proceeds were illegally obtained by the main perpetrator, regardless of the knowledge of the relief defendant, as long as you can show that prong –

Elliot Spoon: Regardless of that and the value that they gave a bona fide exchange?

Steven Klawans: Well the second prong that would affect the analysis if the relief defendant provided some service that appears to be legitimate for the receipt of those funds, then we likely will not be able to sustain a relief defendant action.

Brad Schram: The next question is can a relief defendant become more than a relief defendant? For example, you find out that the business associate did in fact know that the money was ill-gotten gains and was helping your main defendant try to hide assets from both investors and the government.

Steven Klawans: Yes. In fact, I've had at least one case that I can think of off the top of my head where that happened. At the time that we filed the lawsuit we didn't have enough evidence to charge this person with either aiding and abetting or primary violations. However, we knew that the person had received funds that they had no legitimate claim to. So we named this person as a relief defendant. Then through the discovery process we obtained evidence sufficient enough for us to file an amended claim to add that person as a primary.

Brad Schram: The point is when the document comes in and your client says, "I'm a relief defendant what does that mean?" The focus of the relief defendant concept is they're trying to trace money, they're trying to find where the money went that the main defendant had gotten from whoever he got it from. That doesn't mean, and you need to explain to your client, that doesn't mean that you can't change status depending on your level of knowledge you're your involvement. In other words, there's a reason you have the money. What is that reason? So you need to make that part of the process.

Dennis Egan: Going back to our evolution of the enforcement process, assuming that despite the *Wells* submission and despite the discussions with the staff we're not able to work out a resolution. The question then becomes, as I call it, fight or flight? We're going to make a decision whether we're going to try to case against the SEC. What is your position on what I think is a commonly held belief that the administrative law judge assigned or hearing officer assigned is the same person who will be assigned to handle that case is a representative of the SEC and not an unbiased player in the process?

Steven Klawans: Certainly I've heard that before and if you go one step farther to understand that when there is an initial decision issued by an administrative law judge the appeal of that decision is to the commission. So when you say that the cards might be stacked against you I don't think that will be a mistake but that is the system and short of some congressional action I don't think that system is going to change. At the same time, do we lose administrative actions? We do lose administrative actions. Are the administrative law judges to consider the facts and application of the law fairly? They are. Certainly that sentiment is something that exists.

Dennis Egan: My experience has been that because of the availability to the databases of all of the cases that the ALJ and initial decisions the ALJ has been involved with, depending on the administrative law judge assigned to your particular case, we have another opportunity to view what we feel our chances will be ultimately in fighting this case because there very well may be a similar decision rendered by that administrative law judge to give us some guidance. So I strongly recommend that in any instance where you make the decision to go ahead, and in some instances, you may say, "look we're going to go forward with this," determine who the administrative law judge is. There is a pre-hearing that occurs so you have an opportunity to meet and talk with that person. You then have an opportunity to file a summary judgment motion for example. There may have been previous decisions that have been similar to get some sense for where this administrative law judge will go all the while trying to leave your options open with the SEC with regard to making an ultimate resolution short of a full hearing.

Steven Klawans: And I also think it's helpful to know what the numbers say. What is the SEC's success in litigation? I have a problem with some of those statistics. Let me just preface it by saying that these are approximate – don't hold me to the exact numbers. These are very close to what has happened over the last several years. The number of actions that the SEC has brought averages around 600 or 700 actions a year. It's been a little bit more and a little bit less during some years. Of those approximate 600 actions, how many go to trial or go through the administrative process? It's less than 1% that will go to trial or go to an initial decision. 2007 through September 12th, there were 24 trials in administrative actions that would reach a decision. In 2006 that number was 29. In 2005 the number was 42. In 2004 the number was 43. In 2004 the number was 28. It's less than 1% of all the actions that actually go to trial. The number that I don't have, there is obviously a tremendous number of cases where the decision was made to let's go down the litigation path or an administrative proceeding but it settles short of trial. That is a huge number. I don't have the statistics. Obviously that is a huge number that you have to weigh in the calculus. Thinking about what the SEC success rate is – in terms of percentages of the cases that went to trial or an initial decision, and again these are approximate percentages of our win totals, through September 12th of this year, we had a 72% win percentage. In 2006 it was 92%. In 2005 it was 84%. In 2004 it was 79%. In 2003 it was 84%.

Dennis Egan: Those statistics do not include the number of cases resolved through summary judgment which are less favorable statistics for you I believe?

Steven Klawans: That is correct. We have lost some cases at summary judgment in terms of the liability phase and then more commonly there are, whether you call them wins or losses, adjustments that are made in the proceeding.

Brad Schram: You have to keep in mind too that the summary judgment motion is often a very effective way to find out if that case – you can see what their case is. Even if you don't win the motion you have just learned a lot because they have to some degree show their cards.

Audience Member: Assume for a moment that you have lost or defense counsel has lost the motion for summary judgment. Brad or Dennis do you have a view on the use of experts – the use of experts in this proceeding and an administrative proceeding in particular.

Dennis Egan: Dennis and I talked about this a little bit before. In many ways the administrative law judge is a professional. Unless there is a very specific question or esoteric matter on a trading issue, generally I find that they are more factually intensive and a professional witness is necessary. An example might be if he had a case involving mutual funds or stock purchases or sales for example on suitability I would think the ALJ would view him or herself as perfectly capable of making that decision. If you have a proceeding involving some exotic derivatives, which I'm certain we're going to be seeing, it might make a lot of sense to bring somebody in to deal with questions, for example of valuation of derivatives which is a very complicated thing. It may be repetitious, I think it depends on the subject matter.

Steven Klawans: I was just going to add to this that rule 702 of the rules of evidence which governs expert testimony and the *Daubert* and *Kumho Tire* principals that interpret rule 702, I think they still apply in administrative proceedings because the concept of does the trier of fact need assistance in understanding the issues at hand. You just have to change your assessment of whether the trier of fact needs assistance. If you're talking about a lay jury or judge versus an administrative law judge I think that changes that analysis, but yet the factors to apply, although rule 702 doesn't apply to administrative proceedings nor do the principles articulated in *Daubert* and *Kumho Tire*, nonetheless, if there is a need for the trier of fact, the ALJ to get a better understanding of a complicated factual issue, than an expert, I think, would be appropriate. I saw there have been a few cases in which concepts of 702 and *Daubert* have applied in administrative proceedings. If anyone is interested in those I can provide the cite.

Dennis Egan: Can I go back for one second to the statistics that you were giving? I think we shouldn't lose this point – the favorable results by the SEC in the cases that actually go to trial. We also have to recognize that sometimes even though we go and take a case to trial that the sanctions that are ultimately received may be less than the deal we were trying to make before so you may because both sides finally get the facts out in front of an ALJ it's very possible that the recommendation by the ALJ will be less than the best deal that you could make even though you tried to make a deal. A loss isn't necessarily a loss in each instance.

Audience Member: I would like to go back one step to *Wells* submissions. It's like rooting for the Chicago Cubs or the Detroit Lions, we get our hopes way up [inaudible laughter]. Are there statistics on *Wells* submissions and impact or as a practical matter do they really impact the commission at all as we submit them even if there is a change in what the commission might adjust.

Brad Schram: We have some students too. Does anybody not know what a *Wells* submission is? There's a notice that comes before the administrative proceeding has started and the proposed defendant is given an opportunity to make a written submission. You can make it in a number of ways that basically say you shouldn't do this. Here's our view of the facts and we think you should not proceed. That's called a *Wells* submission.

Steven Klawans: Typically another reason to go through the *Wells* process is that often, not in every case, but often the SEC staff will permit counsel to come in and review it's non-privileged work file. Again, in our investigation there is no discovery process. When you're assessing whether to fight or settle, how do you know what the evidence is against you. You come into our office and you look at other transcripts of depositions and non-privileged work product.

Dennis Egan: When you said there is no discovery during the investigative stage, once it's been filed [inaudible].

Brad Schram: The question that was asked from the audience was do *Wells* submission really help or is it like rooting for the Cubs?

Steven Klawans: I'm not aware of any statistics to… that issue or that question but I think it's really on a case by case basis. I have seen the *Wells* process work to the benefit of the proposed respondents or the proposed defendants. I have seen it work where they have persuaded us probably not to drop the entire case but more likely to revise downward the sanctions that we're seeking or that the charges that we're recommending. It has happened. We have to remember too that in almost every case where a *Wells* submission has been tendered to the staff, if we continue with recommending action we will send that *Wells* submission to the commissioners so the commissioners themselves will typically see the *Wells* submission and that could affect the outcome at the Commission level.

Brad Schram: We're really in a position to get your version of events on paper and I think it's a general matter that you don't have much to lose and you usually have a lot to gain by at least making an effort unless you somehow think that it's going to go to trial anyways and I don't want to disclose any more information they may already have.

Dennis Egan: Well that's a strategic dilemma. Once you give up your defense they focus on that during the rest of the investigation and during the OTR period and initiation process so you really have to weigh that. Before we run out of time we also certainly want to discuss privilege issues which were discussed with them this morning in the context of examinations but now we are now talking in the context of enforcement proceedings and Steve has at least some thoughts to get us started in.

Steven Klawans: The privilege issue is one in which it really is a sensitive issue because on the more well known cases and more well known pronouncements by the U.S. attorneys office, on the issue of privilege waivers, the context of the *Thompson* memorandum and the *McNalty* memorandum, just a real quick bit of background – it was a deputy attorney general at the time in 2003 that the attorney general Thompson issued a memorandum to his staff that said essentially to fight and combat corporate fraud we're going to request that the company waive its attorney client and work product privileges so that they can essentially bring to the government evidence that they would not ordinarily have a right to do because of those privileges. The Thompson memo of course garnered quite a bit of controversy because of the way it was used in practice.

And the *Thompson* memo, of course, garnered quite a bit of controversy because of the way that it was used in practice, that, number one, companies were being punished if they did not waive the privilege. They were threatened to be indicted if they did not waive the privilege and it also counted against them if they "protected their employees" by something, for example, paying for their legal fees. So these were some pretty significant issues that the defense bar and a lot of people were up in arms about. So last year, the new deputy attorney general McNulty came out with revised memo which required that the U.S. Attorneys had to seek approval from the supervisors if they were going to request, and that only in rare circumstances would they even consider the paying of attorneys fees to be an issue with respect to the cooperation and what to do with, whether to indict the company.

What still remains is that, for the McNulty memo, if a corporation is requested to waive the privilege and declines that opportunity, that can be used against the company. And that still is in the McNulty memo; that is still generating a lot of debate. And in fact, I think it's Senator Spector, I think, who has proposed back in the last session and in this legislative session a bill essentially doing away with some of these controversial aspects of the way that the government has requested privilege.

Now on the SEC side, I should really distinguish what our practice has been when the issue of privilege and waiver comes up. You know what, I don't see us, at our level, requesting a waiver. What usually happens is that the company comes to us, either because we requested certain information that we didn't know was privileged but that they tell us is privileged, or because they're self-reporting they did an internal investigation, they want to tell us what happened, what they found. And so they want to waive the privilege. And, you know, that comes up more times than you would think. But companies for business reasons often want to do this because they want to get this investigation finished, they want the SEC out of their hair. They don't want to continue to make disclosures anymore and public statements about this terrible investigation that the government is conducting. And so, for business reasons, sometimes they want to get out in front of this thing, drop their privileges, give the government the information that will make the investigation go, go more swiftly.

Dennis Egan: A good example would be, you know, somebody is being accused of conduct that would violate the securities laws and the client wants to say, "well, we hired five former SEC commissioners to write an opinion letter and, in their opinion, this was perfectly legal, and we want that to be considered as part of this." That's a pretty classic example of the reliance on counsel defense, and the problem being, if you want to raise a reliance on counsel defense, there is a lot of case law to the effect that that is in and of itself an implied waiver. So, you have a client who, to protect themselves, wants to be able to say "we checked this out with our lawyers, who are eminent practitioners, and therefore we certainly didn't intend to violate the securities laws. You obviously simply disagree with our lawyers." That's one example.

Brad Schram: And the problem with that example, Dennis, is that, on the one hand you may want to provide the opinion itself but the file behind that opinion, when the client first came in, could be very, very damaging.

Dennis Egan: And that's the issue with waivers, because you guys you start waiving, you are waiving on everything. You can't just say, here's some things, we want to give you this. Now you've opened the door and the client really has to understand, and part of that is you need to see, particularly if it involves a different law firm, you need to see those files; and if the client doesn't have the law firm's file, then you need to have the client contact the former law firm so that you can see that file. Because if there is going to be a waiver, the door is open and…

Steven Klawans: It's a very sensitive issue. I mean, from a public policy standpoint, you can see how the waiver of privilege can be problematic because you've got on the one hand, obviously it benefits the government in the course of its investigations and, as I said before, it could benefit some of the business decisions that are made by the companies. It also can create a situation, if the government is using the decision not to waive against the individual, in most cases the entity, you have a situation in which the general…you are not going to have full disclosure by employees if they know that what they've told general counsel at the company is going to be given to the government. You are going to have a chilling effect on what employees are going to tell company counsel. You also have got a situation in which maybe company counsel feels, well, maybe my organization, my company is in real trouble if I'm not waiving privilege and providing information to the government, and we are turning general counsel into government informants. I mean, these are real issues and concerns that, and I think this is part of the reason Senator Spector is trying to repeal some of this stuff, but at the SEC I know we are very sensitive to these issues and we are trying to balance both sides, one with the company that really wants to waive the privilege comes to us with that idea versus us demanding it, requesting it, or using it against them. We are trying to carve out sort of a middle ground.

Dennis Egan: Another area, if I could just change topics for a moment. An area of frustration, consternation for my clients, and it puts the attorney in a difficult position as well, is that an inquiry occurs, there is the initial amount of investigation, there may be some subpoenas, there may even be some depositions, and then we just don't hear. Call, what's going on, we just don't hear. The client says what kind of lawyer are you, you can't tell me, they won't tell you what's going on? Should I be nervous; what am I supposed to do? And those calls come in and it's not only frustrating for the client, it's difficult for the attorney as well. I know the statistics and Senator, I see that Senator Rasly, who is a former Republican head of the finance committee, had written a letter to the GAO to try to get some movement to try to resolve this problem. Because there really hasn't been any progress in that regard and, what are you views on that?

Steven Klawans: You know, I think the GAO report did, in my read of some of the literature, has focused on, sort of, SEC investigations that have been launched and not closed and no action taken and a number of years or months have gone by without any action either to close the investigation or to bring an action publicly. You know, and I know that the senior officers in enforcement are sensitive to the report and the conclusions in the report and they've already, I think even before the report was issued, have instituted some measures, both from a technology standpoint to try to track these things a little bit closer and also from a managing standpoint to have a little more of a centralized view and reporting structure of when cases are open, why they are open, you know, what's taking so long if that's the case, and should they be closed. I mean, I think everyone I've talked to is sensitive to the idea that, especially when we are talking about a public issuer that quarter after quarter after quarter they have to report publicly that there's this investigation going on yet they haven't heard anything for a while, we are sensitive to the effect it has on the market and we are not interested in affecting the market that way. We have our responsibilities with respect to our investigations, we just have to be more sensitive to these issues and be quicker about it.

Dennis Egan: Do you have a policy, for example we talked at the very start about an inquiry letter, do you have a practice of sending closing letters that say "we've completed our investigation," or does that sometimes not happen?

Steven Klawans: There is a procedure in place in which, when it's been decided that a particular entity or individual who was, this usually happens when they've been named in the formal order, when we get formal order approval to send subpoenas and subpoena testimony, and that person's been named in that formal order and its been decided that that person is no longer going to be recommended to the Commission that they be charged with any misconduct or violation of the securities laws, we send them a letter to that effect.

Dennis Egan: But does the timing span that Brad was talking about, if you dealt with the U.S. Attorney's office you see the same thing. I had a number of years ago an embezzlement situation and we literally gift-wrapped a criminal case and gave it to the FBI, we didn't hear a peep for almost 10 months. So, I mean, they do their investigation but they have a pile of files and you have to explain to your client that just because we responded and we haven't heard anything in 3 or 4 months doesn't mean anything at all, they may not be done, they may be doing more work or it may just be sitting on somebody's desk.

Brad Schram: In some ways there are circumstances where the delay can, ironically, help the client because, in terms of parallel organizations, other SROs for example, may be conducting their own investigations for the same period and may be looking at the same conduct and then issuing a clean audit report which we then say, "gee, you thought this conduct was so abhorrent yet another SRO looked at it and we passed the investigation." Not that that's binding necessarily, but it gives us a little more ammunition. So there could be some silver lining to that.

Dennis Egan: I had one a couple years ago. The New York Stock Exchange had issued an information request and then wanted to depose the registered rep and it was scheduled, they called me twice and I gave them dates that we were available, each time we got reassigned and the last time, I don't think we are ever going to hear from them.

Audience Member: Quick question. Seniors, what initiatives does the SEC have with seniors?

Steven Klawans: The question was with respect to seniors, senior citizens. I know that has been one of the focal points of Chairman Cox's agenda and you will probably have seen, in the last year especially, initial public statements regarding cases that we've brought and I think we've been, you know, fighting these cases of offer frauds, of selling them unsuitable products for years and years and years, I don't know that we are doing necessarily more or less of those cases per se, but certainly I think the message is getting out that we are doing those cases and that we are trying to protect what may be considered in some peoples' eyes the more vulnerable investing class that's out there. And there have been senior citizen symposiums that various members of the staff have participated in around the country discussing issues regarding unsuitability, should seniors be buying annuities, things of that nature. So, it has definitely been a focal point both from the enforcement perspective and from a public policy standpoint.

Dennis Egan: There's materials on SEC's website, although my in-laws I doubt would have, in fact I don't think they've ever turned on a computer, but there is resources at FINRA, I think it's also issued materials on that topic.

Brad Schram: The other issue is distributions of penalties that you and your office have collected. How are they distributed and what role does counsel have in that process?

Steven Klawans: Just a bit of background; I have a few numbers. The SEC has been collecting civil penalties on cases other than insider trading cases since the relevant securities laws were changed in about 1990, I believe. We were then permitted to assess civil penalties. And then in 2002, with the Sarbanes-Oxley Act, we were then able to take what was disgorgement of the illegal profits that we obtained and the civil penalties, and combine them together since 2002, and distribute them in total to the injured investors. Since 2002, and these are called "fair funds," you combine the civil penalty with the disgorgement and call it a "fair fund", I think the Sarbanes-Oxley Act calls it that too, and we have distributed $2.7 billion in fair funds since 2002 through about 150 fair funds. And of those 150 fair funds, approximately 45 or a third of them are completed in terms of distributing all the money. Most of these cases are going to be fraud on the market findings,…, I've distributed money in the *Bristol Myers* financial fraud case, we've distributed about $150 million and we are on the road to distributing $150 million, we've distributed $126 million of that pot, and there is still more to go and the Commission is working as fast as they can on that one to get this money out to the people that …

Brad Schram: By the way, what role does counsel play in that process and how do you decide to whom you are going to give the money? Just briefly. Does counsel of an interested party have an ability to say anything before the decision is made? Is that local, is it D.C.?

Steven Klawans: The question was what role does counsel play in the distributions and the answer to that question is, you know, typically what happens is that the actual, not in every case but in a lot of cases, the distribution plan, how the funds are actually going to be distributed, will be drafted by the counsel and the client. That doesn't happen in every case, but that was one role that defense counsel will play. If it's a situation in which you have a Ponzi scheme, a receiver has been appointed or a special master has been appointed, and that person is dictated by the court to go ahead and collect, marshal the assets and distribute them, what role does counsel play, and you've served as special master and may be able to speak to it better, but certainly they would get to weigh in on matters that are brought before the court in terms of what the distribution plan is, is this fair to the investors. I find typically that the defense counsel at that point, they've already had their guy plead guilty in a criminal case or consent in our case and they don't want to spend any more money or might not have any more money from their clients. Often times they drop out of the picture at that point.

Dennis Egan: The tension that I find in that situation is that, on the civil side with the SEC, the case for example where I've been special master, it has been complete cooperation. We create the claims process, we make the recommendation, it's supported by the SEC, we make that distribution. Interestingly though, on the criminal side, where there are forfeiture proceedings, frequently we won't have access to that money and there will be two pots.

Elliot Spoon: Any other questions from the, yes please.

Audience Member: With regard to, you mentioned that sometimes you try to, aiding and abetting sometimes is primary violators. Have you been limited as the government, and after all your proceedings are civil, have you been limited by *Central Bank* with the charging of aiding and abetting as a private plaintiff would be right now?

Steven Klawans: No. The answer is no. The question was whether the SEC is limited by the finding in *Central Bank* that private litigants cannot pursue secondary actions or aiding and abetting actions and the answer is no. We at the SEC will pursue and bring aiding and abetting cases all the time. We're not limited by *Central Bank*.

Elliot Spoon: Other questions from the floor. Dennis had made a reference to his in-laws when talking about seniors, and I should remind Dennis that he's been eligible for AARP membership for several years now.

Elliot Spoon: This panel we are going to talk about the recent case before the U.S. Supreme Court that oral arguments were heard on Tuesday in the case of *Stoneridge Investors v. Scientific-Atlanta*. The argument involves the existence of so-called scheme liability under Section 10b of the Securities and Exchange Act and Rule 10b-5 promulgated by the SEC under the Exchange Act. While the *Stoneridge* case did not itself involve professionals, we will discuss the facts of *Stoneridge* and we will see this decision is likely to have a significant impact on professionals such as attorneys, accountants, advisors, et cetera.

Now, some background in order to understand some of the arguments that were made and that will be made today. We are going to focus on Section 10b of the Securities and Exchange Act, which provides that it is "unlawful for any person, directly or indirectly, to use or employ, in connection with the purchase or sale of any security, a manipulative or deceptive device or contrivance." Those are the key terms and, as you may know, Section 10b does not by its own terms provide that a private plaintiff may bring an action. So suits that are brought under Section 10b are done because the Court has implied a civil remedy, has implied a private right of action under Section 10b. That fact, as well, will be relevant in the consideration of the *Stoneridge* case.

Rule 10b-5 was of course promulgated by the SEC pursuant to its authority under Section 10b. It has three subdivisions and the *Stoneridge* case involves primarily subdivisions (a), about being unlawful to employ any devise, scheme or artifice to defraud, or (c), to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person. The existence of scheme liability depends on the interpretation of the sections (a) and (c) of the Rule. Now, the Supreme Court has considered the relationship between Section 10b and Rule 10b-5 several times before. It has said in the past that you cannot construe Rule 10b-5 independently of Section 10b because Rule 10b-5 is derivative of Section 10b.

Section 17 of the securities laws has very similar language to paragraphs (a), (b), and (c). Section 17 has been interpreted and does not require scienter. Rule 10b-5, on the other hand, because it is derivative of Section 10b, has been interpreted by this Supreme Court to require scienter notwithstanding the fact that the language of Rule 10b and Rule 17 is essentially the same.

In *Central Bank*, the U.S. Supreme Court held that, in a private right of action, there is, in fact in any action under Section 10b and Rule 10b-5, there is no such thing as aiding and abetting liability under Section 10b. So what does aiding and abetting liability require? It requires someone else to be, to have violated the statute and somebody else that has given substantial and knowing assistance to the violator. This theory was used to sue attorneys, accountants, advisors, under Section 10b on the theory that they may not have been the primary violator but they gave substantial assistance to the company who was normally, to the public company that was normally the primary violator. In, I believe, in all 11 circuits had held prior to 1994 that aiding and abetting liability existed under Section 10b. When the *Central Bank* case went up to the Supreme Court, the Supreme Court said, "You know what. All the circuits have missed the boat. They haven't read the statute carefully." And they said that there is no such thing as aiding and abetting liability under Section 10b. One must be a primary violator. Those who simply give substantial assistance to those who violate are not liable at least under Section 10b.

However, the Court stated in this language in the opinion in *Central Bank*, which is going to be relatively important in our discussion of *Stoneridge*, it says that anybody including a lawyer, accountant or bank who employs a manipulative device or makes a material misstatement on which a purchaser or seller of securities relies may be liable as a primary violator under Section 10b and Rule 10b-5. In other words, it says that there may be circumstances under which lawyers, accountants, advisors, banks may be liable under Section 10b, but they cannot be liable as an aider and abettor; they can only be liable as a primary violator.

So in the cases that followed, in the federal circuits and in, primarily in the federal circuits, there was of course in the last 13 years much litigation about when is a lawyer, accountant, advisor, a bank, when are they a primary violator.

Audience Member: Would you mind going back to that slide?

Stuart Sinai[8]: I just want to mention something. While I happen to be here for the advocates, advocating for the petitioner, *Central* made the mistake right at the beginning. I mean, the Court made a mistake when it said, "Manipulative device." That's not what the statute says. It says manipulative or deceptive device. They got it confused. When Kennedy wrote this opinion for the majority, if they would have put in what he meant, in fact, which they clarify in *O'Hagan*, it says manipulative or deceptive acts. Because this gets

[8] Stuart Sinai is a member of the law firm Kemp Klein where he is experienced in taking corporations public, SEC litigation, proxy contests, compliance work under '33 and '34 Acts, municipal bond offerings and representation of clients in SEC and various exchange proceedings, including insider trading charges, NYSE and NASD rule violations and fraud investigations. He has also acted as an arbitrator for both the NASD and the American Arbitration Association. Holding a Certified Public Accountant Certificate, he graduated from the University of Michigan, went to work at Ernst & Young. He has given lectures before various legal and accounting groups, and writes for national magazines, concerning taxation and securities regulation matters.

manipulative and deceptive mixed up. Manipulative is something to do with improper trading. Deceptive is something totally different. And yet none of the circuits that have looked at the issue since then, nor has the Supreme Court clarified this language was wrong right at the beginning. I just want to mention that because we'll get into it about deceptive and how …

Elliot Spoon: Now, so after *Central Bank*, there was a considerable amount of litigation about when advisors are primary violators. Some courts adopted what is called the "bright line test," that the secondary act of the lawyer, or the accountant, the advisor must make a material misstatement or omission, and it must be attributed to the lawyer or the accountant in a public way at the time of public dissemination. That's, one would say, maybe a more narrow interpretation of primary liability under Section 10b. In a modified version of the "bright line test," one of our Circuit Courts of Appeals said, "Yes you have to make a material misstatement or omission on which there is reliance, but it doesn't need to have been attributed to the lawyer or the accountant at the time of public dissemination." So that's a slightly broader test to encompass more conduct within the violation.

Audience Member: The lawyer or accountant needn't have made the statement himself.

Elliot Spoon: No, that's not what the 10th Circuit means by that. They mean that they made the statement but the investor doesn't have to be aware that they made the statement.

Stuart Sinai: The 10th Circuit is wrong too, of course.

Elliot Spoon: Alright, you are going to get your chance. Now, I'm just, you know, don't kill the messenger.

The 9th Circuit has taken perhaps the broadest view of primary liability for what we call secondary actors, that is, not the public company itself. It says that if the secondary actor, the lawyer or accountant, substantially participates or is somehow instantly involved in the preparation of fraudulent statements, misstatements or omissions, even though they were not the speaker and it wouldn't have been attributed to them, it would have been attributed to the company, that's enough if they were instantly involved. And, of course, that test for many practitioners raises all sorts of scary possibilities because, of course, securities lawyers should be substantially participating and integrally involved in many of the disclosures that public companies make, and if they are not, they are not doing their job.

Now, a third basis of liability for secondary actors has emerged in the last few years and that is what is called scheme liability. And the theory here is that liability under Section 10b for our so called secondary actors doesn't have anything to do with whether they made a misstatement or omission; rather, whether they have engaged in conduct that is part of a fraudulent scheme. That is, if we go back to Section 10b, the issue for scheme liability is not whether they made an untrue statement of material fact but whether they employed a device, scheme or artifice to defraud, or engaged in any act, practice or course of business which operates as a fraud. And that is the essential basis behind the theory.

Now, the question that many people have been asking is, "Is this a viable theory or is this simply a cute way to make an end run around *Central Bank*'s rejection of aiding and abetting liability under Section 10b and Rule 10b-5?" That is essentially the parties' conceptual points of view with respect to this issue.

The issue, in practical terms, this issue came up with respect to banks that provided funding for certain transactions that, for example that Enron was involved in, and one of the questions was should these banks be liable under Section 10b, not because they made a statement or not made a statement, they didn't, but because they were participating in a scheme that ultimately impacted investors. And, in the *Stoneridge* case, the facts are not as sexy as Enron, but nonetheless I think important for all persons that would be secondary actors.

Here's what happened in *Stoneridge v. Scientific-Atlanta*. Charter Communications was a public company and they purchased cable boxes from Motorola and Scientific-Atlanta. Charter, of course, is a cable communication company and Motorola and Scientific-Atlanta sold them cable boxes. Charter asked both these companies to purchase advertising, apparently at higher than normal rates. In exchange, Charter was going to pay the amount equal to the advertising cost as an increased cost of buying the cable boxes. So, from Motorola and Scientific-Atlanta's point of view, the transaction was a wash. They charged Charter more for the cable boxes but then, with that amount extra that they received for the cable boxes, they bought advertising from Charter Communications. Obviously, as far as Charter was concerned, Charter's revenue increased because they were able to take their advertising revenue into income. The amount that they paid for the cable boxes, the excess was amortized over a period of time. So the revenues increased even though they…excess revenue and paid out the exact same amount, the revenue, they were able to recognize the revenue immediately but they did not have to recognize the expense immediately. So the net impact on Charter's financial statements was that their net income was, after this transaction, their revenue increased and their net income increased as well.

Stoneridge, who was a shareholder of Charter Communications, alleges that the financial statements were misstated as a result of the arrangement, and I just described how they were misstated. Therefore, accordingly, Charter violated Section 10b and Rule 10b-5 and the fact that 10b, assuming these facts are correct, which I think the Court has to assume in its analysis, there isn't any question that Charter violated Section 10b and Rule 10b-5. The question is did Motorola and Scientific-Atlanta. Remember that they were not an advisor, they were simply a vender. But a vender that knew that, for example, that, for purposes of this case, that they already had a binding contract to sell the cable boxes for X dollars and Charter said, "Well, increase the price." And so, obviously they knew that there was something fishy going on here. Specifically, they said, "Look. Motorola and Scientific-Altanta are the prototypical case of someone who would violate Rule 10b-5(a) and (c). They didn't make any statements but that's not why they should be liable. Because they participated in conduct and, of course, to be liable under Section 10b you have to prove all of the elements of Section 10b, it was, and this was done in connection with the purchase or sale of a security, there's issues about reliance and scienter which our panelists will address.

In the case, the plaintiff in his brief to the Supreme Court, the plaintiff had proposed the following test to deal with this so called scheme liability. That is, a person engages in a deceptive act as part of a scheme to defraud investors and violates 10b and Rule 10b-5(a) and (c) if the purpose and effect of his conduct is to create a false appearance of material fact in furtherance of that scheme. That is the, there may be other tests, but this is one, this is the test that petitioner suggested in their brief.

The impact of *Stoneridge* is of course profound. We were chatting informally up here and the question was asked, "What do you think would be the immediate impact of a victory for the plaintiff in *Stoneridge*?" And the answer was, "Malpractice premiums would go up significantly." And so, the idea is that depending on how the Court rules, and if it doesn't expand the types of activities by secondary actors that come within the scope of Section 10b, that will clearly have a significant effect on all of those secondary actors.

Alright. Now you've heard a little bit from Stuart, and you know how passionate he is about this subject. I think you referred to it as the corporate…

Stuart Sinai: Evil-doers.

Elliot Spoon: Stuart will present the case for the plaintiffs. Jay Cragwall will present the case for the defendants. And I will attempt to moderate. You should also note that this was argued before the Supreme Court on Tuesday, and you may know they made the transcripts of those arguments available on the same day. So I will play the role of the various Justices at the appropriate times and ask the same questions they asked the lawyers for each of the parties.

Elliot Spoon: Do we have questions from the floor? Yes.

Audience Member: I have a question for Mr. Cragwall[9], let me help Mr. Sinai overstate the facts a little bit. Let's assume that the CFO for Charter goes to the *Scientific America* and says "Look, I gotta inflate my share price here. I've worked with all my other vendors, I've tried to get them to help me falsify my records, nobody else will do it. I need your help here. I really need to over state the price here so that I can mislead my shareholders. Can you help me out? Oh, and by the way, it's going to help you too because I'm going to pay you more for these boxes." Don't you think in that kind of extreme, where *Motorola* and *Scientific America* have scientered, they know the purpose of the transaction, don't you think there should be some kind of liability there?

Jay Cragwall: We're talking about the Feredal Securities Law, not Dram Shop liability. What you're talking about is dram shop liability for people who deal with issuers that give you the drink, and that's just not what this statute covers. You are the primary actor. You are the one who has perpetrated the securities fraud, and I'm sorry, it doesn't. I am a person who, in your situation, has knowingly rendered substantial assistance. Congress was asked in 1995 by the SEC to make that a cause of action for private civil liability and Congress said "No." If Congress gets around to passing a dram shop act like that, then that would be covered. But we don't have a dram shop act yet in Section 10(b).

Elliot Spoon: Joe [Speigel]?

Joe Speigel: One brief response. One, *Affiliated Youth* did away with reliance in omission cases. I don't know how you'd get away from that, and that is something that occurred many years ago.

Elliot Spoon: I think he actually got away with it in the burden of proof, with respect to reliance, not with the reliance requirement.

Joe Spiegel: The second issue is, do you feel, Jay [Cragwall], that Enron, Worldcom, would have occurred if *Central Bank* hadn't have been decided the way it

[9] Jay A. Cragwall, Jr. is a partner with the law firm Warner, Norcross & Judd where he represents businesses and individuals in civil litigation matters in state and federal courts throughout the United States, including acquisition and business control disputes, federal taxation, First Amendment and other complex commercial cases. He graduated with first honors from Vanderbilt University where he associate editor of the *Vanderbilt Law Review*. He has also recently been named a Super Lawyer in the 2007 edition of *Michigan Super Lawyers* and was listed in *The Best Lawyers in America*.

did? That being the gate-keeper function of either an under-writer or an issuer.

Jay Cragwall: Well, let me tell you about this gate-keeper theory and give you my reaction to it. I've talked with the loss prevention partners in Vincent and Elkins who were sued on this gate-keeper theory. I was going to put an adjective in front of it and I stopped. The way that complaint was framed, it made it sound like Vincent and Elkins was heavily involved, if you will, the gate-keeper for the Enron fraud. They spent more money than you can imagine defending that case, and eventually the Plaintiffs let them out voluntarily, without the payment of a dime. After the bankruptcy receiver from Enron had excoriated the Plaintiffs from bringing them in in the first place. But because they were charged with being the gate-keeper they couldn't get out on motion. The district court incorrectly denied their motion to dismiss. Now, consider the conflict of interest that is raised by the question that Joe just asked. You're a lawyer, you have a duty of confidentiality to your client. You are one half of a communication that is subject to privilege in Anglo-American Law. Now all of the sudden, Joe, the claims bar say you're a gate-keeper too. Suddenly they've converted you into someone with duties to the public, just like a certified public accountant who undertakes an audit engagement. How are you going to resolve that conflict of interest as the gate-keeper? If Joe is right, you have an obligation to turn your client in. Well, you don't have an obligation to turn your client in. Under Sarbaines-Oxly that was proposed and it was rejected. You may have an obligation to report up but you don't have an obligation to go to the public. As a matter of fact, if you go to the public you are breaching your ethical obligations to your client and you can be, and should be disbarred.

Audience Member: How do you address the issue of noisy versus quiet withdrawal as opposed to going to the public which is something that existed from the early 30s all the way through the 90s? That is to say, the function of a securities lawyer from the 30s to the 90s was to create a gate-keeping function and each year they had a choice, quiet withdrawal or noisy withdrawal.

Jay Cragwall: Well I would address that by saying that you just stated the situation. I believe a noisy withdrawal would have been ethically ill advised. I would have advised my partners not to make a noisy withdrawal. And that was considered in the Sox rules and rejected. A noisy withdrawal is not and has never been a part of our ethical jurisprudence. You cannot waive a client's confidences without the client's consent.

Elliot Spoon: Let's give our two advocates a last round of applause.

FINRA ENFORCEMENT AND RELATED ISSUES

Joseph Spiegel[10]: We're going to attack with great vigor FINRA[11] enforcement and related issues. This is going to move across several areas, simply because with the creation of FINRA, we now have a bigger gorilla than we ever had before. FINRA has taken over a great deal of the regulatory responsibility. We have today Mike Hindelang, and Mike is at the Honigman firm. He's put a lot of time and effort into this presentation, and graduated from Wayne State University Law School and has an MBA. Mr. Moseley over here, Mel Moseley, I've known him for a few years. He's with Warner Norcross & Judd. He did in fact go to law school magna cum laude from Indiana University, and Order of the Coif. Do want to start, Mel? Were you going to go first?

Melvin Moseley[12]: I was, but they've got a real lengthy one up. I was going to use a little bit shorter one. I'm trying to get to it.

Michael Hindelang[13]: We're within ninety seconds of starting.

Joe Spiegel: All right, all right.

Melvin Moseley: It's fine Joe, you can keep talking man.

Joe Spiegel: I'll keep talking. I think one of the issues that you all will have to deal with when dealing with FINRA enforcement, is that you're going to run across the same issues you heard this morning, with respect to the process in many

---

[10] Joseph H. Spiegel, of Joseph H. Spiegel PC, has extensive experience in drafting corporate and partnership documentation, including shareholder agreements, employment contracts, buy/sell agreements, private placement memorandums, and general and limited partnership agreements. He specializes in federal and state securities law in corporate finance and broker/dealer areas, commodities law on the federal and exchange levels, and general corporate and partnership law. He has lectured in the areas of securities and commodities law, and federal civil procedure, and has co-authored many articles including "The In Pari Delicto Defense and Attorney Misconduct, or It Is Time to Get Rid of the "Law-Free Zone", Michigan State University Journal of Business and Securities Law, 2005 J. Bus. & Se. L. 65, Spring 2005. Mr. Spiegel received his B.A. in History from Cornell College in 1968, and his J.D. from John Marshall Law School in 1974.

[11] Financial Industry Regulatory Authority

[12] Melvin G. Moseley, Jr. is a partner with the firm of Warner Norcross & Judd, where he practices securities litigation, business and commercial litigation, and environmental litigation. Mr. Moseley handles all aspects of securities litigation, including NASD arbitrations involving customer and industry disputes, District Business Conduct Committee hearings and appeals, SRO and state investigations and enforcement actions, federal and state actions under federal and state statutes and common law, including class actions, and claims before the American Arbitration Association. Mr. Moseley received his B.S. from the University of Tennessee with highest honors in 1987, and graduated magna cum laude from the Indiana University School of Law in 1987.

[13] Michael P. Hindelang is an associate at the firm of Honigman Miller Schwartz and Cohn, where he practices corporate and securities litigation. Mr. Hindelang received his B.A. in Economics from the University of Michigan in 2001, and his M.B.A. from Wayne State University in 2004. He graduated cum laude from the Wayne State University Law School in 2004.

regards. Keep in mind that NASD[14], FINRA, has no jurisdiction over a non-registrant. And that's the substantive difference between the two processes as we see them. So for example, you may have Mr. Jones or Company X engaged in some difficult or improper acts or actions, but if that person is not a registrant, the NASD has no ability to go into court, has no ability to get an injunction. That's left up to the SEC[15] and if it's a criminal case, it would be handled through the United States Department of Justice with the SEC being its advisor. So the first thing you have to think about when you're dealing with FINRA is that you're usually, or always dealing with a registrant. Because you're dealing with a registrant, that person does not have the same rights, although may have many duties and obligations that a normal other person would have. So for example, when documents are requested, when information is requested, I think one of the seminal issues that Mr. Moseley is going to talk about and Michael are going to talk about, is this really cutting edge issue of enforcement and invocation of the Fifth Amendment. But also, an issue that has been bubbling up for the past two to three years, is whether or not the NASD is what we call a state actor? Is FINRA subject to the same limitations that a Securities and Exchange enforcement attorney or a Department of Justice attorney, or any other governmental authority is? Given the recent merger of regulatory personnel, creating one large self-regulatory organization, superseding in great measure things like the Chicago Board Options Exchange, Boston, Philly, et cetera. There is really only one, now, self-regulatory organization. It has yet to shake out as to what does that mean. What does it mean to have a self-regulatory organization that is the only game in town? So, I think that those are two of the really outstandingly cutting edge issues. We're almost ready here.

Melvin Moseley: It's not our fault, really.

Joe Spiegel: I don't want to steal any thunder.

Michael Hindelang: We'll blame Joe.

Audience Member: Can I ask I question while we're just waiting? If, in the state of Michigan, and in the past I've done litigation services for clients, mostly attorneys, I've seen the grievance process take place in Michigan. I recently had an issue with enforcement in Chicago, where I encountered a young attorney fresh out of school who obviously took a job with FINRA. I think her performance was very poor. Do I have the ability to file a grievance against her?

Joe Spiegel: I'm not going to comment on that.

[14] National Association of Securities Dealers
[15] Securities and Exchange Commission

Audience Member: She's an attorney from Illinois, and if Illinois has a grievance process?

Joe Spiegel: Let me make a suggestion, I would consult with Illinois counsel, an Illinois attorney. That's my best advice. Mel?

Melvin Moseley: Okay, thanks Joe. Sorry for the delay there guys. I'm going to try to jump through these slides. I know it's late in the day, so feel free to jump in, raise questions as we go through it. Just raise your hand if you want to chat about one of the issues in particular. I'm basically going to talk about a few of the recent regulatory issues, in particular relating to seniors, equity indexed annuities, and a Reg S-P issue. Recently, September 2007, there was this joint report issued by the SEC, NASAA[16], and FINRA relating to seniors, at the Senior Summit. They reported their findings from a year long examination of 110 securities firms and branch offices that offered free lunch seminars. And what the report showed, one hundred percent of the seminars were sales presentations. Which, I guess that doesn't really surprise me, I mean we all do these presentations, seminars, et cetera with the notion of getting meetings lined up with clients. But the joint report noted that they though that was somewhat misleading in that it's called a seminar but it's designed to sell. Fifty nine percent reflect the weak supervisory firm practices, fifty percent featured exaggerated or misleading advertising practices, thirteen percent appeared to be fraudulent, or actually referred to the appropriate, or most appropriate regulator for potential action. This joint report kicked off a number of releases, only some of which I'm going to touch on here, and only some of which I touch on in the outline that's in your materials. The PowerPoint that's in your materials is a little bit longer in this one. But some of the releases – there was a FINRA news release announcing a major regulatory sweep at the Senior Summit. There's going to be two new sweeps out there. Use of professional designations to mislead seniors, you know "certified senior specialist," "certified senior planner," I mean there's literally hundreds of them. FINRA has I think on their website now a listing of the various so-called credentials and what it actually takes to get certified. Early retirement seminars is the other area of the sweep. They're looking at seminars designed to encourage people to retire early, or to transfer their savings, retirement savings, to the selling firm or broker. There was a FINRA regulatory notice, 07-43, that came out at the same time period. FINRA reminded firms of their obligations relating to senior investors, and highlighted industry practices to serve these clients. The gist of the regulatory notice was to urge firms to look at and review their existing supervisory procedures in light of the special needs of seniors. Some of the special needs, this regulatory notice warned that seniors can have special susceptibility to misuse of the certifications and designations by advisors,

[16] North American Securities Administrators Association

high pressure sales techniques at these seminars aimed at seniors, diminished capacity of the seniors, et cetera. So it urges firms to be proactive in educating seniors, and including making seniors aware of the many, many, many investor alerts out there from the SEC, FINRA, NASAA organizations that try to educate and advise not just seniors, but investors in general, about how to avoid fraud. In light of this focus that came out of this summit and out of the various releases that are citied in my lengthier PowerPoint and that are out there, I think that firms need to assess their vulnerability and make sure that their supervisory procedures are up to snuff, especially if they have, they allow folks or have reps who are heavily concentrated in the free lunch, free breakfast, free dinner seminar area, and they're out there pitching to senior citizens. And some brokers do make a practice out of that, that's their business model. They have a clientele of certain areas, certain companies, whatever. They hold these seminars, and they pitch a product, try to get a meeting with these people, attendees. You know, there's nothing wrong with that, but there are existing rules that require that those things be supervised, and what the regulators found in their examination was that often, the supervisory procedures were lacking.

Joe Spiegel: When you say sweep, what do you mean by that?

Melvin Moseley: Well, basically...

Joe Spiegel: Like in your experience, defending some of those sweeps.

Melvin Moseley: Well, the sweep itself is really just, they're going through and they're going to come in and look for, look at firms that have these issues, when they're doing senior seminars. And they're going to be looking for problems. They're going to look to see, is there pre-approval of the seminar materials that are used by the reps? Is there pre-approval of, if he's got a standard speech, or power slides, or whatever, whatever's handed out? Is the material misleading, or is it evenly balanced? Are there outrageous claims within the materials, like the FINRA notices have warned about – seven critical steps to retiring rich, famous and beautiful, and so forth? They're going to come in looking for those areas, as an area of focus. I'm going to talk a little bit about.

Audience Member: Is there a definition, are they using the AARP definition of senior? What is a senior?

Melvin Moseley: I don't think, I haven't seen it actually defined. I think they need to be careful, or be wary of anybody who's on in age. Now I don't know, maybe there's been something out there. I haven't seen it defined anywhere. Have you?

Michael Hindelang: I have not.

Melvin Moseley: I think they're just saying, people who are elderly, in FINRA's usual way, you'll know them when you see them. They haven't defined it to my knowledge. So I think you're talking people who are approaching retirement age, or who are retired. I'm going to talk a little bit about equity indexed annuities. I think it's a pretty hot topic, especially when combined with some of the senior seminars out there, the free lunch, free dinner seminars et cetera sometimes pitch the equity indexed annuities as we'll see in a minute. I'm going to kind of skip through this because you can read up on these on your own, and they're in the materials covered in detail. Why are they getting so much attention? I think because first of all, they're a high commission product. The regulators typically are concerned about high commission products because they can be oversold by the reps. They also are often pitched as a safe, or safer investment, sometimes pitched as an investment where you can't lose money, and they have long periods during which there are surrender charges involved, so they're not totally liquid. If you look at the FINRA investor alert here, "Equity Indexed Annuites- A Complex Choice," which came out in summer of '05, they talk about the complexity of the products, they talk about that the return varies more than a fixed annuity, but less than a variable annuity. So there's more risk and more potential return than a fixed annuity, but less risk and less potential return that a variable annuity. Basically, the product is structured so that's it's tied to some kind of market index, say the S&P 500, and what the equity indexed annuity does is it'll say, okay we'll pay you a minimum of three percent on your money per year, or if greater, some market index adjustment factor. So if it's keyed to the S&P index, let's say the S&P does ten percent, the formulas for calculating it are pretty complex, and they might say that you're going to get whatever the S&P index gets, less the percentage of say, two percent. Maybe capped at eight percent. There's all kinds of adjustments that can be built into the contract to limit the total amount on the upside. On the downside, you're not going to do worse that the guaranteed interest rate, but the guaranteed interest rate may not be payable on the full amount of principal put in. So let's say you invest $100,000, the contract says you get a three percent guaranteed interest rate, the comparable index loses money, the three percent kicks in, but the contract may say that it only pays the three percent interest on ninety percent of the principal put in. So what does that mean? You can lose money. Plus if you had to get out early there's probably a substantial surrender charge, and therefore you can lose money. And that's why FINRA cautions that EIAs are long term investments, they're illiquid, and that you can lose money. And they're not totally illiquid, like most variable annuities they have some percentage that you can take out per year without getting any surrender charge, often ten percent, something like that. But they're not fully liquid. The thing I guess from the industry's perspective about the equity indexed annuities is that they present potential traps for the broker dealers. Are they a security, or are they not? We don't know. You look at the guidance from the Notice to Members 05-50, and it basically says yeah, it may be, it may not be a security, we'll tell you what the factors are and you'll know it when you see it. And so, the notice to members summarizes Rule 151's safe harbors under the Securities Act, which I'll skip the first couple elements and concentrate on the last one, "the product must not be marketed primarily as an investment." And I venture to say that most, and this is where Joe and I might agree on this, most equity indexed annuities are probably sold or marketed more like an investment. They're saying, we can do better than the fixed annuity, and not have the risk of a variable annuity. And if you get in the situation where the product is marketed primarily as an investment, then it's not going to be immune from being classified as a security. And what happens then? Well, Rule 3040 could apply, and you might have to treat it as a security.

Audience Member: Mel, I have a question. If the regulators think equity indexed annuities are so bad, why don't they just prohibit their sale?

Melvin Moseley: It's a common question, you know. I guess, what right would the have to prohibit? They don't say it's bad in every case, and they recognize that it can have some legitimate uses, just like in the case of variable annuities. It's not like it's all bad. And so, I'm not sure what authority they would have to prohibit a product like that where there's some legitimate uses. And it's a good question, it's a common question. But I think it's more in the sale of the product, and probably a little bit with the regulators' tainted view of the products that creates the issue. And I guess the dilemma for the firms, what I sensed in the notice to members that came out in '05, the NASD would like you to treat it as a security and supervise it. The firms are in a dilemma. They don't know whether they should supervise it and thereby take on liability for something that might be more of an insurance product they don't have to supervise, or not supervise it and risk running afoul of their supervisory duties if there's a sale made by their rep and it's deemed to be a security. So, they're kind of in a quandary, and I think that FINRA would like the securities industry to take possession of the equity indexed annuities and supervise it, but I don't think they have authority, I think they recognize they don't have authority to treat it as a security subject to their jurisdiction in every case. But I think they are trying to backdoor it a little bit in some cases where, or bootstrap their way into it by taking the position that where people are recommending that a security be liquidated to buy an equity indexed annuity, they have jurisdiction over it.

Joe Spiegel: Have you had any experience with the insurance regulators in this area?

Melvin Moseley: No.

Joe Spiegel: Okay, any joint FINRA...?

Melvin Moseley: Well, I take that back. The one case I'm going to talk about in a second involves the SEC, the state of Hawaii's insurance licensing division, and the securities division. So yes, but that's not my own personal direct experience. Actually, I'll get to this case, it's a good lead in and segue to the case. I call this the "Senior Summit Trophy Case" in this recent regulatory action, because it was filed right along the same time, same date in September here when this summit was going on, all these regulatory notices were coming out, and it just so happened that they had this case come out that involved all the good stuff. I mean, it was a guy, it was SEC v. Senior Resources of Hawaii, and indirectly relates to one of my clients because one of my clients is a registered investment advisory firm not named in this case, but whose rep was named, whose investment advisor representative was named. The SEC filed this release seeking emergency action in federal court against the agent who allegedly targeted and defrauded seniors in retirement communities in Hawaii. The complaint sought preliminary and permanent injunctions, disgorgement, et cetera. Among the allegations, he held free breakfast and dinner seminars, targeting seniors with eye-catching headlines, the same kind of stuff we just saw warned about in the FINRA regulatory notice. At the seminars, attendees were invited to set up free one on one meetings with presenters. Same thing we heard about in the Senior Summit proposal. It's designed for sales, not just a seminar. Allegedly, representative on multiple occasions fraudulently induced seniors to sign blank forms by misrepresenting the purpose of the forms and how the forms would be used, using the forms to sell existing securities holdings without the clients' knowledge or consent. So, taking advantage of senior citizens, misusing or misrepresenting the forms is the allegation, and the proceeds were used to buy equity indexed annuities. So it had all the things that are going on in the regulatory domain, and that's why I say it was a trophy case. The other thing, there's been something recently issued about cooperation among the SEC, the other regulators, and the states. As I mentioned earlier, the state of Hawaii securities commissioner issued a preliminary order to cease and desist. Which I didn't say here, the insurance division also took the guy's insurance license away in pretty summary fashion. It's amazing what lack of due process exists on the insurance level. So they definitely cooperated. And they cooperated in the investigation, I know for a fact because it started out with the state of Hawaii, they kind of passed the baton to SEC, SEC took over and then all of a sudden, they all hit. One thing that was interesting to me, and I alluded to this earlier, I'll just comment on it a little bit more, is that the regulators seem to be taking the position that the senior seminars designed to lead to individual business meetings, that element of it is fraudulent. And that to me seems like a stretch. Everybody knows, when you hold these seminars, I mean, lawyers do it, accountants do it, brokers of course do it, real estate agents do it, banks do it, and everybody knows that the purpose is to get your business. When they ask at the meeting, if you like, fill out the card at the end, set up an individual free meeting with me, I don't see that as fraud. And I kind of suspect that the regulators wouldn't take great umbrage if that was the only thing going on. But when you combine it with other factors, like maybe some outlandish headlines or nuggets that are in the presentation, and some other questionable conduct, they're coming. Last thing I wanted to talk about involves another client of our office, which is NEXT Financial Group. It's widely publicized, so I'm not violating any confidentiality obligations and so forth that Mr. Cragwell so aptly warned us about earlier today. What's interesting about this, I guess, certainly is the SEC's attempt to, I think, rule make through enforcement. And I think it could have some pretty far-reaching ramifications down the line, based on their interpretation of Reg S-P, which we'll discuss here in a second. They filed this in August 2007. The SEC alleges that NEXT Financial Group violated Reg S-P by disclosing nonpublic customer information about customers to non-affiliated third parties in the account transfer process, without giving notice and opportunity for customers to opt out of the policy. More plainly stated, I guess, what is going on is, they are hiring new representatives, and they're assisting the representative in transferring accounts into the new firm from the old firm. It happens every day, all over the country, again and again. The SEC's position is that if you're not ensuring that the old firm had a privacy notice that tells the customers that the information may be shared with a non-affiliated third party, here NEXT, or the rep after they terminate because the rep is now a non-affiliated third party to the old broker-dealer, the SEC says you violate Reg S-P. Same thing on the outbound side, NEXT lets representatives leave, and take certain copies of information for customers so they can continue to work with and serve those customers when they leave. The SEC took the position that because NEXT didn't at the time have an express, explicit notice in the privacy policy telling customers that could happen, and giving them an opportunity to opt out, they violated Reg S-P. They also said that NEXT aided and abetted and caused other broker dealers' violations by encouraging the reps to come over and bring their clients. The ALJ in our conference call, certainly seemed to have a problem with the aiding and abetting part of this claim. But you think about it logically, what can the hiring new broker dealer firm do with respect to the old firm's privacy policy? Nothing, and therein is the problem, I guess. The basic issue, is can brokers and reps continue to use a customer list to notify clients of the rep's change of broker dealers, and assist with the account transfers, absent privacy notices on both ends, the old firm and the new firm, that expressly tell the client what's going to happen and give them an opportunity to opt out?

Melvin Moseley: The SEC says no. I'll just refer you to this article from Shane Hanson[17] who's my partner. It's a very good article, and I am stealing a lot of his

[17] Shane B. Hanson is a partner with Warner Norcross & Judd LLP; he practices in the area of financial services regulation of banks, broker-dealers, investment advisers, financial planners and money managers. Mr. Hanson

material with his permission when I go over this. But, it's a very well thought out article, in *NSCP Currents*[18]. It's called "Balancing Client Privacy and Client Service Regulation S-P Applied to Recruiting Representatives," and it's in the September October 2007 issue.[19]

I think I already covered the positions of the SEC[20], so I am going to skip through this. What's interesting is that SEC concedes that there really have been few customer complaints about their information being shared.

Why, because the customers want to continue working with the broker in most cases that they've been working with. It's sort of a personal relationship business. And, so it's not really that, you know, the customers' complaining that's causing the issue. And its interesting to me, I guess, why the SEC wants to get involved, you know, with this particular situation because I think the customers are benefit from the sharing of information. It makes for a more efficient transfer process. And, in fact, I think it was last year or the year before when the publication came out, talking about the great dissatisfaction that securities brokers' customers had with the delays associated with the account transfers. And, this scenario, where the SEC's position, if it were the law of the land, I think, would create a catch twenty-two because before leaving, the advisor representative has to do one of two things. I mean, he either has to go get individual consent from each of the customers if there's no privacy policy in effect, which would probably violate his duty of loyalty to his firm under existing law. Or, he does nothing, he leaves, his is now a nonaffiliated third party with information in hand, and he's violating Reg. S-P[21]. Ultimately, clients, I think would suffer because it just creates delay.

Now you say, well you say the easy solution is why doesn't everyone just change their privacy policy? But you know that interesting thing is that for years the industry sort of wanted to have its cake and eat it too. They want to stop departing brokers from leaving with the information in a lot of cases, but on the other hand, they want to be able to go and get clients from the firms that they hire brokers from. So it's not so easy that they are going to voluntarily cooperate with this stuff. What I guess I want to point out is that the Gramm-Leach-Bliley Act[22], which gives rise to Reg. S-P implementing those provisions, can be interpreted in a way that I think makes more sense than the SEC's position. And that is to say that the disclosure in the context

---

has published "Bank Growth Through Thrift Acquisitions," "Regulation of Financial Planners and Investment Advisers," and "Franchising a Business Concept" to name a few. He received has law degree from University of Michigan, graduated C*um Laude*, and a B.A. from Albion College, Phi Betta Kappa.

[18] *NSCP Currents* is a compliance journal published by the National Society of Compliance Professionals Inc.

[19] www.nscp.org.

[20] U.S. Securities and Exchange Commission.

[21] Regulation S-P are the privacy rules promulgated under § 504 of the Gramm-Leach-Bliley Act.

[22] Gramm-Leach-Bliley Act (Financial Services Modernization Act of 1999) (Pub.L. 106-102, Nov. 12, 1999, 113 Stat. 1338).

I've just outlined are permitted because the Gramm-Leach-Bliley Act allows disclosure of nonpublic customer information as necessary to effect, administer, or enforce a transaction requested or authorized by the customer, or in connection with servicing or processing a financial product or service, requested or authorized by the consumer, or in connection with a proposed actual sale or merger, transfer, exchange, etc,. That plainly seems to include an account transfer situation, and when the legislation was passed they declined to offer any specific examples prohibiting the kind of exchange we're talking about in a normal account transfer setting where one rep moves from a firm to another firm. Therefore, I mean, they certainly knew about it because it happens every day. And I think it's logical that, you know that Gramm-Leach-Bliley Act can be interpreted to allow the kind of activity at issue. And Reg. SP mirrors those two provisions I just read. So both, you know, the Gramm-Leach-Bliley Act and Reg. SP can be read in a logical coherent way that makes sense under the circumstances. I mean, the whole purpose of it was to make sure people's information is not sent out, you know, willy-nilly to marketing services, sales services they don't want anything to do with, or that it be misused like, you know, identity theft we hear so much about. This particular scenario, helping the client transfer from one firm to another, I don't think is what Reg. SP was designed to prohibit. So, those are my thoughts on that, and with that I will turn it over to Mike, and he'll tell you some of his thoughts about maybe the ramifications that on the litigation landscape and other issues."

Michael Hindelang[23]**:** And I will try and get it done in a little shorter time frame than we had planned so we can get you out of here close to the original time.

We are going to talk about three things, the first or which is tied directly into what Mel just discussed, and presents a little different twist on it, the protocol for broker recruiting and how the Reg. S-P discussion will affect that. Enforcement . . . the Fifth Amendment that Joe was mentioning, and whether you can get Fifth Amendment protection in dealing with a federal enforcement action. And finally, e-discovery, which everyone's heard about and is now beginning to have to deal with.

Beginning with the protocol, it's a 2004 agreement, initially between four broker-dealers[24] and then expanded too many more, which dealt with a

[23] Mr. Michael P. Hindelang is an associate with Honigman Miller Schwartz and Cohn LLP; he specializes in litigation, corporate securities litigation, and e-Discovery. He co-Authored, "Quiet Periods for Follow-On Offerings," *Compliance Reporter*, Vol. XI, No. 46, November 15, 2004, and authored "Alternative Dispute Resolution," *Wayne Law Review*, 2004, and "The Disappearing Tax Advisor Privilege," *Wayne Law Review*, Vol. 49, No. 3, 2003 He received his law degree from Wayne State University Law School, graduating Cum Laude, Order of the Coif, and Dean's Scholar; received his M.B.A. from Wayne State University; and his B.A. from University of Michigan.

[24] The broker protocol was initially announced on August 10, 2004 between Merrill Lynch & Co., the Smith Barney division of Citigroup Inc. and UBS AG's UBS Financial Services Inc., and a deal with Morgan Stanley

industry wide in general. It was initially between the four, and now between everyone, standard method that for allowing registered reps to change firms. And specifically, the protocol says, is to further the interest to privacy, freedom of choice in connection with movement of registered reps, acknowledging that customers want to follow their brokers as a general rule. And you do have two competing issues which were acknowledged back in '04, which [are] the customer's privacy and their information, and the practical ability to transfer the business from one broker dealer to the next. What the protocol does is it allows the registered reps that are transferring firms to take a specific set of information with them, client names, addresses, phone numbers, e-mail addresses, and account types. It does not allow social security numbers, other details about the accounts, statements, or other information that would really facilitate the movement. And, as Mel pointed out, this seems to be at odds with the new SEC push towards what Reg. S-P really means. To date, the broker dealers have not seen action against them specifically based on the protocol by the SEC, but it seems that if it keeps going down the road that Mel just discussed, it's inevitable that broker dealers that are following the protocol to[25] minimize their litigation between one another over business leaving, is going to result in enforcement difficulties for them, if they continue doing this.

Where is going to end up? I don't know. Michigan case law has dealt with the issue twice in the past several years. Once before the protocol, once after the protocol, and didn't mention the protocol either time. There is a 1999 Merrill Lynch case, the *Ran* case[26], and *Raymond James v. Lenard & Company*[27]. In *Ran*, the court decided that all of this information could be protected as a trade secret under Michigan law. And therefore, the brokerage firm that the registered rep was leaving could keep that information because it was a trade secret. Fast-forward to the Leonard & Company case and its not proprietary information that protectable as a trade secret. And, this dealt with customer lists developed by the registered rep while at the firm, but the holding seems to be inconsistent with the first holding. When you throw into the mix the new push towards Reg. S-P and the protocol if you are involved with firms that are both protocol signees, where this is going to end up, no one really knows, but there is a lot of movement in the area. Fifth Amendment . . ."

---

as pending on that date. Jed Horowitz, *Three Firms Adopt Rules to Handle Broker Defections*, The Wall Street Journal, Aug. 10, 2004, Deals & Deal Makers, at C5.

[25] National Association of Securities Dealers (NASD), the NASD was a self regulatory organization that worked with the SEC to oversee the United .States securities industry. As of July 2007, the NASD consolidated with the member regulation to become the Financial Industry Regulatory Association (FINRA). www.finra.org.

[26] Merrill Lynch, Pierce, Fenner & Smith Inc. v. Ran, 67 F. Supp. 2d 764 (D. Mich. 1999).

[27] Raymond James & Assocs. v. Leonard & Co., 411 F. Supp. 2d 689 (D. Mich. 2006).

Audience Member: Before you go to that, Mel . . . have you had any reaction with FINRA[28] on the protocol?" Has the NASD formed . . . ?

Melvin Moseley: Cases you mean?

Audience Member: Yeah, any informal feedback from FINRA on the protocol?

Melvin Moseley: Well, not directly in the way of a question, but I have had some cases recently that involved firms that had the protocol in effect. And, I like when I am defending the departing rep., I will like those cases because the protocol, I think, tends to help me argue on behalf of the departing rep or the new hiring firm, that it's not confidential as they recognize in the protocol. Now they can say, "well the new firm's not a member." Ok fine, but you can't sort of have private information in on context, you know; it's really confidential private trade secret stuff, but then you share it . . . widely with other reps in the firms. And so . . . I have found that to be an effective tool. And I have seen that also in case law at the TRO[29] stage, where it's been helpful to the defendants in the case opposing the TRO, to argue the protocol. . . [t]here's a case out there . . . I don't remember the case citation, but it wasn't that long ago and it involved a rep . . . going to a firm that was not a member of the protocol. But the court said well the protocol sort of waters down the issue of immediate and irreparable harm because it's being allowed anyway.

Michael Hindelang: The protocol also allows non-solicitation agreements, so that can add another level of complexity if there is a non-solicitation agreement in place, then you actually have a situation where you could, perhaps, take the information, but not use it to contact anyone until the term of the non-solicitation agreement runs. So, there are a number of varieties to these situations that will keep popping up over the next couple of years.

Melvin Moseley: The other interesting thing Joe . . . I believe that the SEC sort of, blessed is maybe not the word, but the protocol was approved . . . not objected to, or whatever, in the customary fashion. So it's weird then that the SEC comes out in *Next*[30] and has a kind of different position.

---

[28] Financial Industry Regulatory Authority (FINRA), created in July 2007 by the consolidation of the NASD and member regulation to become the largest non-governmental regulatory organization in the United States. www.finra.org.

[29] Temporary restraining order (TRO), "A court order, usu, preserving the status quo, forbidding the opposing party from taking some action until a litigant's application for a preliminary or permanent injunction can be heard. A temporary restraining order may sometimes be granted without notifying the opposing party in advance." BLACK'S LAW DICTIONARY 1286 (5th ed. 1979).

[30] Next Financial Group Inc. is a wholly owned subsidiary of Next Financial Holding Inc. "Next" is a broker-dealer headquartered in Huston, Texas, with over 700 registered representatives nationwide. On August 24,

Audience Member: You know the thing about *Next*, we aren't signatures at the firm that I represent, and I'm employed by. We are not members of the protocol. We've always been concerned about Reg. S-P. We've always thought that it could be an issue, and we've . . . looked at the SEC's position on all the time as one where they simply haven't dictated any responsibility. And the thing about *Next*, if I read the blurbs on the case right, if you are note a member of the protocol, you have not client consent, it is the firm from whom the information is taken on a Friday night without their knowledge that pays the price. It was the firm that because they didn't somehow have adequate procedures in a relationship based business to prevent a financial advisor from walking away out with names and addresses. It just makes no sense . . .

Melvin Moseley: Yea, you raise a good point on that, I mean, How do you protect, especially, you know Next Financial Group is an independent contractor . . .

Audience Member: Right, I was going to say, they have different issues so their deterred.

Melvin Moseley: Yes exactly, there they view the clients as clients of the broker.

Audience Member: It's really unfair, it seems to me.

Melvin Moseley: Eric?

Audience Member [Eric]: Well, I read the cease and desist order that was issued in connection with Next Financial and, with all due respect to your client, they did a lot more than what would be allowed under the protocol.

Melvin Moseley: No doubt about it . . .

Audience Member [Eric]: They were asking recruits to bring in, not just names, addresses, and phone numbers, but all the account numbers, all of the financial information, and bringing it in a digital form. So that they could in effect, set up all the accounts with a push of the button once they arrived here. And I think the problem arose, in that the SEC said, "Thou shalt not disclose, or obtain in advance, all this confidential proprietary information." And they get this whole laundry list, like account numbers and financial information, and then

---

2007 the SEC issued and order to Next instating administrative cease-and-desist proceedings pursuant sections 15(b) and 21C of the Securities and Exchange Act of 1934, *available at* http://www.sec.gov/litigation/admin/2007/34-56316-o.pdf.

they throw in, name, address and phone number, in there. And that is where I think causes the confusion because they don't say, and or at the end and it's unclear. I would submit that even after *Next*, you could still argue that because name and address, and phone number are generally available publicly, that by definition, it can't be proprietary information. And therefore, the broker should, consistent with not just the protocol, but with their obligations to their customers; announce to the customers using the basic kind of contact information.

Melvin Moseley: Yeah, I make those arguments in defending the reps all the time, but the thing to keep in mind is that, Reg. S-P, when you read it, actually says a list of customers is proprietary unless you can prove it's publicly available. And a strict reading of that means, "can you show me where can get this list of customers publicly?" Because, you know, you can't remember them all, probably. The guy's got 300 clients. "Go show me where you get that list." Can't do it. Even if you say, "it's all in the phone book," Ok fine. You know, there are going to be some that aren't. And I guess more problematically is the Reg. S-P requires that you do all that before you use the information.

Audience Member [Eric]: But, then that gets back to the catch twenty-two you talked about.

Melvin Moseley: Right, I'm saying you've . . . supposed to be able to demonstrate before you treat it as public information, that it is public information. Once you go to all that trouble, then . . . you've already defeated the benefit of using it to begin with.

Michael Hindelang: And in Michigan, it can still be a trade secret; the *Ran* decision says the names addresses, that [were] a trade secret because it was developed while you were at the broker, at the previous broker dealer. So, you've got not only the Reg. S-P, the privacy issues, but then the trade secret issue.

Audience Member: In the *Next* case, to my knowledge, *Next* is not a self-clearing firm.

Melvin Moseley: That is correct

Audience Member: So that information had been conveyed, not by Next but by the clearing firm, which I believe is personal. So I was pursing that subject are included in the matter. . .

Melvin Moseley: On which, on the inbound scenario you're talking about?

Audience Member: On the outbound scenario . . .

Melvin Moseley: Where the Rep. leaves *Next* . . .

Audience Member: And the accounts are conveyed to another firm.

Melvin Moseley: Correct. But in that context *Next*'s problem, according the SEC is that they don't have in their privacy policy, or didn't at the time. The do now, a statement saying, "When your representative leaves *Next*, we will allow them to take certain information with them, including . . . names, address . . . to service your accounts."

And on the other context, it's the sharing of the information with the clearinghouse firm, I suppose, is one instance of the unauthorized sharing of the none affiliated third party. The other is the rep himself is deemed by the SEC to be a nonaffiliated third party once he leaves the old firm, if you can believe that?

And one last comment on your point Eric. In the independent contractor world . . . when I was writing submittals to the SEC in that case, I went online, I searched around. You would not believe how many websites openly tout the transition team, professional transitional team to make it easy for you to transfer your accounts. "We will take care of it totally for you. Prepopulating forms . . . ." There [are] even several third party services that allow prepopulation of the forms . . . where they've got the forms from various firms, and so forth. And that's the whole point, you get the information in a document in the right format, then its just, out it goes. So, its not just Next, it's not just an unusual thing in the independent contractor world.

Michael Hindelang: Ok, Fifth Amendment, the issue that arises with the Fifth Amendment is whether FINRA, the NASD, is a state actor. If the NASD is not a state actor, then the fact that they can revoke your license does not allow you to invoke the Fifth Amendment and claim that it's unfair. If they are a state actor, then their ability to revoke your license in order to compel you to testify is impermissible. So, the FINRA enforcement can come in and compel people to testify under 8210[31]. The sanctions that are allowed under 8310[32], fines suspension, revocation of registration. And the issue arises if the testimony you are going to give is going to be self incriminating.

[31] FINRA Rule 8210 Provision of Information and Testimony and Inspection and Copying of Books, *available at* www.finra.org.

[32] FINRA Rule 8310 Sanctions for Violation of the Rules, *available at* www.finra.org.

Frank Quattrone[33] was a high profile example of this, joint investigation by the NASD, NYSE[34], and the SEC. The NASD came in and took his testimony under 8210. After they took his testimony they advised him that they would be recommending charges. And then set a second requests for testimony. And he decided that it could be self incriminating, and ended up being sanctioned when he wouldn't provide testimony. And the question is, is there . . . The test that was raised in the *Quattrone* case[35] is, is there an improper merger between the enforcement action and the criminal action? They were looking there . . . the NASD and broker participation in a joint action with the commission or are they acting separately? And there's a further refinement in the *Weisman*[36] case that just came out September 18th. Where in *Weisman*, the NASD and Nasdaq[37] were sued for using promotional materials, touting Worldcom[38] as being listed on Nasdaq, then claim governmental immunity. The *Weisman* court acknowledged the governmental role of the NASD in enforcement and prosecutorial roles, while distinguishing advertising roles as being fairly commercial. This distinction seems to clarify, even though there are other cases that raise the same question in *Quatrone*. How is the relationship between them? Here, the Eleventh Circuit is saying, the NASD does have a governmental role when they are acting in enforcement of prosecutorial capacity. Therefore, they would be a state actor. It's in their commercial capacity, where they're advertising, where they're doing things that are outside of the specific grant of authority, as in SRO, that would not allow them governmental immunity, and which would remove them from state actor status. The Eleventh Circuit has in its most recent decision; the other circuits have not addressed it in the same way, and have dealt with the prior question that we have dealt with under *Quatrone*. And so the question is, will this distinction hold, and if so, you now have a Fifth Amendment right not to provide testimony under 8210 in enforcement proceeding because the NASD is a state actor. That is not explicit in the *Weisman* decision; I want to be very clear. However, they do make the distinction, between state roles, the governmental role, and commercial roles, which is the first time that we've seen that distinction.

---

33 Frank Quattrone, a high profile investment banker who was convicted of obstruction of justice on May 3rd, 2004. Editorial, *The Quattrone Exception*, The Wall Street Journal, May 4, 2004, Review & Outlook, at A20.

34 The New York Stock Exchange (NYSE) on April 4, 2007 launched its combination of NYSE Group, Inc. and Euronext N.V. to form NYSE Euronext, *available at* www.nyse.com.

35 *U.S. v. Quattrone*, 441 F.3d 153 (2d Cir. 2006).

36 *Weissman v. Nat'l Ass'n of Sec. Dealers, Inc*., 500 F.3d 1293 (11th Cir.2007).

37 "NASDAQ is the largest electronic screen-based equity securities market in the United States." *available at* www.nasdaq.com.

38 Worldcom Inc. was a telecom company that was involved with a civil fraud suit filed by the SEC, alleging accounting fraud. Subsequently Worldcom sought bankruptcy protection under chapter 11 of the U.S. bankruptcy code on July 21, 2007 in what turned out to be one of the largest bankruptcy filings to date. Young, *Leading the News: WorldCom Files for Bankruptcy --- Debt, Scandal Overwhelm; Operations Set to Continue During a Reorganization*, The Wall Street Journal, July 22, 2002, at A3.

Melvin Moseley: In the context of the . . . civil enforcement actions, how do you think that . . . let's say there is a Fifth Amendment right, and you say, "Ok I'm not going to cooperate in your investigation, I'll take the Fifth." What does that really mean, affectively, assuming that right exists? Can they sanction you for taking the Fifth?

Michael Hindelang: They would, in theory they could of course sanction you. You would then have to go seek relief, claiming that that's an unconstitutional state action, depriving you of your registration because they are compelling your testimony in contravention to your Fifth Amendment Right. It's not an automatic, they can't do it, and as a practical matter it will probably take someone being requested to testify, invoking their right, being sanctioned, and taking this through the courts until someone decides the explicit rule. Sooner or later, will that probably happen, or will there be a clarification? Yes, but for right now, you're right, you still could lose your license, and they could keep doing things the same way. And then they would argue to the courts, obviously, that they are not a state actor, and attempt to get a decision directly on point. [Are there] any other questions on the Fifth Amendment? Let's see if we can get e-Discovery in briefly.

E-Discovery, most of you have heard, or all of you have heard after this morning that the federal rules changed on December one of '06 to specifically address electronically stored information or (ESI), and how that information is discoverable in federal litigation. There is also a request for comment on proposed joint guidance, notice the numbers 0730, which deals with e-mail retention that I'm going to get into shortly. The Federal rules, which while not applicable in a FINRA arbitration, provide you guidance nationwide how to treat E-discovery matters, require that ESI matters be preserved, reviewed and produced, just the same as paper is.

What is ESI? Anything that is stored electronically: email, word documents, data bases, spreadsheets, voicemail, anything that you can think of that is stored in some electronic format is covered by the federal rules. And, it's more pervasive than even most people might think. Ninety-three percent of data now created in American business is created on an electronic format. Seventy percent of that is never reduced to paper. It's only in electronic format. There were 161 billion gigabytes of electronically stored information created in 2006. By 2010, it will be up to a trillion gigabytes if it keeps going the way it's projected.

Melvin Moseley: It's where all the good stuff is.

Michael Hindelang: Oh, yea, e-mail alone, two point seven trillion e-mails in the U.S. in 2007, or about 9,000 e-mails for every man, woman, and child. That is an incredible amount of information."

Audience Member: Talk about needles in a haystack.

Michael Hindelang: Well yes, that's why the electronic production portion is so important. This amount of information cannot realistically be searched. You would have a room full of attorneys searching for weeks or months to review the amount of e-mail a broker dealer would generate any relevant time period for litigation. What needs to be done is search electronically to limit for dates, names, keywords, depending upon the situation. You could dramatically cut down the amount the material that you have to review, and frankly if you are not able to do that, it becomes an impossibility.

Notice to members 0730 deals with a proposed role regarding the review of e-mail and permitting a review of the sample percentage only. SEC is discussing a new books and records rule, which would likely focus on e-mail due too their increased prevalence. E-mails are now so easily searchable and commonly used that they need to be specifically addressed, and as more and more transactions take place, recommendations, customer interaction, e-mails are going to get increased scrutiny.

So, what does one do to deal with the e-Discovery, and what does it really mean? The increased burdens are first, preservation. How do you keep e-mail from being deleted, not only at the point of the computer, where someone could hit delete? Assuming that's easy to deal with technically, you have servers where you could save that.

How do you preserve what's on the servers? You need to have automatic deletion policies to clear stuff out, or it needs to be moved off-site, simply because of the volume.

How do you search? You are going to have backup tapes, you are going to have multiple servers, you are going to have, perhaps, archive or legacy systems if you upgrade your computer system and it's not compatible with the old system, you now have two systems that need to be searched if you get an enforcement request or even litigation.

And then how do you store this? The storage is cheap, but it's not that cheap. You have to have the ability to store this incredible amount of information, whether its e-mail or anything else, and stored in a way that can be preserved and searched. The costs of this are not only in the hardware and software to deal with this, but having personnel who can ensure that you have a system in place that's defensible during an enforcement proceeding, or even defensible to explain why an e-mail that people think should be there is not there, in litigation.

Are you going to need to use vendors, or third parties to come in to help search or control the amount of information? The potential for increased costs is incredible, there are ways to deal with it, but the pitfalls are also costly. Sanctions, Morgan Stanly[39] just paid a twelve and a half million dollar fine.

Adverse *inferis* instructions in court, if you fail to properly deal with electronic discovery, one of the sanctions that the court can issue is an instruction to the jury to presume that the deleted information is adverse to your position. It may not have ever been there, it may have been extremely helpful to you, it may have been innocuous, but it is a sanction that is very hard to overcome. Other e-Discovery issues include metadata, which was mentioned earlier.

Metadata is data about data. Think of every document as having two sides, there is a side that you can see, it is the front of the page, [and] the back of the page contains a variety of information, depending upon the program. It could be just, when [it was] last saved and who saved it, it could track every time the document was accessed, modified, printed, edited, who did it, when it was done, and that could all be stored there. It's different for each program. And, metadata is presumptively discoverable.

There are also rules, and this was eluded to earlier, about whether attorneys can search for metadata in, take it outside of the discovery context for a second, a proposed settlement agreement.

Can you go in and attempt to pull out the changes that the previous person made, and see what their initial draft looked like? The ABA and the D.C bar have taken the position contrary to that of New York, Florida, neither Alabama or Mississippi, I don't recall which one. So, you know it has it hasn't been decided in Michigan yet, no one knows how it will go.

Form of production was addressed previously. Someone mentioned cloning, and the dangers of cloning. There are people that say, "Well fine, we need to save this, just copy the whole server, we'll set that aside and now we've got it." You've got two problems. One, you are paying for an entire duplicate set of information. And second, you've preserved, perhaps dramatically more than what you need, and now it needs to be searched in every

[39] Morgan Stanley is a publicly traded financial services firm that paid $12.5 million for mistakenly telling regulators that the e-mails sought by the SEC were destroyed during the September 11, 2001 terrorist attacks.

enforcement action or piece of litigation that arises while you still have the present. And so, you are multiplying the universe of information you're holding, and you're further increasing your costs by trying to cut costs on the front end.

And then the fun area is electronic information. Where is it? In the broker dealer context, if we are talking about privacy issues and everything else. The start of this, how easy it is to transfer files in a matter of seconds from Mel's computer to a flash drive, to another computer? More stages of that, you have in virtually half the laptops now, a SD card. SD's a memory card, it goes in my phone, [and] it goes in half the cameras that are made. You could have someone take data, put it on one of these memory cards, take back home, stick it in their camera where no one would ever find it, but they've got it hidden for when they want to use it or need it. There are all sorts of fun nefarious things that one could do with electronically stored information.

And then finally dynamic data. You have data bases. You have inventories that are constantly changing, instant messages. Do registered reps what to use instant message services to contact their customers? Even if you block them, there was just an article in the Wall Street Journal[40] about a website that serves as a portal for IMs, allows you to use five or six different systems through a webpage that isn't blocked by IM blockers on the [rep's] site. And all of this is falling within e-Discovery arena, and some of it is creating significant litigation concerns and enforcement concerns in keeping track of what sort of information is out there.

Melvin Moseley: You know, my guess is that someone will get a handle on this . . . . It will be burdensome, but will be just like paper is now. It is a pain, but we know how to go about it. But now, it's sort of, you're in that no man's land. Unless, you have a sophisticated corporate client with an IT department you can go to and get all the information . . . Just like you said, you don't really know where it is, where to go, how to get it, and neither does the client a lot of times.

Michael Hindelang: Right . . . there are a variety of firms that, if you try and do this in-house, then your in-house IT people may have to testify about exactly what they did. If your law firm is doing it, they may have to testify. So, you almost are forced to have your law firm hire a vendor who will then testify. And, you also need either inside counsel or outside counsel who understands these pitfalls, and can help guide you through because [of] the repercussions, as Mel pointed out. Until someone gives us more decisions that really guide

[40] Mamberto, *Instant Messaging Invades the Office --- Companies Say It Spurs Broader Collaboration -- And Scares Some Bosses*, The Wall Street Journal, July 24, 2007, at B1.

where we are going there have been some flyers out there, in terms of the sanctions. And what's important to Mel and [me], sanctioning trial counsel as well as the client. So this is going to be a fun issue to watch.

Joseph Spiegel: I want to thank the panel, who was terrific.