PROCEEDINGS OF THE 2009 MIDWEST SECURITIES LAW INSTITUTE SYMPOSIUM*

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INTRODUCTION AND SUMMARY OF EVENTS

Elliot Spoon[1]: Good morning, everyone. My name is Elliot Spoon, I am a professor and Assistant Dean here at MSU College of Law, and I want to welcome you to the 2009 version of the Midwest Securities Law Institute. We have a few things to cover before we turn it over to our first panel. The first is to acknowledge some of our law students who have worked so hard to put this Institute together this year, as they do every year. So, I'd first like to call up, to acknowledge, two of the leaders of the Business

* **Note from the Editors and Disclaimer:** The following is a minimally-edited transcript of the panel speakers from the 2009 Midwest Securities Law Institute (MWSLI) Symposium, an annual one-day gathering of securities lawyers held at Michigan State University College of Law on October 16, 2009. Biographies of the speakers are footnoted throughout. Opinions of these persons are not necessarily the opinion of their respective agencies. Opinions are not to be used for any legally binding purpose regarding the speaker or any agency.

1. Professor Elliot A. Spoon began his private practice at Butzel, Keidan, Simon, Myers & Graham. Later he chaired the firm's corporate department and was a member of its management committee. He also chaired the business transactions practice group and was a member of the executive committee at Jaffee, Raitt, Heuer & Weiss. Spoon teaches contracts, corporate finance, mortgage banking, and securities regulations at Michigan State University College of Law. He is co-chair of the Law College's corporate law concentration and faculty advisor to the JOURNAL OF BUSINESS & SECURITIES LAW and the Business Law Society. Additionally, Spoon serves as the Assistant Dean for Career Development and Director of the Externship and Legal Education Opportunity Program at the Law College. Co-chair of the Midwest Securities Law Institute since 2004, Mr. Spoon graduated *cum laude* from the University of Michigan Law School where he was on the staff of the Journal of Law Reform.

Law Society, Kate McDonald[2] and Todd Jennings.[3] Kate is the President of the Business Law Society and Todd is the principal liaison with the Midwest Securities Law Institute, and they've worked for many months to make sure that this gets pulled off in spite of what I may or may not do. We're very proud of what they've done and I'd like to acknowledge them now.

The next group I'd like to call up are the two Co-Editors of the JOURNAL OF BUSINESS & SECURITIES LAW, Matt Leffler[4] and Philip Ellison.[5] This is a wonderful story. Six years ago, the students had the idea of starting a journal about business and securities. There are very few, in fact, journals of business and securities law in the country. This was purely a student operation. They had no official recognition from the law school, but because of six years of hard work, a couple of weeks ago, the faculty of the law school and the Dean approved the JOURNAL OF BUSINESS & SECURITIES LAW as an official journal of the Michigan State University College of Law. It is a wonderful journal; we've published some pieces of participants here, and in fact, in the Journal is the official transcript of this Institute and has been for several years. My co-chair, Joe Spiegel, has asked me how many hits the website containing the Institute has gotten over the years and it's certainly something approaching ten thousand, because we monitor this very closely. We are very proud of the growth and now offi-

2. Ms. Kate L. McDonald is a third year law student at the Michigan State University College of Law and President of the Business Law Society. She is also a member of the JOURNAL OF BUSINESS & SECURITIES LAW. Ms. McDonald previously graduated from University of Wisconsin-Madison.

3. Mr. Todd M. Jennings is a second year law student at Michigan State University College of Law. In addition to being the Midwest Securities Law Institute Student Representative, Todd serves as the Alumni Liaison for the JOURNAL OF BUSINESS & SECURITIES LAW. Mr. Jennings graduated from Grand Valley State University with a B.B.A. in Business Economics.

4. Mr. Matthew M. Leffler is a third year law student at Michigan State University College of Law where he serves as Co-Editor in Chief of the JOURNAL OF BUSINESS & SECURITIES LAW. He previously served as Editor of Events. Mr. Leffler previously graduated from the University of Illinois at Urbana-Champaign where he studied political science.

5. Mr. Philip L. Ellison is a third year law student at Michigan State University College of Law where he serves as Co-Editor in Chief of the JOURNAL OF BUSINESS & SECURITIES LAW. He previously served as Editor of Publications. Mr. Ellison previously graduated from Lake Superior State University with a B.S. in Business Administration and earned his M.B.A. at Central Michigan University.

cial status of this Journal and we know that what is published in here really does have an impact and is read across the country. Being also entrepreneurs that they are, they have indicated to me that subscriptions for the Journal are a good thing, and you can get your subscription forms on the table outside and we would appreciate you at least entertaining the idea that this may be something that is worth subscribing to. Thank you.

The last thing I want to say about the students is that we have strongly encouraged our students to attend, both to hear the speakers and to meet all of you in the practice field. As you may know, the job market isn't so good out there. It's particularly not that good for entry-level lawyers. We encourage our students to meet practicing lawyers to get a better understanding of the market and also to make contacts. When it comes to breaks and lunch, we're going to make them approach you and we would appreciate it if you would reciprocate. Now, it is my pleasure, as sort of the official opening of this conference, to introduce to you our Dean, Joan Howarth. Dean Howarth has been at the school now almost a year and a half and has already had a major impact on life at this law school. With a great deal of pleasure, I introduce Dean Howarth.

Joan Howarth[6]: Thank you, Elliot. I want to first thank Elliot and his co-chair, Joseph Spiegel. As the chairs of this event, this is an enormously important event to us. In fact, as I was coming in this morning, I thought, I could welcome you to two events here. You all are, perhaps unwittingly, participants in Michigan State University's homecoming weekend and I hope that that won't cause too much dis-

6. Dean Joan Howarth began as dean of the Law College in July 2008. Prior to her deanship, she was a professor at the William S. Boyd School of Law at the University of Nevada, Las Vegas, since 2001. There, she was instrumental in building the Boyd School of Law, founded just a decade ago, serving for four years as associate dean and helping to establish Boyd's early and strong national reputation. She began her career as a law professor in 1989 after stints with California's Office of the State Public Defender and the ACLU Foundation of Southern California. She has been a faculty member at the Golden Gate University School of Law and a visiting professor of law at the University of California, Berkeley, School of Law, UC Hastings College of Law, and UC Davis School of Law. Most recently, she has taught courses on constitutional law, gender law, and a Capital Defense Clinic. The scholarship for which she is most known focuses on gender and the death penalty. She is a leader in legal education through work with the Association of American Law Schools, the American Bar Association, and the Society of American Law Teachers.

ruption for your lives. There will be a parade later and all sorts of other things. Even more importantly, you are participants in what, to the law college is a more significant sign of the fall season, and that is the wonderful Midwest Securities Law Institute that Joe and Elliot have been putting on now. This is important to us as a law college for lots of reasons. First of all, we are absolutely committed to building an excellent business law program here at the law college. We have wonderful faculty, including Elliot and others. We have great students, including the students who are here and will be participating with you today. We have extensive, fine programs, but I know that there is no such thing as a truly excellent business law program in the law school unless we have great lawyers here, on campus, who are working with us and with our faculty, with our students, and with themselves in bringing really the most important issues related to business law, and in the case, particularly securities law to our law school, to our students, and to each other. This is an important event for us, since I said we are ambitious. We're pretty proud, we're very proud of what we've already accomplished, but we're very ambitious and we are, I see very much, that an event such as this one is part of building the excellent business law program that we are building here at Michigan State University College of Law. Thank you very much. I also want to say we pride ourselves on being good hosts. If there is anything that you need, there will be people here, Elliot and others, people here at the table outside, to help you to get whatever it is that you need, because I know that if we can make things comfortable for you, then this will be the kind of engaging, intellectual, and professional day that you all have come for. I want to also especially thank all of the experts who have come to be able to lead the seminar today, starting with the fine first panel and the other panels during the day. Thank you very much for participating with us in what I know will be a fine event. Thank you.

Elliot Spoon: I'd like to introduce, for some brief remarks, my co-chair, Joseph Spiegel.

Joseph Spiegel[7]: Every year, I try to think of something that has happened over the past year that gives us pause. There was an article in the New York Times which reflected upon the last four hundred years of bubbles.[8] 1637, the tulip mania. 1720, the South Sea bubble. 1920s, the U.S. stock market, real estate debacles. The 1840s and 70s, the railroad bubble. 1980, the gold bubble. The 1990s, the dot com stocks. 2008, oil. 2009, real estate, derivatives, credit default swaps. I can't imagine what government, and I use that term broadly, thought in this last year when everything started melting down. It gave me pause and I thought, well, Warren Zevon had a wonderful chorus to one of his songs. It was about a young man that goes to Cuba and is gambling, not too different than some of the banking institutions in this country. He got into trouble gambling and the chorus goes, "send lawyers, guns, and money, the shit has hit the fan."[9] I think what you're going to hear over the next day, or this day, is what to do when that event occurs. We have a phenomenal set of materials, an excellent set of speakers. I've mentioned nine bubbles. I don't know what the tenth bubble is going to be, whether it's something like Beanie Babies, or viaticals,[10] or whatever. I'm going to leave that to your own imagination and pocketbook as to what the next bubble is going to be. I'm going to turn this back over to Elliot. Thank you for coming.

Elliot Spoon: The CEO of a large financial institution attempted to describe for me what he considered to be the three stages of business cycles. After there has been a cataclysmic

7. Mr. Joseph Spiegel is an Ann Arbor, Michigan-based attorney with extensive experience in securities litigation and FINRA (formerly known as NASD) arbitration. He specializes in federal and state securities law in corporate finance, broker/dealer areas, regulatory matters, commodities law on the Federal and Exchange levels, and general corporate and partnership law. He received his B.A. from Cornell College in 1968 and his J.D. from John Marshall Law School in 1974.

8. Catherine Rampell, *Same Old Hope: This Bubble is Different*, N.Y. TIMES, Sept. 14, 2009, at B1.

9. WARREN ZEVON, *Lawyers, Guns and Money, on* EXCITABLE BOY (Asylum Records 1978).

10. A viatical settlement is an investment contract in which an investor acquires an interest in the life insurance policy of a terminally ill person at a substantial discount. When the insured dies, the investor receives the benefit of the insurance. Michelson v. Voison, 658 N.W.2d 188, 189 n.1 (Mich. Ct. App. 2003) (citing SEC v. Life Partners, Inc, 87 F.3d 536, 537 (1996)).

event, there is typically an inquisition and then a reformation. Right now, we're sort of between, and they overlap. We're partly in the inquisition phase, and partly in the reformation phase. Our first panel is going to be talking part of the inquisition phase, which is criminal issues with respect to securities violations and raising a number of issues, including the criminalization of business conduct. We have on the panel Richard Zuckerman, William Bila, and the Honorable Virginia Morgan, who will be addressing various issues of criminal securities violations.

CRIMINAL SECURITIES VIOLATIONS AND PROCEEDINGS

William Bila[11]**:** On behalf of the panel, two things. First, thank you all for coming and the opportunity to have us here today. Second, please, any questions, comments at any point during the presentation, please just jump in. It always makes it much more interesting when we get some audience interaction. Please feel free to jump in if you've got a question or a comment at any point along the way.

We have a hypothetical for you. I believe there should be a copy of that in the materials. We'll have it up on the slides as well. The hypothetical is a thinly-disguised real case of mine. Like dozens of other cases, it's about a company that rode the mortgage sub-prime balloon to spectacular heights and then popped just like a balloon and created massive losses. When you have situations like that, everything gets turned upside down. I represent insurers who issue directors and officers liability policies. The classic claim involves me looking for ways to save a bit of that policy limit for the benefit of the insurance company. Directors and officers have very different interests. They want out. Get me out of this lawsuit. Get me out of these proceedings. Pay my lawyers. I don't care what it costs. That's your problem, not mine. When you have a loss as spectacular as this, everybody knows right out of the gate that there's not enough insurance. One hundred fifty million dollars is not enough insurance. So, roles get reversed. The insurance company is actually looking to honor that com-

11. Mr. William P. Bila is a founding partner at Walker Wilcox Matousek, LLP of Chicago, Illinois. His practice is focused on directors and officers, financial institutions, and employment practices liability, which covers a diverse spectrum of claims, including subprime, deepening insolvency, option back-dating, derivative actions, market timing, contingent commissions, state and federal investigations, wage and overtime class actions, mergers and acquisitions, securities fraud class actions under the 1933, 1934 and 1940 Acts, and all types of employment disputes. William is a frequent writer and speaker on a number of professional liability topics through the Professional Liability Underwriting Society, American Bar Association, American Corporate Counsel Association, Public Risk and Insurance Management Association and American Conference Institute. Recent speech topics include options back-dating, deepening insolvency claims, insurance coverage for criminal actions, rescission and application defenses, mutual fund and investment advisor risk management, online insurance transactions, insurance company exposures and trends in claims against public officials. Mr. Bila received both his B.A. and J.D. from the University of Illinois at Urbana, in 1985 and 1988, respectively.

mitment to get people out. All the directors and officers in their various factions want to make sure that they're the ones that get out, or they're the ones that get out first. You have a keen interest suddenly on the other side on saving those policy proceeds. You get involved in some very unique conflicts and it requires some creative thinking. Let's go to our hypothetical. We've got Wolverine Farm Mortgage Company, founded in 1997, and saw its path to growth via the sub-prime mortgage boom. So you see spectacular growth there from '01 to '05, from one hundred fifty million dollars in loan production all the way up to fifty billion dollars in loan production. Everything's going great, the stock price is soaring, lots of people are employed, lots of people are making money, lots of people are getting mortgages, everything's great. November 2006, the housing market starts to slow down. Wolverine ensures its investors that there's no problem here. We recognize the challenging environment, but we're solid, we're good, our portfolio is sound. Bad news starts to leak out in 2007. Suddenly, we're revealing that reserves for loan purchases are insufficient and we're starting to book pretty significant losses. By late March, the stock has fallen from literally one hundred forty dollars down to pennies. In April, the company files for bankruptcy and by May, the company is announcing that previously filed financials are unreliable. What you have here is a recipe for a lot of civil lawsuits and a lot of SEC investigations and probably some criminal prosecutions. That's exactly what happened in our hypothetical and in real life. We've got a preliminary inquiry into alleged accounting irregularities. We've had a grand jury subpoena issued. We've got criminal charges brought against the CEO, the CFO, and some key management personnel. We've got an SEC investigation. They've asked the company for documents. They've asked some directors and officers for documents. They've requested, or expressed an interest in receiving Wells letters. Those are letters, for those who might not be familiar, written on behalf of the directors and officers, trying to convince the SEC that there's no "there" there, that there's no case, there's no fraud, there's no crime, this is just something that happened to this bank and every other bank. Then we've got some formal civil charges, ultimately being filed by the SEC against upper management as well as the audit committee of the company's board of directors. We've got a shareholders class action suit accusing the company of securities fraud and insider trading under 10(b)[12] and 20[13] of the Securities Exchange Act. We've got a bankruptcy trustee who has initiated a suit on behalf of the company against the directors and officers and he's demanded eighty million dollars to release all claims against everybody except the CEO and the CFO. The trustee is going to pursue those people for personal contributions on top of anything that she can get out of the insurance. So, what happens? All this paper starts flying, lots of people start hiring lots of lawyers, lots of expensive lawyers. Very good lawyers, but very expensive lawyers. Because of conflicts of interest and potential conflicts of interest, you'll see that you can't have one firm defend all or most of these people. You've got to have several large law firms involved. That creates a pretty significant burn rate on the policy. If you're not familiar with a directors and officers policy, defense costs are paid out of the available limits. The more you spend on defense, the less you have for settlements or judgments. The burn rate on a situation like this – anybody want to guess the monthly burn rate? Two to three million dollars a month.

Audience: That's just for us.

William Bila: You can see that a series of proceedings that goes on two, three, four years can really cut that one hundred fifty million dollars in half in no time at all. In our hypothetical, we've got Illini Indemnity Company that has issued a policy with one hundred fifty million dollars in limits. Illini has agreed to advance all legal fees and expenses under what is called a reservation of rights. Counsel for the outside directors are keenly interested in knowing about that burn rate because they recognize that the criminal defense, especially, of the CEO and the CFO might consume as much as two-thirds of that monthly burn and they want to do everything they can to try and control that.

12. 15 U.S.C. § 78(j) (2000).
13. 15 U.S.C. § 78(t) (2000).

Issues faced by counsel. This is where I think we'll start having our panel members interject. Let's talk about conflicts of interest. How serious of a concern is that conflict of interest, what needs to be done, and what can be done, if anything, to try to coordinate or consolidate the efforts to preserve that pile of money.

R. Zuckerman[14]: The most likely triggering event that starts one of these things off is a letter from the SEC to the company asking for documents. The SEC investigation typically, but not always, precedes either contact by the criminal people or even the opening of a criminal investigation. Once the letter, which usually encloses an SEC subpoena, issued after a formal investigation has been authorized by the Commission. The company will call its usual counsel and say, "I got this, what do I do?" That triggers a variety of issues with respect to the law firm, or it should. First of all, who is the law firm representing? It really can only represent either a company or one of its significant officers. The law firm has to make a decision as to who it's going to represent. Likely if it's ongoing counsel for the company, it will represent the company. You then have to start thinking about how the firm will be engaged because you want to maintain, as much as possible, until you decide to waive it, which is usual these days, the attorney-client privilege. Then, once you sit

14. Mr. Richard Zuckerman is a senior partner in the Litigation Department at Honigman, Miller, Schwartz and Cohn in Detroit. In addition, he chairs Honigman's white collar crime and government investigations practice group. During the mid to late 1970's, Mr. Zuckerman was an attorney with the Organized Crime and Racketeering Section of the U.S. Department of Justice, assigned to the Detroit Organized Crime Strike Force. Among the many investigations and trial in which he participated was the investigation into the disappearance of Jimmy Hoffa and the seven month income tax evasion trial of Anthony Giacalone, the individual Jimmy Hoffa was to meet the day he disappeared. Subsequent to leaving the Department of Justice and entering private practice, he has concentrated on representing corporations and individuals under investigation by various agencies of federal and state government in Michigan and elsewhere. Currently, he is co-lead counsel for the Detroit Free Press in its FOIA lawsuit against the City of Detroit, its ex-mayor, and the ex-Mayor's former Chief of Staff seeking text messages and related documents pertaining to a whistleblower lawsuit filed against the City of Detroit and the ex-Mayor, Kwame Kilpatrick, by two former Detroit policemen. In addition, he was recently selected by a Michigan Fortune 100 company to be its lead counsel in a five hundred million dollar lawsuit against the U.S. Government for interest due on overpayments of corporate income tax. From 1978 to 1995, and again in 2004, Mr. Zuckerman was an Adjunct Professor at the Detroit College of Law, now Michigan State University College of Law. He has authored articles on various aspects of federal practice and is a frequent speaker on white-collar crime and related topics.

down and start taking facts from corporate officers, you have to be very clear when you talk to the officers as to who you represent, what purpose you're there for, who owns the attorney-client privilege, which is the company, whether the privilege will be waived, whose decision is it, the company's, and issues like that. Because, if you are talking with corporate officers, you may discover during the course of the conversation that they may need separate counsel. You have to be careful and keep the lines very clear as to who you represent. It's also conceivable that in a large public company, where this matter is brought to the attention of the board, the board may refer it to the audit committee, and the audit committee usually consists of outside directors. The outside directors today, and the entire board, are very nervous. They may require separate counsel for the board and they may require separate counsel for the audit committee. Depending on circumstances, and I've been involved in situations where all this has happened, then one or more members of the board want their own lawyer because of imputed liability issues in the civil context and, perhaps, depending on individualized conduct, also conspiratorial liability. Everybody gets very nervous. The first issue is, know who you represent. Be authorized by the board to conduct an investigation and then make certain, in discussions with the board, whether or not the board wants separate advisory counsel, whether the audit committee is going to conduct the investigation and they want separate counsel and then see whether or not any individual board member wants counsel. Then you begin an inquiry. If you decide to do a favor and be all persons to all things, you'll wind up either being disqualified at some point in time, usually by the SEC right away when they find out you're representing the company and the individual, which is a foolish thing to do and it's also sophomoric. Some people try to do that. They'll try to disqualify you, and then, of course, you could wind up being sued for malpractice because you can't possibly balance conflicting loyalties like that. I would note, on the disqualification side that even if there are waivers among people, when you at least get involved in a criminal investigation, a federal one, courts have an independent obligation to determine whether or not there is a conflict, notwithstanding cross-waivers among people with conflicting interests. The court can disqualify you and the remedy is to be out of the case, not just "Okay, you can't represent both of them, pick one." You're out of the case. You also have to be careful and mindful, not only to not create an issue with the client you represent, but not put yourself into a situation where a court, certainly in the criminal context, and perhaps even a civil one if the SEC raises it, can disqualify you as well because, for example, if you do something that dumb, your client, the company, will sue you. They'll want their legal fees back.

Hon. Morgan[15]: There's always the fact that you could face obstruction of justice if somebody down below says, "he made me say this" or, "he made me say that" or he goes to the prosecutor independently because he or she is afraid of going to jail and says, "this is what the lawyer said in the meeting and I'm concerned about that" and you could turn out to be the focus of the investigation.

R. Zuckerman: It's possible. I mean, the real issue to lawyers is: are you going to get thrown out of the case without earning any money? You have to be very careful, however, for ethical reasons and also for civil liability reasons. Those two predominantly, not to wind up resenting people, people or entities that are at cross purposes. Even if you don't know for sure at the time they're at cross purposes, it's foolish to put yourself into that particular situation.

15. The Honorable Virginia M. Morgan is a United States Magistrate Judge in the Eastern District of Michigan, having been first appointed in 1985. Her work focuses on federal criminal and civil litigation with an emphasis on facilitated mediation and settlement. Previously, she was Chief of General Crimes and a trial lawyer with the United States Attorney's Office and began her legal career as the first woman assistant prosecutor in Washtenaw County. Prior to becoming a lawyer, Judge Morgan taught high school mathematics and science on the Navajo Indian Reservation, in California and in Ohio. Judge Morgan is active with national and international judicial associations and is a Fellow of the State Bar Foundation. She is past national president of the Federal Magistrate Judges Association, and a former member of the Federal Judicial Center Board of Directors, the Long Range Planning Committee of the Judicial Conference of the United States. She has served on various local, state, and national committees including the Ethics and U.S. Courts committees of the Michigan State Bar (and is past chair of the Washtenaw County Bar Young Lawyers section). Her international activities include presentations to Russian judges and judicial workshops in Serbia and Montenegro. She is the author of numerous articles and published opinions and regularly teaches new judges for the Federal Judicial Center in Washington D.C. Judge Morgan is a graduate of the University of Michigan and the University of Toledo College of Law, where she was salutatorian.

We're very careful. We try to be very careful about that. Also, one bit of jargon. These are policies where the available limits go down as the legal fees are paid from the policy, so, if you have a one hundred fifty million dollar policy and all the lawyers cost twenty million dollars, there's only one hundred thirty million dollars left to pay – those are called Pac-Man policies, because the lawyers are gobbling up the limit. So if you hear somebody talking about a Pac-Man policy, that's what a Pac-Man policy is.

Hon. Morgan: What do you think about joint defense agreements and when would you get involved in them?

R. Zuckerman: It kind of depends. I look at joint defense agreements as agreements among lawyers who don't trust each other. In which case, you can sign a joint defense agreement, but you don't want to do that necessarily with the other lawyer if you don't trust him in the first place. Joint defense agreements are very case-specific and they can be very problematic. They're problematic in these contexts. They usually contain a provision to exchange confidential information, be that one lawyer to another or where you have these joint lawyer meetings. Sometimes the clients are present, which is a very bad idea, but some lawyers bring their clients to these meetings. You're exchanging a bunch of confidential information and you do it under a joint defense agreement so the attorney-client privilege isn't waived. Then, one of the clients decides to bail out and cooperate because that's the position he's left in. Then you have to go to the joint defense agreement and see what's in there, assuming you know what's in there. Hopefully, you read it before you signed it, about what you have to do with respect to a client who is leaving a joint defense arrangement. That agreement itself can raise a variety of issues, and I don't particularly like them. You know, I know how to talk to other lawyers on a case, they know how to talk to me. We don't need among us some document that's nothing but litigation fodder. However, you get into this more frequently if you're dealing with a large case with lawyers from various jurisdictions that don't know each other. The first thing someone is going to say is, "let's have a joint defense agreement." I don't like them because any time you have an agreement, a contract, you raise issues. There's also, among some prosecutors, I have not personally run into this, a notion that somehow the joint defense agreement itself is obstructive. You've got to be careful about joint defense agreements that contain language that can be implied to mean that people won't talk to the government if asked, or you need permission to talk to the government among all your co-defendants. It raises a lot of issues. There is a lot of literature on it. Whether you sign it or no, I think, is a function of who is in the case, meaning who the other lawyers are, and what the language of the joint defense agreement is, particularly the language regarding withdrawal from a joint defense arrangement.

Hon. Morgan: If you represent the company, then do you see your primary client as house counsel?

R. Zuckerman: No, the client is the board of the directors. House counsel is an intermediary and in these kinds of cases most of them stand aside, nobody wants to make a decision in these cases they leave it to outside counsel. Now they are your contact point, you deal with them whether or not they are involved in the function of what the board directs them to, but you're the company lawyer and as such the manifestation of the company is the board. And in some cases, it's the audit committee, because the focus of these investigations is usually on the people that run the company, the CFO primarily, the CEO maybe the COO if it's that large of company, and some of these people might be corporate board members, so that's why a lot of these investigations are run under the auspices of the independent directors because one or more of the company appointed board members may be, if not an actual person involved, a potential person involved as the facts develop. It's hard to report to the guy that cooked the books.

Hon. Morgan: And what do you do when that happens?

R. Zuckerman: When you find out…

Hon. Morgan: Right when you have explored some internal documents or whatever and you find out that this guy might be or is the one who cooked the books, at that point then do you recommend that you get a new lawyer do you stop reporting to him, how do you handle that?

R. Zuckerman: As I said it is unlikely that an internal director would have cooked the books. It is more likely that the president, CEO or corporate board member cooked the books. If you're in a situation where the president of the company has convinced the independent directors that he can run this investigation and then you discover that there is some involvement. Your duty is to go the audit committee and say here are the facts as we see them right now even though perhaps they are not conclusive we no longer feel comfortable with his involvement and his knowledge and his being involved in the investigation. So, you have to isolate him out from any role in the investigation. But, I don't think you'll find many of these full blown investigations being conducted other than under the auspices of the audit committee or such committee made up of only the independent outside investors.

Hon. Morgan: So this investigation would include document preservation and review of all that by you and/or your law firm.

R. Zuckerman: These questions open up a Pandora's Box and that is the whole notion of electronic discovery. You can have a three hour discussion about electronic discovery. There are certain things you got to do right away when you get notification from a governmental agency that the Company's under investigation, one of which is to make certain that everything is preserved. It is easy to do that, it sounds easy and it is somewhat easy to do that depending on the sophistication of the company's computer system. For example, you can freeze all of the servers so that nothing can be deleted anymore at the server level. A lot of companies have distributed computing so perhaps you also have to isolate and prohibit an individual who has saved files on his own hard drive from deleting documents. Some companies are laptop only; they're virtual office laptop type organizations. You got to figure out a way where someone can't take his laptop home and start, you know, running a disk sweep program. But, you have to first, and then you have to preserve takeaways. So the first thing, I mean there are a lot of first things in these kinds of cases, who do you represent, you got to freeze the documents. You get this enormously burdensome SEC subpoena you got to try to have a conference with the SEC right away to narrow it into something reasonable. You got to make a decision about anything that you're being told or suspect that would lead you to believe that any particular person or group within the company is culpable. What do you do with those people and their data versus some guy out in Samoa somewhere and you worry about what he is going to do with his data. Preservation, document preservation and electronic documentation is a big deal.

Hon. Morgan: How much of this do you expect to be shared with you. Do you just expect a bill at the end of the month or do you have an ongoing conversation, like Mr. Zuckerman.

William Bila: We like to be very much part of the process from beginning to end and we like frequent communication. Very often there's privilege concerns expressed, we ask for, a lot of times the documentation productions in these cases are literally millions of pages. Insurance companies already pay good defense lawyers to whittle those down and figure out what the twenty, keep-you-up-at-night documents are. We like to see what those documents are; we like to look at them. That raises attorney/client and work/product privilege concerns. A lot of times we have to enter into some sort of confidentiality and/or joint defense agreement, in order to satisfy those concerns. A lot of the times we are just simply able to point out that the only people that would really try to attack you there are going to the civil plaintiff's counsel. The key to upholding privilege, they understand they are not going to get the insurance company check unless the insurance company understands the case. So very often, a short simple dialogue among plaintiff's counsel, defense counsel and insurance counsel will solve that problem. Sometimes formal agreements and/or consent decrees are required in order to get us the information. The more the insurance company understands about the case, the sooner they understand it, the better position they are to respond when there is a request for settlement or something like that.

Audience: How do you deal with grand jury subpoenas, grand jury testimony, grand jury documents? I mean does the insurance company have a right to that?

William Bila: We ask for a lot. (Laughter) That is something that we don't get as often as we like. A lot of times we try to find substitutes for that. Sometimes we'll sit in a room and somebody will read a transcript to us and allow us to take notes. Sometimes…

Audience: Doesn't that violate the grand jury secrecy rules?

R. Zuckerman: Well wait you're not going to get a grand jury transcript until your indicted which is a little late in the game and then the government has complied with what is called the Jencks Act which is the time at which, it is a federal statute 18 USC 3500, I think, that defines when a defendant is entitled to get statements of witnesses.[16] If someone is reading a grand jury transcript pre-indictment, there is some form of obstruction or there is a problem there as to how you got your hands on it. The grand jury proceeding separate, it's secret and you are not entitled to a copy of the witness transcript like you would in a dec. So that's kind of, you got to put the focus somewhere.

Hon. Morgan: But, you will get a grand jury subpoena and somebody may request the insurance company pay for representation.

R. Zuckerman: Yeah, everybody wants the insurance company to pay and the tension is what do you tell the insurance company, not because you don't want to tell them things, but you might not want to, and I'll get to that in a second. But, the real problem is privilege waiver, and you've got to be careful of what district in which you are litigating or conducting, where the investigation is being conducted because the law on privilege/waiver, although fairly uniform, it is not one hundred percent uniform. If you want to communicate with the carrier we like to say the investigation is ongoing and company denies all wrong doing please pay. That's about, then they have to get away from that kind of letter and you try to figure out what you need to give them so that they continue to pay because they usually have a cooperation paragraph in their policy. If you don't cooperate and they become uncooperative then the money dries up. One way to do it is to speak to them in terms of the government allegations. There is nothing wrong with telling someone well this is what the government thinks and then where you get into, because that will outline the case. If they want

16. 18 U.S.C. § 3500 (2009).

to know well what do you think about what the government thinks? Then you've got to figure out how to do it in a way, which if it's discovered, doesn't cause a backlash to the individual client. The other problem you may have in policies, and I'll leave that to Bill, is they have an exception for coverage for criminal conduct, some of them do. I don't know if that is sometimes defined in some policies, sometimes it isn't, so you've got to be careful about facts because they can get added to policies, they might want to try and use that.

William Bila: You know I think that just about every D&O policies will have an exclusion for criminal acts. Most of the time that exclusion uses the key phrase "in fact." And the way courts interpret that and the way the policy is marketed, in fact means that there has to be a judicial termination of some sort. That there has "in fact" been a criminal act. So you're going to have to have before you can try to deny coverage for criminal acts exclusion, some sort of an adjudication.

Hon. Morgan: So you have never filed a dec[laratory] action before there was a criminal case to decide whether or not you were going to pay or not pay?

William Bila: Generally no, although there is a recent decision out of New York that suggests that we should. I don't know if people are aware of the case, the decision in *Underwriters of Lloyd's v. Milberg Weiss* just came down recently.[17] Milberg Weiss for those who do not know is a notorious plaintiff's securities class action firm. They were the lead dog for years and years and years and they had some very bright and colorful lawyers who prosecuted these class actions against companies. And the joke in the insurance company was that although they hated writing a lot of checks to them, they described them as the marketing department for D&O policies. But the firm got into trouble when it was revealed that they had been making cash payments to class representatives that had not been authorized by the courts. Generally when these cases are settle, the courts authorize a very small payment to the class representatives, but Milberg Weiss

17. Certain Underwriters at Lloyd's v. Milberg LLP, No. 08 Civ. 7522, 2009 WL 3241489 (S.D.N.Y. Sept. 30, 2009).

was adding to that to ensure that these class reps would come back the next time they thought they had a case. The firm literally lost this; there were criminal convictions; a couple of the main partners are in jail. And, so there was one of these big ugly messes that we like to talk about. They had a malpractice policy with Lloyd's, and when they applied for that policy they represented that they were not aware of any circumstances or situations that might lead to a claim. When the investigation started they turned the subpoenas etc. into Lloyd's and started receiving defense clause payments. It was several years, four… five…six years later that criminal convictions came. And after the criminal conviction was established, Lloyd's filed suit to suspend the policy and get the defense clause payments made returned to them. Milberg Weiss challenged that on statute of limitations grounds and said that Lloyd's should have sued sooner and that it was up to them, knowing that these government investigations were going on, to conduct their own investigation. And they should have investigated and filed suit, even before the criminal convictions came out. The decision in my mind, just isn't very real world, because had Lloyd's filed suit while these criminal proceedings were going and brought in the Milberg Weiss partners for depositions and started asking questions, the answer to every single question would be the same, "I decline to answer on the grounds that this might incriminate me, I exercise my 5th amendment right to remain silent at this time." So you would have had a non-proceeding and there would have been a motion to stay and freeze this until after the criminal case was resolved. And if that's what you were going to wind up doing, why not just declare that that's the appropriate time to bring or not bring this case, but not before.

Audience: Question, well there would be though even in that case, individuals who might be completely innocent who would be covered, wouldn't they, for defense purposes? So, it's not a one size fits all, we have a whole range suspects and some are innocent and some may be involved, and so the policy would clearly cover those who are in the innocent category, and you can't really sort that out early.

William Bila: It's hard to sort out early, but you're absolutely right. I think just about every D&O policy that's out there has these conduct exclusions: criminal acts, fraud, personal profit, and those exclusions are severable which means if the CFO was cooking the books, but the Vice President of Sales wasn't involved in that the Vice President of Sales would be, if he's sued, would be entitled to coverage and a conviction here is not going to impact a conviction over here. The same thing applies to rescission clauses in the policies. There is a little more variation there but most commonly today you could only rescind as to people who knew that the misrepresentations were being made to the insurance company. And the so-called innocent insured still have the right to recover on the policy even though the coverage might be shut off for other people who knew that there were lies on the insurance application.

Audience: What do you do when the medium-high, like Rocky has mentioned, when the medium-high officer, whatever, gets hit with a grand jury subpoena, they go and they testify and you want to know what they said, is that a failure to cooperate?

William Bila: It is only a failure to cooperate if we can…if we're not entitled to something under the law we're not entitled to it and you can't pin failure to cooperate on that. But yeah, if the defense counsel has the transcript to something if they got it one way or another for whatever reason, if they have it, we would like to see it. And we like to do it in a way that's least intrusive, or non-intrusive on any sort of privilege concerns. But, obviously if we don't understand the case, we aren't going to be able to put a value on the case and we aren't going to be able to respond when that demand comes in for eighty million dollars.

R. Zuckerman: Let me just clarify the rules for grand juries. They don't apply to…except with particular bank fraud investigations that are denominated under Title 31, the grand jury secrecy provision being in Title 18, the rules of secrecy do not apply to the witness. I don't want to help the insurance company necessarily because you wind up sometimes with three enemies, the SEC, the Department of Justice and the insurance companies. But, a witness can tell anything the witness remembers to anybody the witness wants to talk to, as can theoretically the witnesses lawyers, however the witnesses lawyer when they debrief their client who is in the grand jury as a witness, the lawyer wouldn't repeat that because that's a privilege issue.

Hon. Morgan: So you have 6(e) secrecy applied to attorney client privilege.[18]

R. Zuckerman: Yes, 6(e) secrecy applies to neither the witness nor the lawyer; they can go and flap their mouth off without dealing with the grand jury except if it's a specific type of bank fraud investigation.[19] That would have to be annotated on the grand jury subpoena itself, then you can't discuss. But, other than rules of privilege, where the lawyer wouldn't repeat anything, if the client remembers, the lawyer thinks it's in the clients interest to say something about the test the questions and the answers the witness can do that.

Hon. Morgan: The witness can say that I didn't tell them anything?

R. Zuckerman: Well, I mean, of course everyone tells the truth when they are under oath, we all know that. (Laughter)

R. Zuckerman: The real practical thing is to take a witness to a grand jury, federal grand jury. The lawyer is on the outside of the room, there's a little waiting room that you sit in, you can't be in the room with the witness, the only people allowed in the room are the government lawyer, the grand jurors, the witness, and if necessary an interpreter. You instruct the witness as his lawyer...

Hon. Morgan: And the reporter…

R. Zuckerman: Oh yeah and the reporter of course of course, you instruct the witness come out and take a break, take a breather, don't sit in there, you know, getting the third degree for hours and so you go in at nine o'clock and then at three o'clock the witness comes out that he didn't…he was so nervous he didn't understand he was supposed to come out every forty-five minutes and then you saw what were you asked the answer is well I don't remember. What do you mean you don't remember, did they ask you this? Ah, maybe? You know then you have

18. FED. R. CRIM. P. 6(e).
19. *Id.*

to go through prodding contest like a psychologist dealing with an amnesiac to figure out what was asked and what the answers were and no matter what is said you have no idea if that, if those were the questions and answers. So, it's fairly difficult in a practical sense to give any third party a good idea of what went on because the client can be. I've seen this where the client says he did not ask me if I was in Cleveland and then you read the you know, months or years later you read the transcript and he was not only saying he was in Cleveland he was telling them for pages what he did there. So, you know, there is this issue about if whether or not what the client says is valid, it varies among witness. But, the "I don't remember" stuff is very common. You have a witness in a grand jury room all day long whose total recollection is fifteen minutes you know that you missed something.

Hon. Morgan: But you should know that the witness in a grand jury is entitled to a court appointed lawyer if they can't afford it or if the insurance company refuses to pay. Which, of course, means they are no longer responsible to this team or getting feedback or have any joint issues. So, sometimes, well frequently, when a person gets a grand jury subpoena or a letter to come in and offer testimony they come in separately, there's nothing on the record, it's all a sealed matter. The federal defender is appointed, since the federal defender can only represent one witness, or one person in the investigation private counsel is routinely paid by the court for their involvement in that. So it can be somebody who's completely unrelated to the team that is not expecting to get an insurance check. Then that person is free to do whatever they are going to do and you don't know what they're going to do.

R. Zuckerman: There is something lawyers can do to kind of facilitate at least understanding of what the government is interested in and hearing the government's questions. That is if you receive a grand jury subpoena, presumptive that is for a criminal investigation. What we usually do is we call the government, especially because the government has self-restraint on subpoenaing people believed to be targets or subjects so they're really usually subpoenaing a whole variety of witnesses in the corporate structure. And assuming we are not representing the company or an individual and we're representing "X" number of company employees. Which it is possible to do to represent multiple employees that have no conflict among them. In that case, the government likes it if there is one lawyer; it is easier to facilitate the interviews. One thing we try to do is we tell the government, well look this is a criminal investigation and if I'm not in the room they are taking the 5^{th} and I'm not going to agree to pass or wait nine months to get a formal immunity order out of the Department of Justice, but if you want to interview them in an office context with me present, we can arrange that for next week and the government will jump up. In that case you will know exactly what the questions and answers were.

Audience: If that's true in criminal investigations do you see the same kind of self-restraint in the SEC approach? In only interviewing non-targets.

R. Zuckerman: No, the SEC is quite the opposite. The SEC, first of all, the SEC only, presently, only has civil enforcement authority. They are looking to have a right of first refute…they are looking to get some form of criminal enforcement authority and they have to work at what's literally called the treaty between the SEC and the Department of Justice as to whether or not the SEC is ever going to be able to indict someone without DOJ approval or involvement. But, in SEC investigations include, they go after everybody, because it's a simple case. You know, their depositions and quotes are not traditional depositions, but they routinely subpoena the CFO, the CEO, the, everybody. There isn't, because it is a civil case and they can go after people civilly and they do. They don't have the restraint of we don't go after targets or subjects because that jargon is square peg in a round hole for them. You say to them are these people targets or subjects, we don't use that jargon. We don't tell them anyway, we are just conducting an investigating. But, it doesn't take a genius to figure out who they are really interested in, who they are going to seek to take an enforcement action against.

Audience: Richard, can you represent the CEO, the CFO, head of information technology? Can you as one lawyer represent all of them as they get deposed by the SEC?

R. Zuckerman: Not if they don't want you to. Because they…

Audience: I am asking you, it's your issue now.

R. Zuckerman: I won't do it. I don't think that's good pool for the benefit of the client because there can be nuances in connection with the testimony of any one particular person that can cause the lawyer or law firm a problem. It's possible to represent the whole variety of other people because they're not people against whom an enforcement action will be brought. And there is no conflict, they are just fact witnesses. But, I, we stay away from, at least I do, representing or attempting to represent people at a higher level once the SEC issues a subpoena. It is possible to consult with three to four people at once, and then assuming that, assuming there isn't any conflict among them. And then, when the SEC issues a subpoena you usually have to pick one of them that you're going to represent and the other ones are farmed out.

Audience: Let's assume that you pick the CEO and you are going to represent him and then the Board asks you to do the internal investigation. Do you have a problem?

R. Zuckerman: No, you just don't do it. (Laughter) If you are representing somebody in the corporate hierarchy individually and then the company says to you, it wouldn't quite work that way because if the SEC issues document subpoenas, which is how these things are all kicked off, you are going to align yourself. I can't think of a situation where the SEC was involved, the CEO got a law firm and then somehow or other unless the CEO was really hiding the ball from the Board, then the Board finds out later. If this is a public company and the CEO does that he shouldn't be…he'll be short-lived as CEO, but you just, I mean there is a recent case on this called *Ruehle* which is in the Ninth Circuit in the District Court where Irell and Manella, which is a years ago Irell and Manella was a tax motif you know, like all other firms, as things grew they morphed into a full surface firms.[20] Ruehle was the CEO of the company they were representing him I think in a civil class action that ran parallel with an SEC case and then they decided that while they were representing him they would represent the company and investigate. Well, now they are all, all

20. United States v. Ruehle, 583 F.3d 600 (9th Cir. 2009).

of the lawyers are in front of the California Bar about conflict of interest. *Ruehle* in the Ninth Circuit when that went up, on that different issue, it went up on something to do with the statement itself. That case it was whether the statement given by Ruehle to the lawyer who was investigating and was privileged or not, but that is a different issue, which maybe we will get in later.

Audience: What kind of information is the government going to have that you, Mr. Zuckerman, may not know about?

R. Zuckerman: Well, they will know what everyone else is saying in theory. Well depends if you are talking civil or criminally.

Audience: Criminally.

R. Zuckerman: In a criminal case when your client is subpoenaed there is no telling where in the timeline of subpoenas witnesses your client fits unless you know all the other lawyers case. In which case, you'll find out who went before, and sometimes you'll find out what was said. In these kinds of investigations you won't run into electronic surveillance but you may run into consensual monitoring. Sometimes, the DOJ has been in this a long time, they've had people in the company wearing wires, they've had people in the company taping their phone calls, you know, then what they do is then they start to interview and/or grand jury people hoping someone lies because it's easier to prove a lie then sometimes the underlying complexities of financial schemes. So you got to always be very careful when you talk to a client about the counsel, the type of information the government may have when the clients interview. Now, if you're in a grand jury and you lie; that's perjury because it's under oath. If you give a voluntary statement to an investigating agent outside of the grand jury context it's not perjury because you are not under oath, but there is a parallel statute called a false statement statute which carries the same penalties. So, you got to be very careful in dealing with the government; with the client involved in these complex cases, the government can have a ton of stuff: documents that it's received, witness statements that it's received. Perhaps somebody's phone has been recorded or somebody's worn a mic in a meeting and that's not that unusual.

Hon. Morgan: And income tax issues issue under 6103(i) where the government can get tax return and taxpayer return information in connection with a criminal investigation released to them without notice to the taxpayer.[21]

R. Zuckerman: Well 6103[22] was enacted as part of the Watergate statutory, this is that kind of like…what did you say in the beginning you know when you have the inquisition and then the what…

Elliot Spoon: Reaffirmation.

R. Zuckerman: There is a whole bunch of reaffirmation stuff that comes out of Watergate. 6301 is one of them and that's a secrecy provision within the IRS code 26 U.S.C. 6103 that says what outsiders can and can't get from the IRS about a taxpayer.[23] But, there are exceptions for criminal prosecutions, and perhaps the government has decided to grab a hold of someone's tax returns for a variety of reasons when there is a financial investigation, but it depends on the nature of the financial investigation.

Audience: They don't have to give notice to the target, or the person?

R. Zuckerman: No…life's tough. (Laughter)

William Bila: Increasing trend in SEC settlement agreements we're not paying not only fines and penalties but payments of restitutionary amounts. The SEC consent decree actually spells out that neither the company nor any of the directors and officers are allowed to seek reimbursement from any of those amounts from any insurance policy whatsoever. This is definitely increasing trend to, I guess make sure that the money comes out of the company and/or individual wallets and not out of insurance company pockets. We see that more and more some of the market timing settlements, that sort of thing. You see whether that trend continues or levels off.

R. Zuckerman: There's also a little interesting other paragraph that goes in SEC consent decrees and that's one that says basically since we're allowing you to say that you neither admit nor deny the allegations but will settle on these terms

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21. 26 U.S.C. § 6103 (2009).
22. *Id.*
23. *Id.*

and conditions, once this settlement is signed you, individual who is consenting to the consent decree, cannot not thereafter allowed to make public statements that say that I just settled it to get rid of the government. You have to be careful with clients because that is their natural instinct once they settle because that's what you do in a civil case, just go tell everyone that you settled because you are sick of paying lawyers and that you didn't really do anything wrong. There is a specific CFR that is built into the consent decrees that say you can't do that. Because we're allowing you to say that you neither admit nor deny, that's the way you have to leave it. You can't go and engage in a public relations campaign to say that this is all a bunch of nothing that I was just sick of paying lawyers. That standard routine is non-negotiable you cannot get out of the consent decrees. You should be sensitive to it. One other thing since we're talking about mortgage, or I thought we were hypo . . . well you get side tracked. If you look at my outline on page nine under four if you look at four "g" in particular I built in there the kind of things the SEC and its accountants look for when they're engaged in an inquiry into a failed mortgage lender or what's called a sub-prime wholesaler. These are the kinds of things that they go right to; to see if they can see whether or not the company, the company may have legitimately gone out of business, it's not just, well let me step back. The SEC focus now is not so much now on whether it was a market collapse; it was, obviously no one company caused it. What the SEC is doing for recent IPO's is seeing whether or not the company was aware of anything such that it shouldn't have gone public. That's what they like to do; they can't claim that some company was, you know, caused the collapse of the market. They can't say the whole market didn't collapse, so what they try to do is see whether or not there is some falsity or deficiency within the business itself that should have, should have been know at the time hence the company shouldn't have gone public. Or the company may have had some problems in advance of the entire collapse such that it should have made a public disclosure or perhaps some of its quarterly or yearly filings were inflated. Again, the SEC looks for clear, you know, misstatements. You rarely find the complicated case; you rarely find a case that doesn't have a clear lie in them because juries understand clear lies. It is really difficult to convince a jury about fraudulent conduct if you're trying to go through elaborate explanations about the mortgage business, it is difficult.

Audience: Have you had any experiences with, if you enter into a consent decree, you waive your 5^{th} amendment. Can you still assert your 5^{th} amendment, let's assume you have four to five individuals, yet one entered into the consent and haul him before the grand jury.

R. Zuckerman: You still have your 5^{th} amendment rights; the SEC does not require you to waive your 5^{th} amendment rights

Audience: Except in 1662[24] that's a *Miranda*.

R. Zuckerman: Anything you say to the SEC the SEC could give to the government, but you still have a 5^{th} amendment privilege that you can individually assert. So, you talk to, what Joe is talking about is that you talk to the SEC and they give you this warning and it says we can do anything with the stuff you give us and one of the things they may do is turn it over to the Department of Justice, and there has been some litigation on whether or not these warnings within this big sheet of paper you get when you get an SEC subpoena on behalf of an individual client is sufficient notice of the fact that the SEC might dump this in the lap of the criminal people. The answer to the question is that you had sufficient notice because you are supposed to be able to read, and you have a lawyer that should have told you about it anyway. But assuming that everything you say to the SEC is turned over to the department of justice if you're subpoenaed to testify your client still has the 5^{th} amendment right, he doesn't have to testify.

Hon. Morgan: Somebody could be called to testify from the SEC (inaudible).

R. Zuckerman: Oh sure, and usually the SEC will just dumps this deposition in their lap and if your client has given a statement to the SEC and it's very rare to find the 5^{th} taken when an SEC dep[osition] is conducted. You know, a lot of

24. United States Securities and Exchange Commission Form 1662, *available at* http://www.sec.gov/about/forms/sec1662.pdf.

times you don't, what you're trying to do is semi-cooperate and try to make the SEC understand that maybe there is some technical violation of the reporting rules, but not enough to refer to the Department of Justice and so your client will testify. Well, you don't know what the SEC will ultimately find out and if they decide to refer it then they have your client's transcript which is an omission, an admissible omission against interest if your client takes 5^{th} at the SEC and in some cases that occurs. You know that just heightens the SEC's sensitivity of the fact that they are onto something and elongates the deposition investigation and may, in and of itself, stimulate a referral. So you got to figure out what you want to do. When a client asks you what to do, I say I don't know you have to hire a lawyer. (Laughter)

Elliot Spoon: Are there questions for the panel? If not, let's thank the panel. (Applause)

SEC "TRANSACTIONAL" HOT TOPICS

Elliot Spoon: We are going to transition from trial litigation issues to transactional issues under the new regime at the SEC. There are several important initiatives that will change the way that security practitioners will advise their clients and how clients have to conduct their various affairs. We have with us Marty Dunn, Pat Daugherty, Mark Metz, Bob Hudson, who are going to be talking about a variety of topics including investment advisors and various issues related to the proxy process which we all know is in a great deal of flux. So, each of them has their own PowerPoint so I will do a little monitoring up here between speakers and again as with every panel feel free if you have a questions to please raise your hand and ask the speaker. We are going to start first with Bob Hudson talking about investment advisories and investment companies.

R. Hudson[25]: Thanks Elliot and thanks again for always putting together such a great program. It's a pleasure to be here and welcome to everybody, good morning, happy to join you today. My topic is a little different than the other panelists, we are going to be talking about a variety of things today but in fact it's within the trend exactly as Elliot pointed out of a great deal of activity that's going on right now in Washington looking at a lot of our laws and seeing what needs to be done with them so there are

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25. Mr. Robert A. Hudson is a shareholder in Detroit office of Butzel Long where he serves as chair of the firm's corporate department. He represents domestic and foreign public and private companies and high-technology companies in corporate finance, mergers and acquisitions, e-commerce and general business matters. He has extensive expertise in securities matters including numerous public and private equity and debt offerings, venture capital finance, compliance, reporting requirements, going private transactions, investment management, the organization of hedge funds and corporate governance matters. He regularly assists foreign-based companies in connection with U.S. and cross-border transactions, joint ventures, distribution and sale arrangements and trade matters. His industry expertise includes manufacturing, high-technology including software, Internet and computer services, financial services, automotive and real estate investment trusts. Mr. Hudson served as general counsel for a NASDAQ listed company during its adoption of the corporate governance provisions of the Sarbanes-Oxley Act and under listing requirements and handled a large variety of the company's general corporate and regulatory issues. He has also appeared before the U.S. Supreme Court, the Securities and Exchange Commission and numerous other courts and agencies. Mr. Hudson is a two-time graduate of Wayne State University, earning both his B.A., with distinction, in 1969, and his J.D., *cum laude*, in 1972.

an awful lot of items. One of those I think we all know is the enormous amount of attention that is being placed right now on the fund world, and there are some statistics which are up there I don't think we need to spend too much time analyzing the fact that funds have an enormous impact on the economy, the level of investment is very significant, and obviously that is a concern to our lawmakers and regulators.

The basic issue that has been on the table now for some time has been the issue of what funds and what advisors should be regulated and I just want to give you a quick background on that for those who may not be familiar with the structure. Essentially, we have the funds that are exempted and advisors that are exempted are exempted on the basis of the items that I have laid out here. They are not exclusive but they are by far the one, the exemptions, that people use, or the exceptions that are used most extensively by people. With regard to the Investment Company Act,[26] because as you know it provides that if you create an entity that is going to make investments in other entities by default it may well be within the Investment Company Act. But there are two exemptions for those 3(c)(1),[27] so the references to 3(c)(1)[28] funds, those are funds with under one hundred investors and under the original Investment Company Act it was thought that funds of that size do not need to have regulation at their small amount. 3(c)(7)[29] funds are those that are limited in terms of the type of investors and these are qualified purchasers, which for purposes of our discussion today we can call them super accredited investors. I think most of us know what accredited investors are but they're people with greater financial wherewithal, and there is also still a limitation on the number. On the investment advisor side, the biggest exemption is that relating to people with under fifteen clients and who do not hold themselves out to the public as being investment advisors. And there is also a dichotomy between federal and state regulation and that is that cur-

26. Investment Company Act of 1940, Pub. L. No. 76-768 (1940); 15 U.S.C. § 80a-1 *et seq*.

27. *Id.* at § 3(c)(1).

28. *Id.*

29. *Id.* at § 3(c)(7).

rently, if you are an advisor and you manage assets under twenty-five million, then you are left to state regulation only, between twenty-five and thirty it is optional for you to register with the SEC, over thirty, you must register with the SEC.

Audience: Bob, what is that twenty-five million under management mean? I find a lot of people don't understand that.

R. Hudson: Well it's the amount of money that the advisor is managing Stew, really, it's just again the amount of money in terms of client funds that are in place with the investor, the investment advisor, to make you know investment decisions and recommendations.

Audience: Do you mean custodial funds? Or just funds used (inaudible)

R. Hudson: Just funds. It does not have to be custodial funds. I mean really, custody is another issue entirely. It's just if you are the investment advisor and you have contracts with clients to provide them investment advice and the dollar amount involved in those contracts is over twenty-five million, you are eligible to register with the SEC currently.

Currently, also, there are no requirements on funds or money managers with regard to money laundering, which is a big issue, but and a lot of them voluntarily do it but there is no requirement to do it right now.

So, just again, quick background again where we are. A couple of years ago the SEC thought this was an issue. They adopted a rule under the Investment Advisors Act that said, and harkening back to what I told you about the "under-fifteen" rule, they said we are now adopting a rule that you must look through the funds, and a fund will not be one client of an advisor, as was the case, but you must look through the fund and count the number of people that are invested in the fund, and then if you are still under fifteen you are exempt, but of course, virtually no one would be exempt under that circumstance. So, this rule was challenged by a pretty aggressive and notable gentlemen by the name of Phillip Goldstein. He won the case. The Court of Appeals said the SEC had exceeded their authority.[30] That under the law, a client is the fund itself and not the underlying clients. So this was put to bed basically, and that was it. The law did not change.

Obviously, since that time we have had some enormous changes. We've had the Madoff scandal, we've had a lot of other things, and now there is, I call it, the urge to regulate, and among other things, the North American Securities Administration is urging that states be given much more jurisdiction that the level for federal enforcement be raised to one hundred million, excuse me, for federal registration, be raised to one hundred million under management and the reason for that is they just feel that the SEC is not doing a good job regulating a lot of the funds. So there have been quite a few things that have been proposed. Right now, basically, the bottom line is they would all involve much greater regulation of advisors and funds and states have also taken some action as we will see very shortly here.

There are, maybe its extreme to say, a multiplicity of legislation, but I don't know if that is true. There are a number of acts that are out there; they are actually competing to be adopted. I am not going to go through all the details, because of time obviously, but I did want to point out that, for example, the Hedge Fund Transparency Act,[31] this one would require registration for funds with assets of fifty million or more, it would apply money laundering tools, and it would apply to private equity and hedge funds, which is a major issue by the way because a lot of private equity funds and hedge funds, especially private equity and venture capital funds, think they should not be lumped in with hedge funds since it's really a different investment decision being made by the people that are going into it. So, this Act again would change the Investment Company Act application. It would require, you know, make it an exemption and not an exception. Right now it's an exception, it's right out of the Act completely, it would make it an exemption, so you're in the Act but you're just exempted from it as long as you meet the standards, it would require books

30. Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).
31. S. Res. 344, 111th Cong. (2009).

and records, et cetera. The Hedge Fund Advisor Registration Act[32] would eliminate the under fifteen requirement that we talked about, it would change the law, so within effect overrule the D.C. Court of Appeals decision, and this thing would apply to private equity as well as hedge fund managers, which again, is a source of some controversy.

Hedge Fund Study Act[33] is, hey lets study this, lets decide what we need to do, come up with proposed legislation and provide greater authority over the industry by the President Working Group,[34] which exists right now to advise the President regarding regulation (inaudible).

The Pension Security Act[35] works a little differently if it's adopted. The Pension Security Act says that pension funds must disclose all investments that they have made in hedge funds and identifying which hedge fund it is and so forth. Again, it would also apply to investment and private equity funds and other funds that use the exemptions that we outlined earlier with regards to the Investment Company Act.[36]

The Private Fund Investment Advisors Act[37] is still another one. Again, this would eliminate the "under-fifteen" exemption, and one of the, again, in response to the debate about should it apply to private equity funds and should it apply to venture capital funds, there has been recently a proposal to exempt it, but its under a lot of discussion. There are those who say no, you cannot exclude venture capital funds from this.

Then, finally, the Investor Protection Act[38], which would apply further regulatory control over investment advisors who have had regulatory problems. It would just give the SEC, basically, greater jurisdiction in a number of areas and investment advisors is one of them.

There are also new custody rules being proposed. Again, I think in response to some of the things we have seen

32. H.R. Res. 711, 111th Cong. (2009).
33. H.R. Res. 713, 111th Cong. (2009).
34. Exec. Order No. 12,631, 53 Fed. Reg. 9,421 (Mar. 18, 1988).
35. H.R. Res. 712, 111th Cong. (2009).
36. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (1940).
37. H.R. Res. 3818, 111th Cong. (2009).
38. H.R. Res. 3817, 111th Cong. (2009).

with Madoff and others and what's been done with funds, this one would require an annual surprise examination and it would also require an opinion regarding, by an independent public accountant, regarding custody of the funds. This has gotten a lot of opposition because small funds are saying basically, their compliance with this would be extremely difficult, very expensive, so it's quite uncertain whether this would be adopted. I think we all know the SEC will adopt proposed rules and sometimes they will sit there for years and we never hear anything more about them.

The other force that is impacting what's going on right now is that of preemption. I think most of you know about NSMIA and National Securities Market [Improvement] Act,[39] which gave the Federal Government exclusive jurisdiction in a number of areas. Again, state regulators have been bucking this quite a bit recently and urging very strongly that preemption should be relaxed and in fact the current Administration has said that they want a study of all laws to see whether preemption is really needed or should be so. It appears that the trend now is heading a little bit back toward excluding preemption and even some of the states taking action that maybe put them afoul of the existing preemption laws.

We are going to be hearing a little bit more later today about the Michigan Uniform Securities Act,[40] the new one, but there are a few things I wanted to mention in terms of the impact that is in this Act with regard to investment advisors. There are going to be a number of changes being made. Rules are being adopted right now. Those are going to be critical. There are many, many issues that are being considered in the rules. I'll just mention one. Michigan has had a ban, like a lot of states, on performance based compensation for investment advisors. That has been criticized very heavily, because among other things, not only does it interfere or protect clients with regards to performance based compensation in normal investment arrangements, but it also creates an obstacle for forming venture capital funds and hedge

39. National Securities Markets Improvement Act of 1996, Pub. L. No. 104–290, 110 Stat. 3416 (1996).

40. MICH. COMP. LAWS §§ 451.2101-.2703 (2008).

funds in Michigan since performance based compensation is a critical component of those economic arrangements. So, that is being discussed. Is it going to be changed? Who knows? It might, it might. So, that's something if any of you have an interest in I urge you to contact Oprah and state your views, that might be useful.

There are some changes with regards to investment advisor registration. It is tightening up. Previously, clients would call me and say, "Hey, what do I have to do to be an investment advisor?" And I would say, "Well you file these forms and that's it." "You mean I don't need to have these certifications and tests?" No, well now you do. As of October 1, you must pass these exams, that's for new registrants that are listed on there, and all filings have to be done through the IARD system,[41] which I think many of you are familiar with that is run by FINRA. The, also, investment advisor representatives have to register and that was a big item. Previously, of course, people would form firms, like LLCs, that would be investment advisors, and everybody who worked for it who had any active role with clients was an investment advisor representative. You did not have a register; you were simply listed on the schedule to your form ADB. Now, there is going to be a requirement to actually register all investment advisor representatives and in that regard as well they have to pass a certain tests. So, those are also the Uniform Investment Advisors Exam or the Series 66 or Series 7 exams which are outlined on there. There are provisions to wave it if you have other certifications or if you have been registered in another state within the past few years, which is entirely feasible for a lot of people because most states have required investment advisor registration for some time. There is an exemption for when you have to do this. You have actually until July 1, 2010 to get this done just because they expect an enormous backlog of items, applications.

The transition order, I don't know if you have heard about this, but there have been two transition orders issued by OFIR that's explaining how we are going to be moving into the new Act and that order does prescribe

41. Investment Adviser Registration Depository (IARD), http://www.iard.com (last visited May 28, 2010).

the content of the investment advisory contracts, says what you must have in that contract, and it says it applies to both state registered and federal covered registered investment advisors. My question there is, query, "whether that oversteps the authority of the state with regard to the federal government because the law as I said, 203(a)(b), strictly states what the states may regulate and I think it's somewhat questionable that they are able to regulate the content of contracts for federal registered advisors, no question about state advisors."

There are a couple of new liability provisions as well. Civil liability for giving advice while not being registered, even if the advice is fine and there's no other problem. This is kind of similar to selling a security as a broker not being registered. The security may be great but you are at risk. And finally, an expanded civil liability provision for investment advisors. Yes.

Audience: Is there a private cause of action for that civil liability or is that something limited to the AG?

R. Hudson: Oh, that's going to be a private cause of action. Yeah, a private cause of action. And that concludes my part, I am going to pass it over, I'm not sure whose next actually. Mark Metz, and go ahead whenever you're ready.

Mark Metz[42]: Hi everyone. I want to segue from Bob's discussion of investment advisors, brokers, dealers, and those sorts of folks to talk to you about a rule that governs brokers who are registered under the New York Stock Exchange but actually affects public companies which are traded

42. Mr. Mark A. Metz provides general corporate and securities representation for many of Dykema-Gossett's publicly-held corporate clients, their boards and committees of their boards in areas such as defensive planning, directors' duties, periodic reporting, disclosure, the responsibilities of corporate insiders, stock-based benefit plans and insider trading rules. He has extensive experience in public and private securities offerings, acquisitions and dispositions of public and private companies, subsidiaries and divisions and private debt transactions, including single and multi-bank credit facilities and institutional private placements. Mr. Metz is the leader of Dykema's corporate governance task force, a multi-disciplinary team dedicated to monitoring legal developments, including those related to the Sarbanes-Oxley Act of 2002, and advising clients on various corporate governance and compliance issues. Mr. Metz joined Dykema in 1986. Mr. Metz earned his B.A., *magna cum laude*, from Michigan State University, and his J.D., *cum laude*, from Wayne State University.

on the national security, a rule called Rule 452.[43] I'm going to assume that you don't know anything about this, so let me give you a little background on it just to make sure we are all on the same page here. To understand what's going on, public company shareholders, typically hold their shares, most of them anyway, hold their shares in what's called street name with a broker, Meryl Lynch, UBS, you name it. And, that means that instead of the individuals name showing up on the stock records of the company, it's actually the broker's name, or more likely, the broker's depository, where the broker actually holds the shares in an account at what is called a Depository Trust Company.

So, when you look at a stock record book you would see Depository Trust Company or its nominees Cede and Co. holding a huge chunk of shares and scratch your head and wonder, "who are these guys and why do they get to vote so many shares?" And, then what happens is that DTC, which is an entity that is owned by the brokerage community, passes down voting rights to the brokers who then in turn pass them on to the individual account holders, their customers. Rule 452[44] gives the brokers the right to vote the shares that they hold on behalf of their customers if the customers haven't given instructions on how to vote those shares within 10 days before the meeting. And then there's a laundry list of items that are considered non-routine on which the brokers can't exercise voting rights without instructions. They can only exercise them on routine matters. The change is that uncontested director elections have now been added to the list of non-routine items so that instructions are required before a broker can vote on directors, which is obviously the main item at any annual meeting. So what's the effect of this? Well, the main effect of this change is going to be to reduce the number of shares that are voted for incumbents in elections and the total number of shares that are voted at a given share holders meeting, an annual meeting. As you can see sort of outlined, exactly how that all works because brokers

43. Self-Regulatory Organizations, Exchange Act Release No. 34-59464 (Feb. 26, 2009).

44. *Id.*

typically vote for incumbents and a lot of retail investors who hold in brokerage accounts never bother to give instructions.

The change is going to have the most effect on companies that have adopted a majority vote standard at their company for elections, particularly where activist shareholders (inaudible-ringing-laughter) I must have said something wrong. (inaudible-ringing) send management, send the board a message, just vote no. And if your company requires that a majority of votes cast be voted in favor of the directors, and certain things happen, if there aren't a majority of votes cast that obviously can result in some problems, usually a resignation or the director does not get elected at all.

For companies with a traditional plurality requirement, which means whoever gets the most votes, basically nominees just needs one vote in favor if it's an uncontested election. For those companies, the change is not going to affect the outcome of the election. The directors will still be elected, but it will affect the message, the strength of the message, that the activist shareholder is able to send because the votes are going to be skewed highly in favor of the activist shareholder.

So, we talked a little bit about the main effects, another effect that it is going to have is that it is going to increase the power of institutional shareholder advisers like Risk Metrics Group. A lot of you know who that is. It is a private company. They post voting guidelines, corporate governance guidelines on the Internet, and they tell everybody "this is what we expect, and this is how we are going to advise people who ask us for advice on how to vote for directors." So, it is going to give those people, those companies, a lot of additional power because institutional shareholders are going to constitute more of the percentage voted at these annual meetings. And since brokers have typically voted the shares for their customers even if no instructions were received, the director vote was the primary means to fulfill to quorum requirement at an annual meeting. So, that number of shares is going to come down and if you have not typically had a lot of votes or if you don't have a lot of institutional shareholders at your company, you may have trouble meeting your quorum requirement.

And then, the bottom bullet just points out that companies that are using the notice and access model that was approved by the SEC a couple of years ago where you basically just send a short notice that tells your shareholders you posted the proxy materials on this website, go here to vote, rather than sending out an envelope with a proxy statement and the proxy card. Those companies are finding that they are getting a lot lower voter return than companies who use the full set delivery. And, so if you put those two things together, this new rule, which is going to become effective for all 2010 annual meetings, and the proxy notices and access model, you may end up with a problem getting the requisite vote.

So what should you do? I list a number of action items on the next couple of slides. The only two that I really want to tell you about is I think that the first think you do is you make sure on your agenda that you have a routine item such as ratification of auditors so that brokers will be voting at the meeting on something. And that gets you enough votes most likely to make your quorum and eliminate that as a problem. The second thing that every public company should do is looking at their proxy statement and especially the disclosure that deals with broker non-votes, what they need, how they are counted, and just make sure that that language still makes sense in light of the change to Rule 452.[45]

The remaining bullets on this slide and on the next slide are some things that you might want to think about and that may require you to do some more strategizing in advance of your next meeting.

So now let's turn to some proposed SEC rule changes that would require some additional disclosure in annual proxy statements and then there are some changes to proxy solicitation rules and Form 8K. I think I'm probably just going to focus on the proposed proxy disclosure changes that are intended to become effective in 2010 if they are ultimately approved. Changes to the compensation and the compensation, discussion, and analysis disclosures are intended to help investors identify whether the company has incentives that can lead to excessive

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45. *Id.*

risk taking by employees. And I think that Pat's probably going to get into this a little bit later. This is a reaction to some receipt problems that gave rise to the issues that we have seen with excessive compensation. If you pick up your *Wall Street Journal* you see it on the headline just about every day where there is somebody attacking the compensation that, especially those in the financial industry, have received. So, this is a reaction to that and the CD&A would require some additional disclosure regarding how the company's policies and procedures regarding compensation do or do not give rise to some excessive risk taking on behalf of the employees.

The other interesting thing here is that the proposal would go beyond what is the rule today, which is to focus typically on the top executive officer tier and their compensation. This disclosure, in the CD&A, would go to all employees, even people who do not make that top tier, which is typically your CEO, your CFO, your next three highest, and then sometimes your former officers who still have high compensation.

They are also proposing a change to the summary compensation table that would require disclosure of the aggregate grant date fair value of equity awards such as options, restricted stocks, et cetera that that be included in the summary compensation table and of course in the total compensation figure that goes all the way over to the right hand side of that table. The proposed change could result in some disproportionately high compensation shown for officers who have been replaced during the year, that are off cycle due to a status change such as an increase in their responsibilities up to the top tier of management.

Today, what the compensation table requires is that you show the expense under 123R[46] paid for or expensed by the company with regard to all of the option or other equity grants relating to the individual. So, what you typically get is pieces of grants as they are vesting, that vested during the year, that are being shown in there. So it is an expense figure for company. Now, the focus

46. Fin. Acct. Standards Bd., Financial Accounting Series: Statement of Financial Accounting Standards No. 123 (Revised 2004), *available at* http://www.fasb.org/pdf/fas123r.pdf.

would be on the grant for that year and on how much is the value the grants. Sure.

Audience: And a big part of that, the 123R because it was the expensing over the year, it kind of kept your NEO's consistent. Who was in your table, who were your top five, was consistent because you kind of knew how it went. Now, it's going to be much more lumpy because whoever happens to get a big grant in a year is going to make more potentially then people he or she works for. So, you have the issue that your NEOs are now going to potentially change, you got to track a broader group of people that you have to include in your proxy, a little bit more of a pain and also you are going to have some ugly numbers. It's going to be some pretty high numbers because it won't be smoothed away by 123R.

Mark Metz: That's exactly where I was going. It's going to cause a lot of turnover. Typically, you had those same folks and maybe once in a while you had somebody who creeps in but this is going to result in a lot of in and out of that table. And then that proposal will eliminate some duplicative disclosures because this information is already required elsewhere in the compensation disclosure tables and grants table, it will take it out of there and it will put it in the summary content.

The proposals would also require some additional biographical information regarding directors and the nominees. The purpose of that is to provide some more specific information as to the nominee's qualifications to serve as the director of the particular company. Types of information that might be disclosed include things like information about the nominees risk assessment skills, going back to that same point a minute ago, any specific past experience that would be useful to the company, as well as information about the nominees particular area of expertise and why that nominee in him/her being elected, for being elected, would be a benefit to the company.

The current requirement only requires disclosure, in the second one, requires disclosure of directorships that are currently held, so the disclosure would expand to require that you look back for five years. The idea here is to look at and allow evaluation of past relationships and particular conflicts that nominees might have.

The SEC is also proposing some additional disclosure on the leadership structure and risk management. Basically, this just goes to additional transparency. The SEC goes out of its way in adopting or proposing these to say, "we're not trying to influence how you set it up, every company's got its own circumstances and does or needs to do what's right for it." It's just asking that companies will explain that better. And then, as to the board's role, the SEC is looking for information regarding who risk managers at the company report to: is it the board or is it somebody up in higher management or is it a committee of the board? And then how the board itself monitors risk.

The final category of changes I want to talk about is the requirement for additional disclosure regarding compensation consultants. And the purpose of these changes would be to reveal any conflicts of interest, either by being beholden to management who may have hired or played a key role in their hiring, or because management uses those consultants for other reasons with regard to administrative claims, whatever pays in lots of fees. That might cause the compensation consultants that the comp[ensation] committee is using to have a conflict of interest. And the proposed information is not unlike what is required with regard to the independent auditors. Making sure that the independent auditors stay independent of the company, you're required to show in the proxy statement how much they were paid for various tasks during the year. In the interest of time, so that these other guys get a chance, I'm going to stop here and just ask if there are any questions. The rest of what I have in the slides is not all that controversial and I'll just leave it to you to read on your own. Any questions on proposed proxy rules or 452? Okay, if not, I'm going to let Marty come up.

Martin Dunn[47]**:** Hey everyone. I'm talking about one topic for about 10 minutes assuming you don't get distracted, but we're

47. Mr. Martin Dunn is a partner in O'Melveny & Myers' Washington D.C. office and a member of the corporate finance practice. Prior to joining O'Melveny, Mr. Dunn spent twenty years in various positions at the U.S. Securities and Exchange Commission, most recently as Deputy Director, and former Acting Director, of the Division of Corporate Finance. As Deputy Director, he supervised that Division's Offices of Chief Counsel, Chief

going to try to see if I can maintain focus, and that's proxy access. A little bit of background on proxy access: it's always good to have the history and where things come from. This issue is as old as the '34 Act, as old as the proxy rules. And it goes back to the age-old question of state law provides shareholders the right to nominate directors; what has to go into the proxy? This is not a question about the right to nominate directors. Everybody will always say that's what it is. That's not it at all. The question is: What do the federal rules require you to put in your proxy because if it ain't in the proxy, you can nominate 'til you're blue in the face and it's not going to have any effect right? You need to get the votes. So the Commission has always wondered what that shareholders are going to raise at the annual meeting is required to be included in the proxies. And this goes back to the beginning: there's 14(a),[48] the legislative history and the whole notion is, the proxy statement on the card is supposed to replicate the meeting. It's supposed to really, fully affect your rights. So, as a result, anything that is going to come up at the meeting has to be included and anything the company is going to raise has to be included. And the Commission has always battled with: well what about the shareholders? And so they adopted Rule 14(a)(8)[49], the shareholder proposal rule, in the early 'forties, forty-two, and it said anything that's a reasonable matter for shareholders to raise at the meeting if a company has knowledge of it before the meeting has to be included in the proxy and put up for a vote on the card. At the time it said the only two limitations were: anything that's appropriate for shareholders to raise and it can't relate to the election of directors because they didn't want to turn it into a free-for-all. Which, right or wrong, that was their notion. They

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48. 15 U.S.C. §78n(a) (2008).

49. 17 C.F.R. § 240.14a-8 (2008).

didn't want a universal ballot. This was management running the meeting.

And since that time, the Commission has battled with: first off, what shareholder proposals are appropriate to include, and that's why you see all the fights over rule 14(a) and the shareholder proposal rule. And they kept considering this question of, what about the nominees? Okay, proposals are one thing, but what about nominees? And every twenty-five, twenty years, the Commission would get the bright idea that they needed to tackle this. And so they'd propose something or they'd have meetings about it, or they'd discuss it. And then they'd realize, "Oh my God, this is impossible to figure out and they'd bail out of it, and nothing would get done. And the last time, when I was on the staff, we tried to do this was 2003. We wrote a proposal because there was a big debate about boards not listening to shareholder votes. You were getting huge withholds. It was the beginning of an era. You were getting shareholder proposals actually getting a majority vote and the board wasn't affecting it or wasn't doing anything. And so there was this notion of dead boards, of boards not listening. And so the Commission proposed and said if you have this triggering event, if you get a certain level of withholds, or if you get a majority vote for a shareholder proposal and the company doesn't act on it, then we're going to say shareholder nominees have to be included on the company's card and in the proxy materials because the board clearly is not listening and there is no way for the shareholders to effect change. So that was the theory in 2003.

The proposals went out. We got, like, 13,000 comments. There was actually a full-page ad in the *New York Times* about, the SEC shouldn't roll the dice with the economy and all this other stuff. I guess it was really going to end the world. And so ultimately the Commission took the bold move of doing nothing. (Laughter.) And so that's that. And so in 2007 we lost a case and I say we because this was very personal to me, the Second Circuit humiliated me in public. (Laughter.) We lost a case on shareholder proposals that said a proposal that created a proxy access process at a company had to be included even though there was this election exclusion.

So the Commission in 2007 put out two proposals. One was to embrace the rule and the other – it was a very long release – and the other was a very short release that just said, no, we're going to change our rule to make it clear you can't do this. So there was this big debate about the long release and the short release, which got named based on their length and ultimately it adopted the short one which said no, we're going to clamp down even more on these proposals. So of course that didn't go away because now you had an election and you had 2008 and so that comes around. And so the Commission is now revisiting proxy access. And so that is what we're going to talk about today.

And it did two things in its proposals that came out in June. One was it proposed a new Rule 14a-11[50], which was the same rule number I'd suggested in 2003 but there you go, nothing is new, which would say under the procedures I'm going to talk about in a minute shareholder nominees would have to be included on the company card and in the proxy materials. The other thing it proposed is that 2007 thing we did about shareholder proposals? We're reversing that one hundred eighty degrees, so those proposals would now have to go in. So those are what the two proposals are we're going to talk about today.

The first, 14a-11, the proxy access. This top part is a very important part. It would apply to every company that has a proxy statement under the federal rules. Why is that important? If you read the release, it has this mantra that it keeps repeating over and over again, which is we're in an economic crisis because companies didn't manage risk. That is the fault of directors. And it's at every company. Now you can take issue with any of those three points, right? But to simply say, okay this is our mantra, therefore, it's got to apply to every company. It's no longer just companies that aren't being responsive. It's not companies that have shown a failure of risk management. It's every company. And that has been a large topic of conversation because, you know, sure, I have clients where they're TARP companies or

50. 17 C.F.R. § 240.14a-11 (2008).

whatever, and their risk management is huge. I have other clients who their only risk management is: are they going to be able to exchange their convertible debt in October before they go under. You know, risk management is very different all over and to say that risk is the same everywhere, I don't buy. But, the proposal is a one size fits all. So that's there.

There can't be – there are no requirements included in state law or a company's governing documents prohibit shareholders from nominating directors. There is no state law or corporate governing documents that do that, so I don't know why they put that in there, but that's there. (Laughter.) Made them feel good.

Audience: You could change the state law.

Martin Dunn: You could change the state law which - we'll get to in a moment, because this is only if state law says that absolutely no shareholders can nominate, not if it says you can nominate if "X," so it's really over the top. I'm agitated. Sorry. (Laughter) I came all the way out here and I've got all this stuff I want to say. But the nominating shareholder, the eligibility part is the way it goes. The ownership requirement would be you have to own it for a year and if you're a big company over seven hundred fifty million dollar market cap, you only have to own one percent, under seventy five million, five percent. So it's the notion that it's easier to own a large percentage of a smaller company. You also, the point of a shareholder group is you can join together. The Commission seemed to have the notion that one percent of a large company was very difficult to get, but if you look at any of the Fortune 25 companies, they have eight to ten holders that are over one percent at least. You know? And I'm being generous there. That's interesting. They have to state whether or not they intend to continue their ownership after the election. If they're not required to intend to do so, they can say no, I'm going to sell out after this. You can't acquire for the purpose of effecting control, and you have to provide a notice to the company and the SEC on what would be a new Schedule 14N,[51]

51. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors (May 20, 2009), *available at* http://www.sec.gov/news/press/2009/2009-116.htm.

basic information about who you are and who the nominee is.

Some other stuff in there: the candidacy can't violate state or federal law, it would be limited to twenty-five percent of your – of the company's board, which I love the greater one or twenty-five percent, they're not allowed four-member boards in public companies anymore so I go with twenty-five percent. It would have a first in approach, which means it's a race to the mailbox. So if you have ten one-percent holders, whoever happens to be the one who gets it in first, their nominee goes on. Needless to say, that didn't go over real well amongst the investor groups, especially the ones with a lot of ownership. And then in an interesting point, you can't have any agreements with the company regarding the nominee. Now when we wrote this in 2003, the intention was you didn't want companies under the – going to the shareholders and saying put in a nominee. You know? That way nobody else can. You didn't want that. Unfortunately, the negative of effect of this is, this is going to limit companies talking to people about who they're going to nominate. Shouldn't the goal be to get the best nominee? So, I think they may have to tweak that and the only reason I mention it is you'd have to file a Schedule 14N. Once you've got it, the process is very similar to shareholder proposals, once you get a nominee. You got - you have to figure out whether they meet the requirements, which aren't many and if they are, you give notice within fourteen days and that you don't think they meet it and the shareholder will only have fourteen days to fix that. Usually it a disclosure piece proving ownership or some kind of thing like that. So that's exactly like shareholder proposals.

Similarly, the SEC would interject its staff, which I'm sure the staff was thrilled about, into this process the same way they do with shareholder proposals, which is a joy if you're on the staff. Because this is the one area the SEC gets into where it has two sides that absolutely want something and they get to look at one and go "no." That always makes friends, right? And that goes really well. So I ran the shareholder proposal process for seven years and I didn't make a lot of friends. And I'm a friendly guy. (Laughter.) So, it's really a difficult thing.

And the process they set up was, you have to go to the staff 80 days before you're going to mail your proxy. All this makes sense because that's how it works in shareholder proposal land.

But what they didn't contemplate was the decisions last year in the *Jana/C-NET* case[52] and *Levitt Homes* case[53], where the Delaware Chancery Court said advance notice bylaw provisions that are keyed off of date of proxy and go one hundred twenty days before like the shareholder proposal rules do aren't valid under Delaware law because they're not reasonable. They're too far away from the meeting. So what everybody did in response to those is they keyed it off to the date of the meeting and they shortened it to ninety to one hundred twenty days. Well, go to notice and access as Mark mentioned before. You have to mail your proxy or make it available forty days before the meeting. And so now, I have my advanced notice bylaw because they said it either has to go within one hundred twenty days or in accordance with your advanced notice bylaw. Well now, I could be getting a shareholder nomination ninety days before my meeting and only have fifty days before I have to mail my proxy in which I am supposed to go through this whole process. It doesn't work. And I think that the SEC has come to realize it doesn't work. It's going to fit it in another way. They're going to get rid of that advanced notice bylaw part. But it just goes to show you how all of the state law and federal law stuff fits together in an incredibly technical, complicated way here. You've got to contemplate all of it. If you're not permitted to exclude it, you have to include the nominee; you've got to put them on the proxy card. You couldn't anymore say withhold these for the company nominees from the group. It would have to be a true, open election. And it would be required to include up to five hundred words from the nominee about how wonderful they are. So that would go in your proxy.

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52. Jana Master Fund, Ltd. v. CNET Networks, Inc., 954 A.2d 335 (Del. Ch. 2008).

53. Levitt Corp. v. Office Depot, Inc., No. 3622-VCN, 2008 WL 1724244 (Del. Ch. April 14, 2008).

What have you seen on the comments since this went out? First, interestingly, you haven't seen thirteen thousand comments. You've seen about four or five hundred which is actually pretty low. What we have seen is companies writing in very specifically talking about how this would affect them. The advanced notice bylaw piece very specifically. So, the other main comment is in support of the proposal. And who's going to support this proposal? You can tell by the letterhead. You can tell how this is going to work. But the areas they've talked about for those who support it are big on the SEC has authority. Why are they big on saying this? Because the SEC included in this a really interesting piece that says, again, it's your right under state law that is being affected here so you can have any provision you want that affects that unless it would limit the rights under 14a-11 in which case state law would be preempted. Very broad. Very broad statement for the Commission's authority under section 14(a). I personally think the Commission has great authority to adopt an access proposal. I don't think they have the authority to adopt – to preempt state law in this manner. Plus, it's a little paternalistic to say you can have anything you want under state law, unless it's less than this because we know you really want this. That really that bugs me. And so that has been, the folks that are supporting this, want to go way out of bounds saying they have authority. Interestingly, there is legislation from Senator Schumer that has a provision in it that says the SEC has and always has had the authority under 14(a) to do anything it wants under proxy access.[54] I love the "always has had." That's kind of new for a law, but that has not been adopted yet. So when we talk in the end about the timing of all this there is some notion of the SEC waiting for the Schumer bill to get passed. So that's there.

Neat discussion about difficulties in board communications, saying that a uniform standard is good, more diversification is good. Most of them think you should extend it from one year to two, to show true, long-term interest in the company for your eligibility to nominate.

54. S. Res. 1074, 111th Cong. (2009).

And they all want it to be largest shareholders, not the first in. I'll go quickly because you have to get going.

Audience: No, no.

Martin Dunn: Those who have opposed it have said, you've ignored everything that's happened in corporate governance in the last five years. It's not necessary right now. It's certainly not necessary at every company in the United States. There should be something to show it. It would take the nominating committee out, which would be the only entity in this game that has fiduciary duties to do right by everybody. That's wrong to do. The information isn't enough. Turnover is not good. Again, they've got the advanced notice bylaws wrong. Now, I'm taking great joy in the fact the SEC thinks it should be one size fits all and there should be triggers because when we proposed triggers in 2003, the big comment was "oh it's a Rube Goldberg device. It's too confusing. You don't know how to write a rule. Blah, blah, blah." And now they're all saying wow that 2003 was good. We liked that. (Laughter.) Who's that Marty guy? That's how I really think in my head.

The revisions I suggest are larger ownership requirement, extending it to two years, putting in my beloved triggers. A notion I like is a recent mission threshold, where you have to get a certain amount of votes in order to be able to nominate somebody again. So you can't just keep "I wanna nominate myself," "I wanna nominate myself," I mean you get no votes and it clogs up the proxy. A big part here is a lot of companies, to improve their corporate governance standards and their scores, have jacked up their independence standards beyond what is required on the exchange and the way the SEC proposed it, they specifically said you would only need to meet the exchange standard for independence. Companies are saying anything that is quantifiable and applies to all directors should have to apply to us. They can't adopt something that says shareholder nominees have to meet more, but they should have to meet what is required for everybody else. So that's been a big conflict.

So that's 14a-11 and before I get to the status of it, I want to mention 14a-8[55]. This is the election exclusion I talked about, the Second Circuit ruling. The SEC would reverse the 2007 and say you have to include a shareholder proposal that would affect your bylaws regarding how shareholder nominees get included on your proxy unless it would disqualify nominating these things you see in front of you. The one I love is or otherwise could affect the outcome of the upcoming election of directors. (Laughter.) I really don't know what that means. But, that's in there. So why do they do this? They put this out because everyone's calling for private order in the access world and the SEC is not giving private order. They're giving 14a-11. They're giving one size fits all. And so what they've said is we're also going to change 14a-8 so that you can do private order so long as it extends the rights under 14a-11, not if it limits them. Again, shareholders should know what they want and if they don't, we'll tell them.

So, that's how this works. What is the status of all of this? The Commission came out, Elisse Walter, Commissioner Walter, and gave a speech a couple weeks ago where she fessed up that the Commission is not going to get this adopted for this process. That they're going to do something in early 2010 because they want a rule that will survive. Some folks think that that's because of the Schumer bill; other folks think that just they've got a lot of comments, they've got a lot of work to do. And so, they're going to do that early in the year. They can do the 14a-8 change, however. It's pretty simple. It's a short rule. They've written it a number of times. However, they seem to indicate that they're not going to do that. They seem to think that these two things need to travel together. If you're cynical, then you think well the reason they don't want to adopt 14a-8 is because then that will take the political pressure of them doing something for this season. And once the pressure's off, it's off. If you're not cynical you're think okay, we should do this in a combined effort, coordinated, get everything right. So, long story short on proxy access, you need to be aware of it. It's coming. It's not going

55. 17 C.F.R. § 240.14a-8 (2008).

to come in 2010, fortunately for all of us. And hopefully the one that comes along by next year will be thought out and will have some of these kinks – I mean this was thought out, but thought out in relationship to the comments and we'll take some of the kinks out.

So, with that, I've already probably gone about five minutes too long, question?

Audience: You feel fairly definitely though that this package of rules in some form will be adopted?

Martin Dunn: Something will.

Audience: Something will be adopted?

Martin Dunn: There is way too much political inertia, pressure, whatever the right word is to let this stop and we're not close enough to the election in 2010.

Audience: But we're also far enough away from the Spring of 2011 that there will be time to learn how to implement them and it won't be a rush?

Martin Dunn: That's the hope.

Audience: (Inaudible)

Martin Dunn: And there would have been time. Who knows even how well it would have worked. Shareholders getting in late in the game. You've got to get a nominee so they can get enough votes.

Audience: Well this was, this was, third time is a charm.

Pat Daugherty[56]**:** Yeah, we're in overtime so I will be brief but I, oh yes, I said I would talk about change from the top down. This is less rules and regulations. Maybe a notch more philo-

56. Mr. Patrick Daugherty is a partner of Foley & Lardner LLP with a corporate, M&A, finance and regulatory practice of national scope. As both a deal-making lawyer and a seasoned advisor, he draws upon nearly thirty years of experience in New York, Washington D.C., Charlotte, and Michigan to customize solutions for business executives and financiers. Early in his career, Mr. Daugherty was counsel to SEC Commissioner Fleischman in Washington D.C. Mr. Daugherty advised Commissioner Fleischman on all major initiatives of the SEC, including the reform of U.S. financial market regulation after the 1987 stock market crash and the storied prosecutions of Ivan Boesky, Michael Milken and Drexel. Building upon this experience, today Mr. Daugherty routinely represents clients in dealings with every "Division" of the SEC – not only the Division of Corporation Finance that regulates public offerings, public M&A and public companies, noted above, but also the Division of Trading and Markets, the Division of Enforcement and the Division of Investment Management. Patrick Daugherty earned a bachelor's degree, with distinction, from Northwestern in 1978 and a law degree, *cum laude*, from Cornell in 1981.

sophical than that for better or worse. So why are we talking about change in corporate finance? Richard Posner's most recent book, and he writes one every six months whether he needs to or not, has been a sequence of dramatic events culminating in the status quo, low interest rates, the housing bubble, the biggest of all bubbles, the collapse of the bubble, the collapse of the banks, and that would have been one year ago while we were here actually, frenzied efforts at resuscitation, a drop in output and unemployment, signs of deflation, and an ambitious program of recovery. That program comes from the President and the fact that we have a President who has introduced legislation about the SEC upon gaining office tells us how profoundly unsettling the situation was. I mean I think most of the time the President, the incumbent President, whoever it may be pays no attention to the SEC. And those are in good times. Other change agents: Senator Schumer, obviously, Congressman Frank running the key committees, new chairman of the SEC, new director of Corporation Finance, and I'm going to excuse Director Cross because she was practicing law at the time, and I'm going to excuse the President because he was campaigning, but the other three and particularly the Congressman and the Senator had something to do with low interest rates, the housing bubble, the collapse of the bubble, et cetera. A person might rationally ask whether people who were so deeply involved in this mess can rightly assign blame for it or seek to cure it. And I haven't gone to the Fed because that has nothing to do with the SEC, but we know who's involved there and we know where they were a year ago and two years ago. So, these are however the critiques went out at least in my view this is what people say; I'm not expressing a view pro or con, these are the facts on the ground, this is what people say people say that the agency, and particularly trading and markets defer too often and too much to the industry, especially the biggest firms. That the libertarians ran wild for 30 years. Or more. Forty years. From the seventies onward. That would include me in the eighties. That a single agency but not this agency must be given the power to supervise all large and/or highly leveraged and/or interconnected financial holding companies, so called "Tier 1 FHCs." That enforcement should have caught Bernie Madoff before he stole all that money and we don't know how much it was. These are the three estimates: first it was fifty million dollars, then it was sixty-five million dollars, but two months ago it was readjusted to thirteen million dollars. Those are dramatically different numbers, but it's a lot of money and it is conceded that he got away with it. That no sizeable hedge fund or other investment vehicle of any description can be allowed to operate completely unregulated. In other words, if you're big, if you're important, if you are full of money, you will be regulated. That the agency - I'll say the agency qua corporation finance, I say defer, needs to defer less to corporate managers and traditional ways of managing companies. Defer may be too strong a word, it may be better to say that the criticism is that there needs to be a policy shift to facilitate greater involvement of shareholders. This is the movement. This is the zeitgeist.

So the Administration wrote a white paper[57] which underlies everything that's going on in this field and put it out in summary, and I was astonished when I read it because I thought it was going to profoundly rework the SEC – and it didn't. I found, and I was surprised to read this, that most of the recommendations really don't bear directly on the SEC at all, or on corporate America – other than financial firms of course. But you have to understand that the SEC no longer supervises the largest financial firms, they're all (inaudible). Those that do bear on the agency or corporate America are just a few, just these few. (Inaudible) "we will support legislation requiring all public companies to hold nonbinding shareholder resolutions on the compensation of senior executive officers," I don't think that's saying too much, mind you, this has been the rule in England for a long time and the practice there has been that only rogue companies get singled out for criticism here, I think that *this* is a rather modest proposal. Other intrusions on executive compensation maybe not so, I mean we know that there's legislation that would control executive

57. *See* U.S. Dep't of Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

compensation in corporate America, and last weekend's *Wall Street Journal* has a story called "Keeping the Pay Police at Bay" and you know, there has been a lot of populist outrage at the pay packages of the departing CEOs of major financial institutions, and just this morning I noticed Ken Lewis was told he had to give back one million dollars as he leaves Bank of America.[58] I think that this misses the point in several ways. I know Ken Lewis, we worked in the same building for ten years. Giving back a million dollars is not very consequential; the important thing that happened to him is that last year he lost $108 million in the value of the Bank of America stock that he held. That was typical, all the other departing CEOs lost huge amounts of money, the real question comes—

Audience: Well, how much did he have left? (Laughter)

Unknown: I don't know his net worth. (Laughter) I think his departure package from B of A was something like eighty or ninety million dollars, but that covers a career of thirty-two years at Bank of America.

Audience: But the question is what are these… the public outrage which is reflected in one of the change agents that you didn't list is the judiciary, it appears that the judiciary is becoming an agent of change, vis-à-vis the refusal to accept an SEC settlement which appeared to be paltry according to the popular press. What do you think about that?

Pat Daugherty: You know, I don't know that I really have a view about that. Do you Marty?

Martin Dunn: I actually do. (Laughter) It's interesting. The refusal to accept that settlement – I didn't work on any of that at all, I'd been gone a long time so I don't have even have to give a disclaimer of any kind but I still feel the need to. I got the impression he actually doesn't like the amount of the settlement because he doesn't see what civil settlements against an organization really accomplish. All you're doing is punishing the shareholders. His problem was that there was nothing against the individuals in that, which I think is the big change. And the two big changes that I see from that, one is more of a fo-

58. David Yermack, *Keeping the Pay Police at Bay*, WALL ST. J. Oct. 10, 2009.

cus on individuals, and two is more of a focus on the lawyers – which is a bad idea – no I'm just kidding. (Laughter) If people were giving bad advice they need to be responsible for it. So I saw those as the two biggest things about that. I didn't think it was the paltriness of the settlement against B of A, you know the B of A fine, because I've never figured out what civil penalties against a company five years later mean except a (inaudible) effect on everybody else so I agree with you that that is a very big change but not quite – in a different way.

Audience: Does anyone, stepping back from all of this, say publicly that in light of the hurricane that we were in the midst of last fall maybe worse that now assigning tiny amounts of blame here and there to officers of large financial firms is really incredible when actually what Bank of America did may have been the most critical positive move last fall at a time when the whole system was ready to go under. And then for folks to come back, even the SEC, on the fine and the judge, et cetera. I look at this in a broad sense and I say wait a minute, what did they do wrong? They stepped forward in a time of immense crisis.

Pat Daugherty: I think in the main I agree with you, I think we're seeing a combination of envy and vengeance.

Audience: You say that like it's a bad thing. (Laughter)

Pat Daugherty: I do think envy is a bad thing just as I think greed is a bad thing, but vengeance extracted against innocent people is also a bad thing. My view is that the banks did what was lawful. They acted in a lawful manner in boosting their balance sheets and pumping out the mortgage loans that they did. There's complicity on both sides mind you, you have Congress deploring the banks to lend more to what clearly in hindsight were ineligible borrowers – people who couldn't afford to pay – the Community Reinvestment Act,[59] and so forth. But as Posner points out in his book you can't really blame them altogether because they were pushing an open

59. 12 U.S.C. § 2901 *et seq.*

door.[60] The banks wanted that authority, the banks wanted to be able to lend to as many as they could. We were in an era of very low interest rates from 2000 onward. So (a) that increased demand for mortgages, it also made it easier for the banks to fund the mortgages because they could borrow the money with which to fund the mortgages, they didn't have to sell equity capital to do that, so they could lever themselves up, and they did, they did lever themselves up. They then lobbied for and passed the repeal of Glass-Steagall.[61] So we had banks with leverage of thirty to one. Now that works as long as the asset that you're lending against continues to rise in value, and all the models show that it would, but you know five, ten, fifteen percent annual increases in housing price were unsustainable, as we know, so there was a housing market crash which crippled the banks as they were so highly leveraged. I'm not sure that answers your question directly, I'm just trying to doing the best I can. So let's move on because there is a little more I wanted to cover. These are the other elements of the financial regulatory reform package that applies to the SEC's corporation finance agenda. And in my view they're meager. Three key concepts in these papers that I would like to discuss with you because I think they motivate these proposals and I think you're going to hear more about this as they are debated in the coming months and I think rules that reflect these concepts are going to be adopted. Anti-cyclical standards. And by the way these are all good things, anti-cyclical standards are good things, pro-cyclical not. Macro credential analysis, a very good thing, credential analysis less so. Clear and simple design disclosure, I believe, a very good thing. I'll start with macro credential analysis. Banks, and I use the term broadly to include non-bank banks, banks have capital requirements and leverage limitations that are set to credential standards which is to say to maintain the banks as safe and sound institution, to take deposits and to stay in business. That's fine if you are a country bank in northern Michigan or South Carolina, but if you're

60. Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent Into Depression, (Harvard University Press 2008).

61. Banking Act of 1933, Pub. L. 73-66, 48 Stat. 162 (1933), *repealed by* Gramm-Leach-Bliley Financial Modernization Act, Pub. L. 106-102, 113 Stat. 1338 (1999).

one of the five or six largest financial institutions in the United States it does not take into account the externalities of your collapse. It is not good enough to say that we are capitalized to an extent and our leverage is at a degree that will keep us safe and sound with perhaps say a one percent chance of bankruptcy. One percent chance of bankruptcy is acceptable for a country bank in northern Michigan, but if every large financial institution in the United States manages itself to that degree that means there's a one percent chance that the entire U.S. economy will go down, and that is unacceptable, that is unacceptable. So, we need stricter standards of leverage and capital resources for the largest financial institutions which is macro credential analysis – what will the effect of your standards be on the macro economy? That's the point. And that'll be tighter, tighter regulation of the largest financial institutions. Anti cyclical standards—two examples. One is loan loss reserves, and the other is mark-to-market accounting. I passed around a piece of paper that I saw yesterday, I didn't have time to put it in the [pack], but this shows you what I'm talking about. We want standards which will not magnify the direction that the economy is moving in, but on the contrary will buffer it. The smoothing out the business cycle would be a positive for investors and for the economy, so we need legal and accounting standards that have anti cyclical effects rather than pro cyclical effects. In each case, loan loss reserves and mark to market accounting, the focus of attention is on recent historical data rather than to look forward, and so you accentuate the business cycle as follows: you make balance sheets and income statements look better than justified on the up side because the recent data show that there's nothing bad going on, so you don't take a big reserve and you don't take the big mark (inaudible). And on the down side it goes even further because the most recent data is ugly so you take bigger reserves. So if you look at this chart, and it comes from Standard & Poors, and therefore it must be correct right? Standard & Poors is an NRSRO[62] so it must be correct. Actually it's the opinions that are sometimes wrong the data is always right. You will see what I'm

62. Nationally Recognized Statistical Rating Organization.

talking about; the yellow bar is loan loss provisions over time for U.S. Banks. Notice the big upturn in 2007 and to 2008, 2009, taking huge loan loss reserves right now – why is that? That's because in the last couple years things are pretty bad. But if you look further back in time if you look to 2006 – 2007 those are low reserves, why? Because we're in a bubble market with very low lending, very low default rate. My suggestion is, and the Administration's suggestion is, that we want to level this out a little bit. We want the people who set these reserves to look forward a little bit not only backward so that you have bigger reserves in bull markets and smaller reserves in bear markets. And that would help us in the recovery going forward as well. Clear and simple design disclosure I could talk about for an hour but we're out of time. Pat Sonstein who like Posner is from Chicago, has made a career out of this, as well as constitutional law, and is now doing that work in Washington. I think it will be adopted, I think it should be adopted, I think it's very progressive. We'll see it first in mutual funds, and then it will leach over into corporation finance and I'd be happy to talk to you about afterwards if you would like. Here are the divisions' rulemaking priorities, the key one is the last one. Really when you talk to director Cross or listen to her she says "we're mostly responding to requests for information from Capitol Hill and the Administration and we're getting ready for a deluge of rule-writing that's going to come when this legislation is adopted," as I expect it will be. Those are my thoughts, thank you for your time.

Elliot Spoon: Let's thank the panel. (Applause) Five minute break and then our panel on SEC enforcement.

SEC ENFORCEMENT ISSUES

Elliot Spoon: Alright folks, we're going to get started again. We have a panel now dealing with SEC enforcement issues and we're very pleased to have on this panel Steve Klawans from the SEC Chicago office, as well as Hugh Makens and Clarence Pozza and I'm sure we will be in for a very spirited discussion, as we have been all morning. Gentlemen…

Hugh Makens[63]: Can you hear alright from that? How did we get here? We're into an enforcement panel and a dramatic change in the way people look at the SEC and the way the SEC is looking at itself. I sat down and made a list of the things that I thought were the contributing factors, and I didn't get all of them because there's so many factors that lead to our financial crisis – it's actually mindboggling. I keep reading more and more books and getting more and more information about where things went wrong and how they occurred. The first item is innovative products taken to an extreme. The concepts, for instance, of credit default swaps, if early on, was a very modest proposal used to reduce the amount of capital that banks were required to have. Well it grew and grew

63. Mr. Hugh Makens, currently of counsel with Warner, Norcross, & Judd, is a current member of the board of trustees of the National Endowment for Financial Education. Mr. Makens is serving a three-year term on the board of NEFE, which is a nonprofit foundation dedicated to helping all Americans acquire the information and gain the skills necessary to take control of their personal finances. As the past chair and a member of the Warner Norcross securities group, Mr. Makens concentrates his practice in securities and corporate law. He regularly represents broker-dealers, investment advisors, issuers, regulatory agencies, and industry professionals in issues related to securities compliance, investigations, and regulatory proceedings. He has been honored by the State Bar of Michigan for his lifetime contribution to the legal profession with the inaugural Stephen H. Schulman Outstanding Business Lawyer Award. Active both professionally and personally, Makens has served on the NASD Legal Advisory Board and the Market Operations Review Committee of NASDAQ, as a commentator for the Uniform Securities Act Project of the National Conference of Commissioners, and on several committees on the North American Securities Administrators Association. Mr. Makens is also a former director of the Michigan Corporation and Securities Bureau and a past president of the North American Securities Administrators Association. He is a frequent author, lecturer and panelist for trade associations and professional organizations. He is a coauthor of *Michigan Securities Regulation*. Mr. Makens is an adjunct professor at Michigan State University College of Law and a past contributor to the JOURNAL OF BUSINESS & SECURITIES LAW. Mr. Makens completed his undergraduate studies at Michigan Technological University (*cum laude*, 1961) and received his J.D. at Northwestern University School of Law in 1964.

and grew so it was totally out of control. We had a loss of judgment by management and directors of major financial institutions so they both failed to understand the operations of their own companies, and also failed to understand the degree of risk that was attendant to those operations. There was a regulatory failure of failing to instill discipline in the financial institutions contrary to a long history of putting that discipline in place, particularly the OCC,[64] and the FDIC,[65] and the Fed[66] bear a great deal of responsibility for what happened. There was the two words we hear most commonly: competition, everybody was racing for more and more money – building their balance sheets, Pat's point that he made just a moment ago – and greed. Everybody wanted to make more and more money with no end, and without too much regard for the consequences. There was and remains to this day an incredible lack of transparency which prevented the SEC and the CFTC[67] from fully seeing or understanding the full scope of the problem. When there was an effort to regulate hedge funds the primary opposition was lead by Senator Dodd, who today is signing a vastly different song. There was an incredibly foolish decision made by the Fed to permit financial institutions to not calculate any risk that was covered by credit default swaps. They actually removed those risks completely from the requirements for determining the amount of reserves the financial institutions were required to maintain. There was an adherence to models that assumed history will always repeat itself. When you go back fifty, sixty, seventy years in the real estate industry and that was a marked consistency but there were a number of new factors in those equations and they never made it into the models, and the people who developed the models are now saying well we made this mistake and that mistake – bottom line was there

64. Office of the Comptroller of the Currency, http://www.occ.gov (last visited May 28, 2010).

65. Federal Deposit Insurance Corporation, http://www.fdic.gov (last visited May 28, 2010).

66. Board of Governors of the Federal Reserve System, http://www.federalreserve .gov (last visited May 28, 2010).

67. United States Commodity Futures Trading Commission, http://www.cftc.gov (last visited May 28, 2010).

was a vastly excessive reliance on those models and where we saw that most pointedly was in the area of the rating agencies who relied on models to give ratings that, in common sense terms, made no sense at all. There was a lack of risk analysis, control or concern in the mortgage industry, and with financial lenders. Incidentally, I'm sure you're all quite interested that the American Dialect Society named the word "subprime" the word of the year – valuable information. There was the ability of mortgage lenders of all kinds to simply bring in any kind of mortgage and pass it off to a fool so that there was no obligation – they had no risk – they moved it out of their control and into the hands of the public investors. There was a tremendous amount of mortgage inducement fraud. The interesting thing, when you listen to the radio, watch television, there were the ads, doing exactly what we knew was wrong in the first place. Where were the regulators? Where was the FDIC? Where were the state financial institution and mortgage regulators? Who was the principal cheerleader for the failure to keep Fannie Mae and Freddie Mac from being regulated? Barney Frank, and look where he is today, you'd never know it. There was the failure of the economists and other mystics. The political environment in which regulation was discouraged and markets were allowed to police themselves because sophisticated business people would in fact run markets intentionally. I'm sorry there has to be a balance. The efficient market theory has never been a truly accurate theory and never will be in the future. I wrote an article for the UCLA Law Review about thirty-five years ago on why the efficient market theory breaks down, and I haven't changed the views one inch from that time.[68] There is a regulatory system that has been built on "we've always done it this way," so flexibility to analyze and see what was happening didn't occur. We found hedge funds playing with new products and new strategies which often turned out unsuccessfully. Over half of the hedge funds in the United States disappeared in the last two years. Pretty good example of how it didn't work. We had – about ten

68. Hugh Makens, *A State Regulatory Perspective of the Report of the Advisory Committee on Corporate Disclosure to the SEC*, 26 UCLA L. REV. 147 (1978).

years, twelve years ago – long term capital management fail. The biggest collapse of the hedge fund and it actually threatened our economy. What did we learn from it? Amazingly little. The lessons from that time are exactly the same lessons that should've been used at this time, and they were ignored. Then to make things more difficult for the SEC, along comes Madoff, Stanford, and politicians who urgently needed someone to blame. So Barney Frank and Senator Dodd quickly were pointing the fingers over here at the SEC and saying "you didn't do your job." Which brings us to our program, which will contain a full explanation of everything that went wrong, who was to blame, and how we will cure this entire mess. (Laughter) Then again…

Audience: We're in the wrong panel.

Hugh Makens: Yeah. Then again perhaps all we will do is talk about the substantial changes to the division of enforcement and some of the interesting cases and some of the hot frauds that are going on, so on that time it is my pleasure now to turn this over to Steve Klawans who will actually say what you want to hear. (Laughter)

Steve Klawans[69]: Let's hope I can do that. Thanks Hugh, before I begin I am required to tell you that the views that I express today are my own and not necessarily those of the Commission or of my colleagues. Before I get into the substance I want to let you know a few weeks ago when my director of the Chicago office of the SEC Merri Jo Gillette realized that she had a prior commitment and couldn't be here today, she and Joe Spiegel asked me if I would attend in her place, and of course I had been here a couple years ago, I enjoyed being up here and meeting a lot of you and my initial reaction of course was excitement and to be honored that they chose me. But the

69. Since 2000, Mr. Steven L. Klawans has been with the Securities and Exchange Commission in the Chicago Regional Office. Presently, Mr. Klawans is a supervising attorney in the Division of Enforcement with the SEC Chicago Office, and is responsible for investigating and litigating violations of the Federal Securities laws. Additionally, Mr. Klawans serves as an Ethics Officer for the Chicago office. Prior to joining the SEC, Mr. Klawans worked both in private practice, focusing on complex civil litigation, and as a criminal prosecutor with the Cook County State's Attorney's Office. In addition to trying numerous civil and criminal bench and jury cases, Mr. Klawans also drafted various legislative amendments. Mr. Klawans earned his B.A. from Indiana University in 1992, and his J.D. from DePaul College of Law in 1995.

initial reaction quickly turned into suspicion, dread, and terror as I thought about it and said "well let's see, they're asking me to come here within days of the Inspector General's scathing report of the SEC's handling of a certain high profile Ponzi scheme,[70] the surprise rejection of the settlement of the Bank of America case involving the Merrill Lynch bonuses[71] and all the scathing articles that were resurrected as a result of those two events basically saying that the SEC doesn't know what they're doing." And so I'm like "do these guys want me to come up here in front of a firing squad of defense attorneys and securities industry professions and represent the division of enforcement and answer all of the tough questions?" It kind of felt like what the Wolverines must feel like when they come here to play basketball. (Laughter) I knew that would wake everyone up.

Audience: Just digging that hole deeper and deeper. (Laughter)

Steve Klawans: I made friends and enemies with that one. Well I can assure you that these aren't joking times at the SEC, especially in the Division of Enforcement. I know that Merri Jo, my director, and the new director of the entire Division of Enforcement in Washington, Rob Khuzami, take very seriously the criticism that we've faced and are constantly asking ourselves how we can do better. In response there have been significant changes in the SEC that have been implemented and are ongoing, and so I want to take a few minutes and go through some of those changes which affect us who are on the ground working these cases as well as, you know, defense counsel and securities industry professionals and of course the investors, and since we're in listening mode I welcome any thoughts or questions that you guys have.

First, there's been a number of internal process changes that are really going to have a significant effect on how quickly we can do our cases in the Division of Enforcement. For anyone who isn't that familiar with how the SEC works, I work in the Division of Enforcement and

70. Office of Investigations, U.S. Sec. & Exch. Comm'n, Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme - Public Version (2009), *available at* http://www.sec.gov/news/studies/2009/oig-509.pdf.

71. Zachery Kouwe, *Judge Rejects Settlement Over Merrill Bonuses*, N.Y. TIMES, Sept. 14, 2009 *available at* http://www.nytimes.com/2009/09/15/business/15bank.html.

we basically litigate and investigate violations of the federal securities fraud. So these internal process changes again are going to make us and allow us to do our cases quicker so our deterrent message is that much stronger. The first change that is being made is that the authority to grant formal orders – formal orders are the orders issued by the Commission giving the staff the authority to issue and send out subpoenas for documents and testimony, obviously a key part of what we need in our tool bag – so they've granted the authority to issue formal orders to the actual local offices. This may sound like a ministerial kind of change but I can tell you this is the most significant change since I've been at the Commission for the last ten years. Before this change, we had to go through this lengthy memorandum and recommendation process – just to get a subpoena. I had never seen our request for a subpoena denied, and I don't know if that ever happened, but yet we had to go through this long process of drafting a memo and having fifteen people look at it, it would take months just to get subpoena power. Now we can walk down the hall, give them a piece of paper that outlines essentially what the case is about, and we can leave with essentially their approval for the formal order and we just have to get the secretary's office to actually write up the formal order and we can issue it. This cuts down our time to issue subpoenas exponentially. Just to give you some scope as to how effective this is going to be, this change took place in August, so just taking January to August, so this is still under the old system with our new Director Rob Khuzami in Washington who's put in place a number of changes to help us work quicker, the number of formal orders for subpoena power that were issued by the commission – again this is just under the old system – increased over one hundred percent over last year during the same time period. So under this new system you can imagine how many more investigations we're going to open, how many more investigations are going to move quicker, and how many more cases are going to be brought especially in a timely fashion.

Hugh Makens: Bottom line change that's going to affect you is that if an SEC attorney calls or comes by and says "I'd like to get these documents on a voluntary production," and you say "well I don't really think so," instead of waiting now two or three months for that request, he's going to reach into his pocket, pull out the subpoena, and say "well how about you cooperate now?" Is that fair?

Steven Klawans: That is exactly what is going to happen. It is happening. The second internal process change that's going to have a significant effect on how we work is another recommendation process, but this is the one where we ask the Commission for the authority to actually charge an entity or an individual with violations of the federal securities laws or enter into a settlement. This is actually us bringing a case after our investigation. The old process had us, again, draft this lengthy thirty to fourty page memorandum, go through multiple layers of review, and bog down the process. I mean it could take a year or two sometimes to get these things done. Now, there is an emphasis on having these recommendation memorandums shorter, to have less people look at them, and to have less time to look at them. So, again, this is going to result in much quicker investigations and a much quicker time frame within which we can bring our cases. The third internal process change that I want to highlight involves tolling agreements. Tolling agreements are agreements between the staff of the SEC and someone who is being investigated, which serves to suspend the statute of limitations to allow the staff more time to investigate the case so we don't lose conduct to the statute of limitations. This is kind of one of Rob Khuzami's, I would call, kind of evil changes, because what he is going to do, if the staff wants to enter into a tolling agreement with an individual or entity we have got to get his approval. He has already said he isn't going to approve too many of them. So basically, what it comes down to is if the staff knows they have to go the principal's office to explain why it is taking so long to bring the case they probably are not going to go to the principal's office they are just going to bring the case quicker. So that is kind of a self discipline measure which I welcome. I think it is a good thing. In addition to the three internal process changes there has also been some really historic structural change to how the SEC's Division [of] Enforcement is structured. So while the internal process changes were focused mostly on how fast we can do our cases, a lot of these structural changes have to do with helping us being smarter and more strategic about our investigations. The first structural change that we are undergoing right now is to create specialized units. Previously, everyone in the Commission was working in essentially a free market economy in terms of the investigators in the Commission. We could work on any type of case that came across our desk. Now, there are going to be units that are going to be staffed that are going to specialize in particular substantive areas that are particularly complex and require a lot of expertise to handle. The first specialized unit is going to be the Asset Management Unit. The Asset Management Unit is going to focus on investment advisors, investment companies, hedge funds, private equity funds. We are going to be looking at issues of disclosure evaluation, performance, touting, conflicts of interest, and misappropriation. The second specialty unit is the Market Abuse Unit. The focus there is going to be on complex market manipulations and large scale market abuses by market or industry professionals. They are pretty much going to be looking at suspicious trading, insider trading, and things of that nature. One example, although the units are still being staffed, so this case wasn't brought by the unit but it is an example of types of things they are going to do. In May, the SEC brought the *Rorech* case out of New York; it was filed on May 5, 2009.[72] If I mention any cases today and anyone wants any cites or anything you can ask me afterwards and I can provide them to you. But this was an insider trading case involving credit default swaps. This was the first time we had brought a case of that nature. So, the concept of bringing insider trading cases in the traditional equities market is going to change. We are going to be bringing and looking at cases involving insider trading of derivatives and other structured projects. The third specialty unit is the Structured snd New Products Unit. So there are some similarities in the units. Instead of focusing really just on insider trading, this unit is going to focus on other aspects of complex derivatives and financial products, collateral debt obligations and other securitized products. The fourth specialty unit is the Foreign Corrupt Practices Act

72. SEC v. Rorech, No. 09 CV 4329 (S.D.N.Y., filed May 5, 2009) (complaint can be found at http://www.sec.gov/litigation/complaints/2009/comp21023.pdf).

Unit. That is essentially our anti-bribery statutes. We have brought some cases in this area. We have brought more cases in the recent year, but we have created this unit so we can leverage our experience across the nation and bring more of these types of cases. The last specialty unit is the municipal securities unit which is going to focus, of course, on violations in connection with securities offerings by local and state governments. You know, as I said, right now, the specialty units are still being staffed. They are going to hire a national specialty unit chief and then that person is going to be in charge of a number of people. It kind of depends on the unit, and they are still working on the numbers. The people who are going to staff those units can be from across the country to really leverage who in the U.S. working for the SEC has the most experience in these areas, and those are the people who are going to work these cases. You will see more cases in these areas and you will see more experienced folks who are working these cases. Really, the bottom line with it is, and the concept is pretty simple, the first time you investigate a private placement variable universal life insurance case, which I did, and it took me a year to even say that. You know, you are going to be able to investigate that case a lot better the tenth time you do it versus the first time you do it. That's the theory and that's what we are going to be doing. A couple of other quick structural changes aside from the specialty units….

Hugh Makens: Steve, the other thing probably worth mentioning is back in 2007, the Commission created the first of these strategic teams to deal with subprime mortgages. You have actually got six units now that are going to be reaching out and looking for cases very aggressively.

Steven Klawans: One other area of sort of a structural change is to streamline our management structure. They are going to be taking a lot of managers and supervised staff attorneys around the country and turning them into line investigators, so that we can up the ratio of the number of people in the Commission who are actually working cases as opposed to telling people how to work cases. Lastly, kind of related to that, is the change in focus in how do we utilize our resources better and how to get more resources. One quick statistic from 2003 to 2009 the entire SEC staff grew fifteen percent. You can imagine what the increase in securities trading volume was during that period. Anyone want to venture a guess? You'd be right if you said two-hundred sixty percent. We are way behind in terms of resources and I know that our front office is working hard to get more people especially in Division [of] Enforcement.

Hugh Makens: Steve, there was one statistic that struck me above all others in terms of understanding the magnitude of the challenge that the Commission faces. And that is, if you go back about a year and half ago, the total volume of special products that were being sold exceeded the value of all the equity of all public traded companies in all the countries of the world. That is how this has grown.

C. Pozza[73]: On that point, I think that first of all Steve, there are a lot of great Michigan State law students who, if the SEC is looking . . . (Laughter) But secondly, the computerization of the financial markets. I mean, when I started, and you have been doing it a few years. When it was a paper-based system, things were at a different pace. Now, with nano-second trading creation of pools you just push some buttons and it happens. We are moving at light speed, and in terms of new products and the ability of the SEC or the industry itself to get their arms around it, it is really mind boggling. I think it would be a great paper for the MSU Business Law Review to look at and to look at the electronics plus everything else that is going on and how it is impacting the ability to keep reasonable controls on all of this.

Hugh Makens: By its very nature, an enforcement unit, an enforcement division, operates in history, and yet, the Commission can no longer afford to operate in history. It actually has to be forward looking in order to anticipate the problems that are going to come out of products and that is an in-

73. For more than three decades, Mr. Clarence L. "Rocky" Pozza Jr., a Fellow in the American College of Trial Lawyers, has handled complex business, commercial and securities trials, and various arbitrations and mediations with distinction across the United States. His practice area is focused on commercial, corporate, financial, securities, and insurance litigation, regulatory representations, alternative dispute resolution, and preventative counseling. A past chairman of the firm, Mr. Pozza served as managing director of Miller Canfield for 10 years and was head of the litigation group for 8 years. He is currently a principal at Miller Canfield's Detroit office.

credible challenge. Rob Khuzami is talking about dramatically changing the level of technology used at the Commission today but catching up and staying current is going to be incredibly challenging.

Steven Klawans: In fact, I just saw on my Blackberry just before I came up here. I think it might have just been announced today or maybe it's a press release or an article about a press release from yesterday. Rob Khuzami, director of enforcement, hired the division's first Chief Operating Officer. He had announced previously that he was going to do that, but the person who is filling the position is this twenty nine year old kid from Goldman Sachs, who was in their business investigations unit. It shows the effort to really try to stay ahead of the curve on what's happening on the ground.

Audience: Maybe the panel can comment on this. With all of this restructuring that is going on and hopefully more boots on the ground and enforcement to be out there in the industry. If enough cases are uncovered the concern is, there are one thousand cases to pursue and we only have the capacity to pursue five, who makes the call on the no go? I think that is some of the situation with the *Madoff* case, somebody made the call on the no go two or three times on the *Madoff* case. How is that going to be handled in the SEC?

Steven Klawans: There is a lot of change undergoing with respect to that very issue. And one is, in creating these specialty units some of the triage of cases, tips, and complaints will go to those units so that the people who have the most knowledge will presumably have a say in whether it is a go or a no-go case. They have also hired, I forget the name of the firm, but there is a firm being hired to essentially create an electronic system so that we can track tips and complaints which previously were kind of, various systems across the country and different offices handled them differently. So tips, complaints, and referrals are going to be centralized and that is going to be another way that we can keep track of it and have a better way of triaging whatever cases we should do or not do. Then ultimately the Commission just has to trust the people that it hires to make the right call. You know, is this a case that we should be doing or not? There are different metrics that are being talked about in terms of whether a case is something we should do or not do. You are right, there are so many cases we can do; we can never do them all.

Hugh Makens: I think one thing that is going to happen Pat, is that you are going to see more cases referred to other regulators. I think the states are going to be receiving more cases over time. Rob Khuzami spoke at the NASA, North American Securities Administrators meeting a couple of weeks ago, and suggested that the level of cooperation with the states is likely to go up. Largely, it's been states pushing cases up to the SEC that had a national character to them or a complex character to them. There is a lot of logic in those cases being pushed down to the states if they are routine cases. Hopefully, we will see some of that going on. I think a number of the states have a capacity for doing more than they are doing. They are doing a lot already but there are a lot of them.

Audience: Time-wise, what do you think will be the reaction time to a complaint regarding, I know Rocky has a Ponzi scheme operation hypothetical here. Are we talking instead of months, weeks? What is the relationship now between the FBI, the Department of Justice, and state securities on passing this information back and forth? Is there anything being set for that? In other words, traditionally, these Ponzi schemes have taken forever to be litigated through the SEC. Is that going to speed up?

Steven Klawans: I think all the changes are going, whether it is the formal orders, everything that I have talked about today is going to have a positive effect on the speed of the investigations. In terms of the referrals and tips process, again, that system, as I understand it, is going to help us when the tip comes into the door, for it to get to the right people, for an assessment of whether we should take the case, for how to staff it, and for how we should investigate it.

Audience: Will you have the ability, there is an example on this criminal securities violation: A through I, criminal potential charges. Is that branch level? Is that Washington to refer to the Department of Justice?

Steven Klawans: You know, I mean, the interesting thing is every office has a different relationship with their local federal prosecutor's office. The relationship is going to really be more localized. Hopefully, the effort from both regulators involved is that we have to get on top of these things quickly, but every office has different priorities. Terrorism obviously, is still a big part of what the DOJ does. We try to get them to do our cases and work them as quickly as possible. You know, I think I was talking about metrics and what we look at to make the determination of what kind of resources to put into the case and how quickly we can get it done. Is the fraud ongoing or not? That's the first question we have to ask ourselves, and if it is ongoing then we have to address it immediately. I think we have had a good track record of doing that but we obviously (inaudible).

Hugh Makens: The new unit for evaluating tips and whistleblowers is called the Office of Management Intelligence. The abbreviation is OMI and the reason that was selected is, if they don't do their job right "oh me" in trouble. (Laughter) Sorry.

Steven Klawans: I wanted to talk about just one other. This is more of an external process change. I think this will cause some debate. There are some proposals under way at the division to try to foster more cooperation from individuals in our investigations. The DOJ, historically, has had a pretty robust mechanism to get cooperation out of witnesses and those involved in the cases they work up, and we have not had as good of a track record doing that. There have been four proposals that have been put out there to try to reward extraordinary cooperation in our cases. The first one is to create a C-Board, a list of C-Board factors for individuals. C-Board is an action from some years ago that addressed entities not individuals. It basically said: here are all the factors that the SEC Division of Enforcement will consider in terms of assessing an entity's level of cooperation vis-à-vis what should we do with them, do we charge them do we not charge them, if we do, what should the sanctions be. Things like, did the company self report the misconduct? Did they get rid of and fire the culpable individual executives? The concept is, should we have a similar list of C-Board factors for individuals? That is something that people are thinking about. The factors really haven't been publicly discussed but some of the ones that come to my mind are: how prompt was the disclosure of the misconduct by the individual? How soon did he either tell his boss or his management chain or report to the SEC? How fulsome was the disclosure? Is he pointing the finger at the guy down the hall but protecting himself or is he being fulsome with respect to his role as well? The second tool for attempting cooperation is to take a page out of the DOJ's book and literally to provide assurance to a witness early on in the investigation that they will not be charged by the SEC. I don't believe that we have ever done that. I know I have never seen it in my office. If early in the case we were to realize that there is a witness who either, we don't see charging, who we think is a big player, or who we will never get the main perpetrator of the fraud if we don't let this guy walk, then we will consider it. I do think that this tool will be used in cases where there was extraordinary cooperation. The third tool would be an expedited process to allow the division director to seek witness immunity from the Department of Justice because on a lot of these things the rubber meets the road. A witness or a bad guy in the case is willing to pay a fine perhaps or be enjoined by the SEC but he doesn't want to go to jail. If we give him assurance but DOJ does not, are we really being effective? This is a tool that allows our office to be a little bit; it's an expedited process to let us get that immunity from DOJ a little bit quicker. The last one, I was just going to mention, the last tool is deferred prosecution agreements. DOJ has used these against various companies to say, "okay, you have violated the law but we are not going to prosecute you if you provide full cooperation, make your employees available, et cetera." There is consideration of a concept of a deferred prosecution, an agreement for an individual. We will write up a complaint. You know you have violated the law. We are not going to file the complaint. We are not going to assess violations if you cooperate fully with us. Again, these are four tools. They are just under consideration. They are not being used just yet but they are being discussed. What do you guys think about that?

C. Pozza: I think it is good. Generally, I do a lot of work for larger broker-dealers and the level of cooperation is at the highest level. SEC proceedings are taken very seriously. Internal investigations are very thorough. I have not had much personal experience where any client I'm associated with or employee really isn't cooperating. That has really not been my experience.

Audience: Will that be in writing? (Laughter)

Hugh Makens: Will the assurance in writing? That, I think, is one of the more interesting points. You have talked about oral assurances, and part of what is being proffered, talked about at the Commission, is the oral assurance. There are a number of problems with oral assurances. One of the major problems, if you went back four or five years ago, was the turnover of SEC staff. You thought you had a clear understanding with someone, and this was true by the way, at other regulatory organizations as well. You thought you had an understanding with somebody and the next person along disavows any understanding of it. My level of confidence of oral understanding, unless I have five witnesses in the room writing everything down, is pretty low. I think that is going to change now in this economy when people are likely to stay home a lot more instead of going out looking for other jobs because the jobs aren't going to be there. That being said, my level of skepticism about oral commitments remains pretty high unless I've got some other safeguards in the system. From your standpoint Steve, does that make sense? How do you look at it?

Steven Klawans: Clearly, putting myself on the other side, I can see how anything short of written assurance is going to be a no-go. I am sure that those who are going to be finalizing these proposals will know that and consider that. I myself, I don't want any gray area as the prosecutor on the case. I would put it in writing. I don't know what is going to end up in the rule but I'd put it in writing

Hugh Makens: Another thing to consider in the period of cooperation is that the SEC has dramatically increased, in the last couple of years, its use of temporary restraining orders. In that context, when you go into cooperate, one of the risks is that you may get a TRO without notice, without advanced communication. Therefore, you may be exposed to a higher level of risk. I think one of the things the Commission needs to work on is establishing the credibility of knowing, of having some degree of confidence when you go in. Recognizing the TRO should be used only when there is a need for stopping money from disappearing or stopping bad conduct immediately. It has been used more than that; it has gone farther than that on occasion. Now, part of the recent increase in TROs has been that there has been a deluge of exposures of Ponzi schemes. A good number of the new TROS have been aimed a Ponzi schemes, which is logical.

Steven Klawans: Yeah, I agree with that. I feel like every week our office is filing another TRO offering a fraud or Ponzi scheme case. Maybe that is a good segue.

C. Pozza: First of all, Elliot and Joe, thanks, this is a great day for all of us and for the students and all of the guests here. It is really wonderful to be on the panel, especially with folks like Steve and Hugh. A TRO is great but very often the horse is out of the barn at that point. My little PowerPoint is really directed at all of us to think about how we can get at these Ponzi issues, check kite issues, before the regulators know and can act because very often that's where the action is going to be. I have done Ponzi scheme cases now for three decades, probably in excess of twenty five of all kinds. There are cases, where there is a rogue individual at a wonderful broker-dealer, where there is an accountant running a financial fraud out of his back office, all kinds of different cases. I thought I had seen everything until shortly after our session here last year when *Madoff* broke and *Stanford* broke and I thought, "oh my gosh, where did that go wrong." A lot of comment: "well why didn't the regulators pick it up?" Again, they have limited resources and they're coming in after the fact very often. So, what I would like to encourage, especially the law students, is to look at this, stand back from it, and say what can happen on the private side to help prevent these types of schemes from developing. Because, it's one thing . . . We have over the years spent a lot of time arguing about disclosure and proxy fights and this and that and that is important. We fight about a suitability recommendation, a slight issue with disclosure, or a technical violation. It's important. But, to see a widow lose everything, to see a retired couple put a million dollars in the bank that Stanford ran, their life's earnings, and to have that disappear.[74] A life's earnings disappear because of finan-

74. SEC v. Stanford Int'l Bank, Ltd., No. 3:09CV-0298-N, 2009 WL 2371432 (N.D. Tex. April 17, 2009).

cial fraud that is really bad. These cases have troubled me for a long, long time and thinking about how we prevent them. So, when I talked to Steve and Hugh, they are going to make some wonderful comments. But, especially for the students, because you may be able to find a solution, here is what we've got. We've got all kinds of Ponzi operations regulated within a regulated broker-dealer. You know, a *Stanford*[75], a part of *Madoff*[76]. Unregulated, last year we talked about that Minnesota situation. It was a hedge fund and it was just one big fraud. Sometimes it's an investment advisor, sometimes it's a broker-dealer, sometimes it's an individual, sometimes it's a registered representative within an entity. It could be an account, etc. All kinds of people do these things. The investor gives the Ponzi operation money and gets back money. Maybe not, maybe they put it all in and they get a fake return on a statement and they don't take anything out. An interesting footnote question that has become a great issue is what if the investor gets back more than they put in? What if they put in, and this is why when Pat put the numbers up on *Madoff*[77], they were bouncing all over because, what is the true loss? Well, if I put my million in last August, a year ago August, I am probably out a million. If I put a million in 1999 but I have gotten dividends and interest and withdrawals of two point eight million, my statement says two point two million still at *Madoff*[78]. Well, I don't really have a loss except I don't have what's on the statement. There is a very interesting set of issues. What do you do with investors who have gotten out more? In Cleveland, the SEC set up a special arbitration process that broker-dealers could enter into in the Ruditaria situation. I never pronounce that correctly, where the broker-dealers would make sure the investors were whole. The investors could argue that they had reliance damages. They took money out and gave it to a charity or whatever and needed recovery. Punitives were not recoverable. It was a good process and a number of in-

75. *Id.*

76. SEC. v. Madoff, No. 08 Civ. 10791(LLS), 2009 WL 721712 (S.D.N.Y. Feb. 9, 2009).

77. *Id.*

78. *Id.*

vestors entered into it and some of them got money from the broker-dealer, more than they had put in and pulled out. They were whole. They got money on top of that. In Oklahoma, the Oklahoma Department of Securities, for folks who had put in money and gotten back more out, sued all of them and was successful in clawing back every dollar they had gotten in excess to what they had put in. Even if they had gotten money back and given it to their church, the charity, etc. It was really an amazing, difficult situation. So, that is an issue. Now, you have statements, confirms, and tax documents in most cases that go back and forth to the investors. Some of these cases involve check kites where the Ponzi operator doesn't have enough money so they have to move checks quickly through the financial system. The investor puts money in, they make interest payments to other investors, but the till is dry so they get into a check kite float situation. That isn't always the case but often it is. We have got the accounting function and then the custodian of the assets which could be the Ponzi operation or a third party. Hugh was going to make a comment on his view on the custodianship. Then, of course, we have got the Ponzi operation trading the trades with an exchange, or in many of the cases I have had, it's just all fake. There are no trades with anybody. The trades are fake. So, you have different folks involved in different functions. The challenge, I believe, is for the private side, not the regulatory side, to figure out how to deal with the accounting function, the custodianship function, and the trading function on a disclosure basis so that a major Ponzi is really tough to do. Madoff can't pull it off. His accountant, it was a shoe string operation. We can't let that happen. If officers are signing their names, someone has got to be signing their name and standing directly in the line of fire so people's assets are not stolen. That's my little speech. Joe?

Audience: Rocky, sorry, are you in favor of Senate Bill 1551[79], which is Specter's bill getting rid of *Central Bank*[80], reinstating aiding and abetting?

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79. Liability for Aiding and Abetting Securities Violations Act of 2009, S. Res. 1551, 111th Cong. (2009).

80. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

C. Pozza: I'm not sure. (Laughter)

Audience: What you're saying is that a custodian can't today be held liable under *Central Bank*.[81] What Specter is saying is "yes they can."

C. Pozza: What I'm focusing is not so much on what we've done historically for decades, assuming that a five word change in the law will create all kinds, because I don't think aiding and abetting in the Madoff situation would have had any impact. What I'm really talking about are very practical solutions in the structure.

Audience: What about simply requiring an independent custodian?

C. Pozza: Well, Hugh, why don't, Hugh should . . . (interruption)

Hugh Makens: I'm there.

Audience: Or, well, an independent auditor.

Hugh Makens: Yep.

Audience: I think this is, in fact, how they unravel. Ponzi himself was caught, you know, by an audit, and so those are . . . (interruption)

C. Pozza: And it's not required. Now, will that cover everything? No. The totally off the books transactions, and I have had so many of those cases, where they are running this thing out of the trunk, but that's not a Madoff. The audit function works with a Madoff.

Audience: But, even there, if there is an independent auditor, they'll find it immediately. The auditor can't run by conversation. He must insist on seeing, you know, written records, competent evidential matters, court opinions.

C. Pozza: And I agree, except to the point that I've had a number where an agent, a group of them, have just run off the books transactions not from the office with nothing going back and forth. They just do it completely off the books, and unless the auditor knows of the alleged customer, it, so, even in that circumstance, you've got a problem, and that is one I'm not quite sure what the solution is, other than grabbing the agent by the neck and saying, "Are you running a Ponzi scheme?" every six months. I don't know what to do there, Hugh, but on the

81. *Id.*

custodianship and the accounting functions . . . (interruption)

Steven Klawans: Yeah, I think we've reached the point now where there is no reason for money to be held by an investment advisor, where a large percentage of your Ponzi Schemes come from. I don't think there's any reason for the money to be held in the possession and control of that investment advisor, even if they are at the same broker-dealer. And, I mean, you can move money virtually instantaneously today, so I think we've reached the stage where, particularly for SEC-level registrants, there has to be an independent custodian.

I would go a little further, Pat, on the accountant. I would say they have to be PCOAB[82] if you are certified, if you are in fact going to be presuming the PCOAB survives the latest challenge in the courts. But I would require PCOAB if you are going to be at an SEC level and you're going to have any possession or control of funds.

Hugh Makens: I think the biggest step you could take to curtail the abuse in Ponzi schemes, because outside of the investment advisor, I think insurance agents are your next major problem. I think that or representatives of brokerage firms, and often they are the same. I think that if there was a mandate that all insurance companies were required to notify broker-dealers of withdrawals, of significant withdrawals or cancellations of variable product, of annuities, that have been sold through the broker-dealer, that a lot of the money that gets turned into the Ponzi scheme theft, at least the firm's compliance department would have the ability to detect. Now, as I say, there is a number of insurance companies that do that, but there is a much larger percentage that do not provide that information today, and therefore, while the rep gets a notification that money has been withdrawn, there is no notification that's coming the other way.

I would also be more aggressive in terms of approaching, if I was the SEC, of approaching the insurance in-

82. [Public Company Accounting Oversight Board] is a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports. PCAOB Oversees, http://pcaobus.org/Pages/default.aspx (last visited May 28, 2010).

dustry and having them stress, number one, that you can't be involved in any kind of an investment arrangement. You can't try to peddle anything, even if somebody claims that it's not a security. You find that in the brokerage firms, but less so in the insurance business, so I would make that change.

I would also mandate that there be disclosure of outside business activities within the insurance industry to spot the stuff that is going on. Look at our, our, if you look at two major frauds that have come down that are nonconventional, one has been in the area of viaticals, and now life settlements is getting hot, and there a tremendous amount of that is done off book. And then you go back to the Supreme Court case, 2005 maybe, the *ETS Payphone* case.[83] Who was selling that? Insurance agents and people at brokerage firms selling away from their firms, so I think doing those kinds of steps would go a long way.

The other thing you might want to talk about, Rocky, is, or Steve if you have knowledge of this, is the SEC's recent suit against the receiver at *SEC v. Stanford Receivership*[84] and the consequences on clawback.

Steven Klawans: In the Stanford Ponzi scheme case, which is being litigated, the receiver appointed in the case over the assets recovered from Stanford and his companies has decided that he is going to, the receiver is going to, he has filed an action against investors who made more money than they had put in, but instead of the receiver just taking action against the investors for the portion of their proceeds over and above what they put in, he is asking for their principal. He is asking for all their money. Okay, so not just interest, the receiver is asking for, okay, you put in a million, you got two million back from the guy over the years, I want all two million.

The SEC has come in and said, "Wait, that's not our policy, that's not how we do things." We've never penalized an investor and said, "You have to return your principal that you got back from the Ponzi scheme." So

83. SEC v. Edwards, 540 U.S. 389 (2004).

84. Complaint, SEC v. Stanford Int'l Bank, No. 3:09-cv-0298-N (N.D. Tex. Feb. 16, 2009).

we've actually filed a motion against the receiver in the case, which obviously is highly unusual, and I believe the receiver is going to appeal the court's ruling to the appellate court, which denied his right to do this. So, it should be interesting to see how that plays out.

Audience: Steve, could you comment on the Section 20[85], enforcement actions based upon control liability, which is something that Hugh has referred. In other words, if an insurance company is a registrant, and they haven't supervised an insurance agent, is that a claim under Section 20(a)[86], which is almost against an officer, director, whatever, who may not have known, under a strict tort liability theory as a control person.

Steve Klawans: Yeah, I mean traditionally those types of fact patterns fall into the types of cases of failure to supervise, and so if the firm is required to supervise the sales force and had red flags of some wrongdoing and could have prevented the violations by the salesperson, then whoever knew of those red flags can be held liable under the failure to supervise theory. If have, there may have been, but I am not aware of, cases in which 20(a)[87], or control person liability, has been utilized by us to bring that kind of an action. That would be pretty aggressive.

C. Pozza: Joe, where my experience in cases where that allegation was made, the failure to supervise, there is an outside business activity report written, there is a private securities transaction document, there is an annual interview, there are unannounced inspections, and generally the broker-dealer or the insurance company is off the hook if it is totally off the books, and I have a lot of cases where it was totally off the books. Very few where there was knowledge, or even enough information or a "should have known," so some of these are clearly off the books, and they are going to be really tough. But you get a Madoff, and it is not off the books. I mean, it's there for everyone to see.

A couple of other, on the recovery of principal, if you had an investor who invested in July of last year and is

85. 15 U.S.C. § 78t (2008).
86. 15 U.S.C. § 78t(a) (2008).
87. *Id*.

out one million, the entire amount they invested, it's, I can see the argument being made that others should be, who participated by investing in a fraudulent Ponzi scheme, should share the loss. Now, it hasn't quite gone that far, but you can make a compelling individual case that it is unfair, just because they came in late, they get to bear their entire one million dollar loss, where somebody else gets to keep their principal. I mean, that's a little unusual.

But for the students here, you could take this and turn this into some papers or, really, a career because this is a significant issue in our system. We need belief in our financial markets. We can't have people in a state of despair. And this Madoff-Stanford thing, it just shook me because these were so big, and especially in light of everything going on. But this would be a great, you could take any piece of this, what Hugh or Steve has commented on, you could write it up and really have a lot of fun with it.

Pat, when I made my little speech about the hurricane and whatever, what I was driving at, and mentioning long-term capital, there is a wonderful book, "When Genius Failed."[88] I mentioned it last year, you really need to read it if you haven't read it. But there, Treasury put together a Sunday night meeting of the largest broker-dealers and said, "We are passing the hat, we want about a half-billion out of each one of you because the financial system may sink within the next few days if we don't bail out long-term capital." And that was viewed as a positive, and maybe someone could later have said, "Well, that's unfair to the shareholders because why should they have, why should my company in which I own shares put money in? Too bad if long-term capital fails."

So I just see a parallel with last fall when, for example, Ken Lewis and Bank of America stepped forward to buy Merrill at a very critical time for the American and world financial system, in the midst of a meltdown. I think it will be good for the Bank of America sharehold-

88. ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000).

ers in the long run. I believe that, but now there is this great attack on them on a disclosure basis over bonuses. And I understand the sensitivity on bonuses, but I just, looking at it, I see parallels with long-term capital, and I am happy that Bank of America stepped forward at a critical time after discussions with the Secretary of the Treasury. So, there are perils, and that was my, it wasn't really going to the mortgage piece, it was really, I just find it interesting that Cuomo is on the warpath on this and the like.

Audience: Losing a major bank, or losing all your major banks, is very different than losing any other kind of business because the whole system goes down.

C. Pozza: Sure, and that's my little speech, but it's actually an historical perspective, not a speech, so . . .

Hugh Makens: Let me make a closing observation on the point you made, Rocky. That is, the recent exchange of e-mails from Bank of America. One of the directors sent out an e-mail on the acquisition and the terms, observing, unfortunately, it "screwed the shareholders," and the other director responded, "no trail." (Laughter) E-mails can be devastating. Continually remind your clients of that fact.

And also, there is an area we didn't touch on, but I think deserves your consideration, and that is, Steve, do you have a couple of minutes? Could you touch on the two 20(a) cases that have come out recently?

Steve Klawans: Well, there's a control person liability case and a second case which, though the fact patterns were different, they raise, I think, a fundamental question in both of them that I think is pretty interesting. The 20(a) case that Hugh is talking about is the *Nature's Sunshine Products*[89] case, which is an FCPA, Foreign Corrupt Practices Act[90], case that we filed in July of this year. Essentially, a Brazilian subsidiary of Nature's Sunshine Products delivered some cash payments to the Brazilian customs officials to, it sent them to allow them to bring some unregistered products into the country of Brazil. And so they

89. Complaint, SEC v. Nature's Sunshine Prods., Inc., No. 2:09CV0672 (D. Utah July 31, 2009).

90. 15 U.S.C. § 78dd-1 *et seq.* (2008).

prosecuted, we charged the company and the officials of the, the executives who passed off these bribes.

What is interesting about it was that we also charged the CEO of Nature's Sunshine, as well as the CFO, even though we didn't allege that they were aware of the bribes being paid. They were charged under a control person theory, saying that because they were in a position to control the actions of the employees who delivered the bribes, that, as a result, they are responsible for the SEC filings, which failed to disclose these cash payments. And so, that's one fact pattern, which raises this specter, well do CEOs and CFOs have any sort of strict liability test. If someone commits misconduct, if someone violates securities laws on your watch, are you responsible and thus violated the federal securities laws? That's the question that case poses.

There's another case called, let me make sure I get the name of it here; it's titled *SEC v. Maynard Jenkins*[91], who is the CEO of CSK Auto Parts. Okay, and CSK Auto Parts, they, there was an accounting fraud at this company, and they had to restate their financials. The CEO made a bunch of money from bonuses and compensation, of course, during this period of time, and the SEC went in July of this year and said, "Well, under Section 304 of Sarbanes Oxley[92], you are required to give back the bonus compensation that you earned because there was a restatement due to misconduct under your watch even though we didn't charge." This guy wasn't charged with any violations of the securities laws, just under Section 304, saying, "You have to return your compensation." So both these cases present the idea, is the SEC moving in a position of saying, "Well, whether you knew or not, whether you violated the law or not, it's under your watch, you're responsible."

What do you guys think about that one? Do you think we are moving in the right direction or no?

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91. Complaint for Violations of Section 304 of the Sarbanes-Oxley Act of 2002, SEC v. Maynard L. Jenkins, No. 2:09-cv-01510-JWS (D. Ariz. July 22, 2009).

92. 15 U.S.C. § 7243 (2008).

Audience: My observation is that I'd like to see you change the laws to go even one step further, and that is to be able to claw back bonuses that have been paid to people that were derived from illegal activities from a company, and we're not there, and the statutory authority is not there to do that. But if the money has been gained, it's the fruits of the poison tree, taken in a different direction, if the money has been improperly earned, I'd like to see it come back to the benefit of the shareholders.

I am much less enthused about the Commission's practice of asserting penalties against corporations where the wrongdoing was primarily driven by someone acting for their own personal benefit inside a corporation, and I would much rather see those penalties aimed very strongly at the people who were involved, and I would like to see an increased use of criminal sanctions.

Steven Klawans: I'd like to get criminal authority, so write your congressman. (Laughter)

Elliot Spoon: Alright, well, let's thank the panel very much.

ADMINISTRATION OF THE MICHIGAN UNIFORM SECURITIES ACT

Elliot Spoon: Alright folks, welcome back. Our first session this afternoon deals with the new and revised Michigan Uniform Securities Act[93], which, as we were told this morning, was effective October 1st. There are a number of very interesting aspects to this new law, and with us to discuss these are practitioners Tony Trogan and Brad Schram, as well as Diane Bissell, who is with the State of Michigan Office of Finance and Insurance Regulation and is intimately involved in implementing the new Act, so gentlemen.

A. Trogan[94]: Thank you. I'm Anthony Trogan. As some of you know, I'm not Eric Richards. Mr. Richards was unavoidably instructed by a higher authority to be somewhere else today, so I have been asked to sit in for him. Diane Bissell is with us from the State of Michigan, and Brad Schram is here to represent the issuance and transactional aspects of the new Act and defendants' work.

In order to give us a context, somewhere in your packet is a fact pattern which you may find helpful. Again, it is not necessarily something that we are going to discuss completely, but a fact pattern is always nice to give something to focus on and help us understand and contrast points to be made. If I can give you a brief summary of how I would read the fact pattern because it is several pages long, we have your classic widow, older person, unsophisticated lady who generates, all of a sudden, not through her own efforts but as the result of inheritance, a very substantial amount of money, a million bucks, far and away a larger sum of money than she has

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93. MICH. COMP. LAWS §§ 451.2101-.2703 (2008).

94. Mr. Anthony V. Trogan is the president of The Law Office of Anthony V. Trogan and has been practicing law in the Detroit area for over thirty years. He graduated from Wayne State University Law School in 1971. Mr. Trogan has extensive legal experience in the areas of business and commercial law and litigation in addition to being a specialist in plaintiff's securities law. In 2001, Mr. Trogan opened his own firm in West Bloomfield, Michigan, to specialize in claims against stockbrokers. He began working in the securities area in 1979 as a defense attorney and initially represented major brokerage firms in several hundred securities and commodities cases nationwide. Beginning in 1987, with the stock market "crash" that year, he began representing customers. He now confines his practice exclusively to customers' claims.

ever had to deal with before, at a point in her life when the money is, of course, extremely meaningful, given her age, her employment status, and so forth. She is induced by a bank teller where she does work to visit with the bank-sponsored broker-dealer salesperson, not an unusual situation at all. In fact, it is very common, and in fact, I have even had it happen to me. The widow is, she actually, no, just retired. No, she is recently widowed, okay. The widow, in fact, does make communication with; I see one of the arbitrators smiling.

Audience: Isn't everyone (unintelligible)?

A. Trogan: Yes, the widow makes contact with the salesperson, and here's a little bit of a twist, the salesperson, instead of sitting down with her at the branch or at some other location which is established for this purpose, offers to visit her home, apparently, however, not for the purpose of her convenience, but to offer her an off the books viatical, which is not sponsored by the bank, by the bank broker-dealer, or anyone else, but rather is his own product and is being traded away from his broker-dealer, her account if she has one at that point, and without the knowledge, supposedly, of the bank or the bank broker-dealer. It is, however, a real product, which is how I think we bring Brad in, in the sense that it is not a Ponzi scheme, a fictional product, or something of that nature. It is a real product. She buys it. Allegedly, she doesn't understand it, many of the different facets of it. A year later, she decides she needs some money from the viatical. She can't sell it, and, of course, that now confronts us with a problem from a regulatory standpoint, from a transactional standpoint, and from a litigation or arbitration standpoint.

And with that, Diane, I think you were going to speak briefly about the intricacies of the regulatory aspects of this, and take it away. Do you want to sit, or do you want to come up here?

Diane Bissell[95]: I'll sit.

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95. On September 26, 2006, Ms. Diane Bissell joined the Michigan Office of General Counsel, Office of Financial and Insurance Regulation (OFIR) specializing in mortgage fraud, banking, insurance and securities regulatory and enforcement matters. Diane previously worked as Counsel for the Michigan Bankers Association, Associate

A. Trogan: Okay.

Diane Bissell: Okay, I thought maybe the best way to give you some context of what the Office of Finance and Insurance Regulation does and how our Securities Division is able to force enforcement actions, complaints, and investigations is to give you a little bit of background about the agency, how we function, how we're staffed, and also give you some information as to the types of things our Securities Division does, so you'll have that backdrop as we work through this factual scenario. Before I go into that scintillating discussion, however, I must give my state of oath disclaimer, and that is: The remarks or comments which I make up here are really my opinions and comments. I cannot speak for the Commission or the Office of Financial and Insurance Regulation, and the positions I take, unless they are enumerated policy decisions of that office, which I'll let you know if they are, these are my opinions and the things that I think, my speculation, or my perspective.

Audience: That's so interesting because Tony purports to do that all the time. (Laughter)

Diane Bissell: I have my legal counsel here, and he will attest to the fact that I'm good with this disclaimer, so just so you have that background and understanding. Okay. First of all, I have been with the State of Michigan for a little over three years, and in a former life, when I was a law clerk, I worked for Mr. Spoon, and I have to tell you that I'm very privileged to be here today and be a part of this panel. I'm probably the person in this room, with the exception of some of you law students, that has the least amount of knowledge about securities overall. My first securities assignment was from Elliot. It was doing some research on selling away or going private under the CCH Reporter, and I didn't realize that, you know, there were addendums in the back of the book. That was the last assignment he ever gave me. (Laughter) No, I'm just kidding. He was very kind. He showed me what to do and gave me lots more work.

Counsel for National Jackson National Life, and spent over ten years in private practice in the Detroit Metropolitan area. Ms. Bissell earned her undergraduate degree from Alma College and her J.D. from Detroit College of Law.

From there, I do have some background in insurance, and I did a fair amount of broker-dealer arbitrations. But, frankly, in the last three years I think I've forgotten more about securities than I ever learned, so when they came to me about three months ago and said that "you are going to draft not only our securities rules to implement the new Act, but you are also going to be in charge of the remaining rule sets of the agency," I was quite a little bit stymied, and so I tried to get up to speed on this Act and hopefully I won't mislead any of you with any of my comments today. But if I do misstate or make a mistake, please feel free to correct me. I'm pretty humble, and I'm pretty humbled by this gathering, so you won't offend me.

Okay, with that, the State of Michigan consists of approximately thirteen departments. The Department of Energy, Labor, and Economic Growth is the department that houses our agency, the Office of Financial and Insurance Regulation. Within the Office of Financial and Insurance Regulation, we have different divisions: banking, credit unions, securities, deferred presentment, insurance, et cetera. And an anomaly that occurred in June of 2006 was that they pooled all of the attorneys from that agency into the Office of General Counsel, and the reason for doing that is they thought if they centralized the attorneys in one office, it would make us run more like a law firm, and we would then be giving advice to the different divisions, our clients. Well, that's a great theory, but when you don't have anyone in the Office of General Counsel who has a background in an area in which they are giving advice; it creates a little bit of a problem. So, we are trying to work through that, and we have increased in our staff since I've been there of about triple. We have a lot of new staff, though, and so we are changing to, we have a pretty big learning curve for most of those folks.

Now, within the Division of Decurities, we have three areas. We have licensing or registration now, we have examinations and investigation, and then we have a dotted line to what I call product, and I'll explain that in a second. We really have two people who do the registration and licensing, so as you can imagine, as of October 1st, when we are now going to register all of these investment advisor representatives, we've got a pretty big task on our hands. We have a handful of people who do investigations and examinations, and then we have, really, one individual who does, basically, our product review, with the assistance of some of our law interns and law students.

To give you an idea from a product standpoint, we get in roughly one hundred to three hundred different types of products. Most of them do not require any type of review by qualification or coordination notice filings, your mutual funds, so we don't have a lot of products that we have to really do an in-depth review, which makes us different from a lot of states who make everything registration by qualification because they have a department staffed with twenty, thirty people, people who specialize in each exemption area. Now, OGC[96] becomes involved if during the course of a product review or licensing claim examination, a matter that might come up that they feel needs to go to one of our administrative enforcement attorneys. That would be something like somebody didn't comply with a subpoena, we need to order a cease and desist because we found out that somebody is not registered and is selling an unregistered product, we've got an advertising issue. That's when we would get involved. Other than that, many times the examiners and the Securities Division are in direct contact with the prosecuting attorneys, FBI, SEC, other regulatory agencies if there is a really big issue, something that is going to rise to the level of, you know, criminal violations.

Diane Bissell: Okay, so with that backdrop, how is the Office of Financial Insurance Regulation, how are we going to administer this new Act? Well it's been interesting, as of October 1st we have a lot of holes in our statute and so in order to address the holes what the new Act allows us to do is our office can implement rules and there are some sections of the statute that can only be implemented by rules. There are other sections of the statute that allow us to do orders, and thank goodness for that those of you involved in the drafting. Hats off to you because rules

96. Office of General Council within the Michigan Office of Financial and Insurance Regulation.

take a very, very long time to implement and this security rule set will be the largest rule set that this agency or any other agency has ever done. So, in the interim, what we've attempted to do is do cross-walks: compare the old Act to the new Act, the old rules to the new Act, and then with the great help of the industry folks, they've been giving us calls and giving us input in areas they think there are gaps we need in order. For example, the first transition order basically addressed the fact that as of October 1st, we register investment advisor reps. Well, the FINRA system isn't up and running yet, so probably they can't get on that system to get registered until November, so we're giving them a grace period until July 1st, 2010, to go ahead and register as long as they're affiliated with a registered I.A.

Audience: And how many do you anticipate will have to register?

Diane Bissell: The estimated count was 10,000, so that's a hefty number. Now, just like the broker-dealer agents in my day they were called registered reps, if you've got a clean app, the IARD system is going to take you through that process pretty expeditiously. However, those of you who are going to be registering your IARs, I would caution you not to wait till the last minute because as you can see we don't have that many people at OFIR in the Securities Division who are going to look over anything that's not a clean app. And if you find it stuck in a queue there, you know, it's going to take us some time to get to these folks. So I would encourage you as of January 1st to be getting that process in place and be moving through that process.

Audience: Diane, on that point, I noticed under the new Act that the definition of a "finder" has changed in that a finder now is required to register the same way that a (inaudible) would be required to register. How is that going to impact you? Are you prepared for that? Do you have any idea how many people we're talking about?

Diane Bissell: That's a very interesting question. The reason that finder was defined in the Act, I'm not sure. The fact of the matter is, is that it has been the policy of the Securities Division that they don't want to register (inaudible), that was never the intent. However, as you read through the various portions of the Act it appears that an investment advisor is not a finder that's registered as a VD, and so in interpreting the Act, the industry believed that if you were registered as a broker-dealer then that encompasses the finder, so the finder would have to register as a broker-dealer. Now humbly, I would submit there is another interpretation, and that is if you are a finder not registered as a broker-dealer, maybe you have to register as an I.A. It's very unclear from the way our statute is written. We are actually one of the few states that kept in finder. A lot of states, when they went through this process, removed finder from their Act. So, I know Hugh Makens, this is one of his areas, that, you know, he is the guru about it; he understands it in and out. I certainly don't have that kind of knowledge, but I know this is a bone of contention with him as well as to what we're going to do with these folks. Now, in your materials, I gave you a plethora of information on how the agency promulgates rules, and I'm not going to bore you with what is probably the only area that I've ever seen that is completely form over substance, and the process is so convoluted and it takes so long that I can't imagine why we haven't come up with a better solution. And the reason the rule process is arduous, quite frankly, is the legislation did it on purpose because they don't want us, to do by rule, what they should be doing in the law-making process. So there's a reason, a method of madness if you will, but it doesn't make it an easier when we have a statute that's going to require such a massive rule set like the Uniform Securities Act. To give you an idea of a time-frame, we have sent out a first draft of rules to the industry. A second draft will hopefully go out next week. And basically, are sending it to the sub-committees of the Michigan Bar, and they have been absolutely wonderful in providing comments and feedback and very helpful in providing language and that's greatly appreciated. Also, thanks to Warner, Norcross, and Judd because they provided us with a wonderful crosswalk that was color-coded which made it that much easier for us to try to do our job, and that's appreciated. As you all come across things in your practices, please feel free to contact us if there are areas that you can see we have a need for a rule or something. We're very receptive to any information and any input we can get because we'd like this rule set to be something that really works for everyone. Obviously we want to make sure we're protecting the citizens of Michigan, but it's not our job to try to make it impossible for your folks to get registered and to move our economy along. Okay, so that kind of gives you an overview of what we're doing, transition orders, working on rules, we have a frequently asked questions up on our website, primarily directed right now at the IARs, but we'll try to get some other issues up there. We are aware that we have an issue with the oil and gas sales, INTRA, industry exemption. We need to get that rule in place. We need to address the non-profit charitable exemption, which used to be self-executing under the old Act. Under the new Act, we're given some different scenarios as to how we want to handle the non-profit. As of this point a policy decision has not been made by the Commissioner on that issue, so we can go anywhere from sort of a self-executing at a certain dollar level all the way to requiring those charitable non-profits to all register in some form of qualification. That decision has not been made yet, so we're working on that. Now in terms of enforcement, Hugh, you missed the finder question. Did you want me to ask again? This Michigan Uniform Securities Act has really been hailed as supplementing and enhancing the tools that our agency will have at our disposal to enforce the Act. And again, in theory, that's wonderful, and we'd like to think that we're going to be able to live up to that challenge. However, there are some practical considerations, such as resources, no budget, no appropriation of any current budget being contemplated for resources to enable us to do the kinds of things that the Act now allows us to do. Kind of keep that in the back of your minds as I'm moving through this.

Audience: That's in addition to an economy that has been subject to the biggest Ponzi scheme that's ever been perpetrated.

Diane Bissell: Yes. And we have not seen a tremendous rise in the number of consumer/investor complaints comparatively from last year. Product filings seem to be holding their own, which is a good thing. But we don't have a lot of resources at our disposal to handle some of the bigger cases in any event, so a lot of those generally go to the Attorney General for referral, and that's another issue with their staffing or to a prosecutor. And, kind of digressing a little bit, Hugh has been wonderful in working with us to put together a prosecutor's manual. So, in addition to a fund under the Act for investor education, which we're going to be trying to keep the citizen's educated, we are also going to embark on a program working with the prosecutor's in all the counties to educate them on how to bring security enforcement actions. We're hoping they partner with us and that will help them and also help us because we have so limited resources in that area. In terms of enforcement, looking to the new Act under Articles 2 and 3, which are the product transaction registration and the other registration requirements, not a tremendous amount has changed there in terms of OFIR can do. We can issue stop orders, we can tell you the product is not going to fly. Those types of things are still there. We even still have the ability, with a federal covered security, if you haven't met the notice filing requirements or something of that, we have a right to go in and take action on that. Not a lot, to my knowledge, has changed in that area. Where there seems to be some changes that may be significant are more on the person side of the registration and what OFIR can do in terms of shutting down people from selling. Probably the section that's most noteworthy is in Article 4, there's the 412 denial revocation and suspension section. And that gives OFIR the right to look to see if an order will give a public interest and then to take action if someone in that category meets one of several enumerated situations, and the one that always sticks in my mind is the felony. Under the old Act, my recollection was, you had to be convicted of a felony that was related to a financial transaction. In [Section] 412,[97] it says "any felony," so we've already received quite a number of questions for people who have been convicted of a felony, and frankly the one that comes up a lot are DUIs, which the third offense is automatic, things of that nature, where that would be an automatic disqualification. I can tell you it's a hot button because some of you may remember a couple years ago on the insurance side; we have similar language in the insurance statute with respect to registering producers. And for some reason persons were being registered who maybe twenty

97. MICH. COMP. LAW § 451.2412(c).

years ago had some kind of minor infraction, or what someone deemed a minor infraction felony, and the Commissioner had to go through a very arduous process to revoke those appointments. So, he's very sensitive to this. This is going to be an issue that I don't think you're going to see a lot of wiggle room on. The Legislature put in there "felony" and I think that's how it's probably going to stay. So, in a situation like that, the Administrator has the right not only to look at the individual but there are other circumstances enumerated in [Section] 412 where we can also be looking at the firm. And, you have a person who rose to the level that we thought maybe the firm had some issues this gives us an opportunity to look at it from a local perspective.

Audience: Diane, has there been any discussion relative to the solvency question, that is that as this economy has declined over the years, I've seen actions over the years relative to the solvency of the individual registered representative and whether he or she can continue in business under the circumstances?

Diane Bissell: Honestly, we have not had any discussions on that issue and so far we haven't had any questions on that. And I'm not sure, I think it may be contingent on how they answer when they fill out the registration, and what types of things get picked up in the system, either on the FINRA side, the (inaudible) side, and the (inaudible) side, depending on how they completed their registration form (inaudible) gets to our review. But, from a policy standpoint, number 412 also gives the Administrator some pretty broad enforcement powers, we have summary suspension powers, the power to censure, we can go ahead and take action to give someone a right fifteen days to request a hearing. If nobody requests a hearing in thirty days past, any kind of interim order or temporary order becomes final. In addition to that, we have the right to go ahead and issue orders and follow the normal administrative procedures and process in terms of seeking enforcement if we feel there's a person or a firm out there that rises to that level. I also want to point out that under 4-12(3), and that's a pretty important section for many of you, if it's in the public interest, the Administrator has the right to pursue against a partner, a director, or a controlling person, if there's been a disciplinary issue. And that's something I think you want to keep in mind. This morning I think you talked a little bit, I think analogous to 20(a) in some respects, and to my knowledge I don't think we have a whole lot of case law on that. So, that's going to be an area we're going to have to keep an eye on.

Audience: Diane, coming back to our fact pattern, you put such limitations on your expertise I don't know if this fits or not, but given the lady in our fact pattern and the salesman in the fact pattern, and the product, if this were to come into you on a complaint, is there anything different about what the old Act allowed you to do and what the new Act allowed you to do administratively, functionally, or practically, in the way you would deal with this.

Diane Bissell: Not in terms of a consumer complaint *per se*. If it came in through a consumer complaint, it would go over to the Securities Division, to the Examination and Investigation Section, and they would then begin their investigation. If they felt there was information they needed to get access to, they could go to the enforcement side, ask one of the attorneys to put together a cease and desist, injunction, whatever it had to be. We also have the right under the new Act, I think we have the same right under the old, to, as part of the investigation process to compel people to attend, we can't make them testify *per se*, but we can ask them to attend to these records. So that is available under the new Act, and to a certain extent was there under the old as well.

Audience: I would from a practitioner's side look at that fact pattern a little bit differently. I would look at it and say under the old Act that I would argue that this particular product was perhaps an insurance wrapped product and therefore could be sold by non-registered people, meaning insurance agents, and therefore would not be subject to the act. Under the new Act, a viatical[98] is specifically identified definitionally as a security, and therefore would more appropriately be subject to this discussion I think.

98. *See supra* note 10.

Audience: What about this simple matter of the organization of your department and main power? Are things better plaintiffs like this?

Diane Bissell: I don't think anything is worse in terms of the manpower the agency has, or the division has. However, I believe when 2008 passed, the fiscal benefit that was identified was that we need to retain seven to ten more FTEs, which is full time employees. I think there's an appropriation of five hundred ninety-five thousand dollars, somewhere along that line. That has not happened, so in addition to that, we don't have a budget right now. In the budget proposals I have seen, I haven't read everyone, but it does not appear that there's been an appropriation for that. We do have a posting out there right now for another auditing-accounting person on the products side, it's not necessarily going to help Savvy Sophie. And we're looking at, we've had furlough days this year, and we have furlough days under the next budget year and that impacts our ability to do our job, no question about it. Understand that if you're not an essential service and we have a furlough day, you can't go in the building. You can work from home, but you can't go in the building.

Audience: What's going to be the application of the ten thousand new IARs and the fees that are being generated from that source?

Diane Bissell: I think in that 2008 fiscal analysis that was one of the areas of sources to begin up-staffing, so as those registration fees come in, there would be a hope that some of that money would go back to the Securities Division and to OFIR. Also, keep in mind though that above a certain level, whatever money we receive in, they go back to the general fund. And actually, under Article 6 of this new Act, it appears that they double appropriated. In one section it talks about any simple fines, et cetera, going into the investor fund – education fund – and in the last, I think, subsection 6 of that section, it says that they're going to go to the agency, and when they reach their ceiling, it goes to the general fund. To answer your question, yes, we're hopeful that increased fees will help, but some of that's now going to the investor education fund, and again, much of it ends up in the general fund.

Audience: That sounds like a state-supported Ponzi scheme. That's a joke.

A. Trogan: Brad, you were going to talk to us about a number of things. One of which was the changes to the Act having to do with registration and transactional work.

B. Schram[99]**:** Yeah, I'll do a very brief overview. I've supplied an outline of the changes, but from a practical standpoint, this is for the law students that are here as well. Many of the securities practitioners in this room, and I see several even in this first row, tend to be involved not only in the securities litigation – securities enforcement side, but clients will come to them seeking to create a business or investors will come to determine whether the particular investment that the client is looking at is, first of all, a good investment, and secondly, whether it's properly registered or exempt from registration. As you all know, in Michigan, as in all other states, a security must either be registered or exempt from registration. For years, under the Michigan law, [the former] Michigan Uniform Securities Act 402, there were a number of exemptions that individually applied to certain circumstances that we could, what we call, stack exemptions.[100] So, even though by statute there was fifteen non-accredited investors, which by rule would change to twenty five, it was virtually impossible to know in any particular offering if a client came in, which exemptions would be most appropriate, how to apply them, and in the uncertainty of that, the lawyer gets to create a document that was difficult to comprehend and extremely expensive for the client who frequently was looking to raise half a million to a million dollars, and when the legal work was done, and to do it appropriately, we're talking about at least a

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99. As local and regional counsel for several securities firms and developers, Mr. Bradley J. 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. He is frequently requested to serve as a mediator or expert witness on complex securities, business and real estate disputes. 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 U.S. newspapers before attending Georgetown University Law Center in Washington, D.C. There, he received his J.D. degree in 1976 and served as Senior Managing Editor for the Georgetown Law Weekly.

100. MICH. COMP. LAWS §451.2402 (2009).

twenty five thousand dollar assignment. And it just is very difficult for a client to comply with the law. The new Act, now consistent in seventeen or twenty other states, has simplified that process, in many ways for the better. The requirement now is that there is no longer an accredited, under Michigan law, there's no longer an accredited investor definition. That definition has actually become an institutional investor, which is as it sounds, doesn't apply to an individual, and presumptively has the ability to analyze and make investments decision on its own or through its staff. Under the simplified Michigan rule, under (n), there can be up to twenty five purchasers. We always have the issue of whether they were offeror, the number of offers. But if it is an undertaking that is not for general solicitation, that finder's fees, or commissions, because they're no longer finder's fees because they've got commissions are not being paid, up to twenty five individuals can purchase securities where the disclosures are very simplified in where the process is one, where now clients coming in to you can go through a process that is rational. Typically, if there are (inaudible) limitations on (inaudible) transaction, because if you're doing twenty five purchaser transaction, you're typically talking in the half a million dollar range; maybe a little bit more, or maybe a little bit less. So if it is a large undertaking and accredited, federally defined accredited investors will be used, then what we would do is file pursuant to Section 18 of Reg. D offering, typically 506, where there's an unlimited dollar amount, up to thirty five unaccredited, but you have to disclose to those unaccredited, or non-accredited investors a lot more information that you would do under the simplified Michigan version. Also, depending on the dollar amount involved, I believe it's under Reg. D, if it's over two million dollars, it requires audited financials. If it's under two million dollars, I believe it's certified from the accountant disclosure. Now, many people will still, and I would probably advise it because of the anti-fraud provisions, you still want to do an adequate job of disclosing the background of the people involved and the underlying transaction itself. But it is much more akin, and Diane asked me this at lunch, what happened to the old friends and family routine exemption. And really, this has supplanted that, and it's a manageable number that permits startup ventures, where you're talking three to four people, a handful of people who want to create an LLC, they want to put some money into the deal. Probably it's going to be undercapitalized like every deal is usually from the beginning, but under exemption (o), this is (n), under (o) it is permissible to go back to the same group again to raise more money without being considered a second offering. So you can go back to that first group. This is going to be something, I think, that's very beneficial. On the one hand, it's going to perhaps cause some lawyers not to get as much in fees. I think it's great for the public, and in fact, I think you'll be doing a lot more transactional deals, and you'll also have less sophisticated people coming in to say to you, "I've just received this information. There's not a lot here. Can you help me do due diligence to help me make a decision about whether I ought to go into this investment?"

A. Trogan: Brad, in looking over the outline you've given, there's a question that comes to my mind. First, I want to ask Diane something. There was a change, in my experience practitioners don't get many claims involving the sale of unregistered non-exempt securities, but the statute of limitations has changed on that issue. . .

B. Schram: Down from two years to one year.

A. Trogan: Down from two years to one year, and effective October 1, there's a provision in the statute which deals with which limitation period applies and so forth. I'd ask Diane, and then I'd ask you something, Brad; why did that particular statute of limitations go down, and the other ones for general securities fraud go up from two and four, two years after discovery, four years after event, to two and five, two years after discovery, five years after event? Do you know?

Diane Bissell: I don't know.

B. Schram: For two reasons, Tony, I think: to be consistent with the Uniform Securities Act, and with the federal law.

A. Trogan: Okay, just that simple.

B. Schram: I believe so.

A. Trogan: Does anybody else in the room know?

Audience: Yeah, I was in the drafting session. Brad got it dead on.

A. Trogan: He's got it right?

Audience: He's got it right.

B. Schram: You never believe me Tony. (Laughter)

A. Trogan: The next question I would ask you Brad, going back into the outline again, Eric has placed the discovery period here at eighteen months, maybe to promote that discussion we just had, but putting that statute of limitations issue to one side, did the substantive provisions, the anti-fraud provisions of the new Act, make defense of this claim, as we've articulated it, and as we have it in the outline, does it make defense of this claim easier or harder?

B. Schram: Overall, I think it embraces the old Act and most of those defenses would be the same. From the earlier comment I made about the expansion of the definition of security, then there would be a larger sweep of what products would be deemed to be securities, and therefore fall within the purview of the Act under the enforcement procedures, as well as the arbitration issues that were, I'm sure, spoken about earlier today. So I think for the most part, they'd be the same.

A. Trogan: Okay, now, we've got a situation in our fact pattern, where the product involved is a security. I think that's a given under the new Act. Might not have been under the old Act, is that true?

B. Schram: Yes. Correct. That's primary distinction.

A. Trogan: Ok. That issue is now clear. With respect to the…

B. Schram: Back to you Tony, I'm sorry, back to your point, if we were defending on that basis, we would move to dismiss anything involving the Uniform Securities Act. You may have other common law claims; there may be a breach of contract, which is a six year statute as you know. There may be fraud, but we would say it didn't fall within USA.

A. Trogan: Now, I think that our fact pattern makes our case against the salesperson kind of easy, but let's turn to his employer. Are there changes in the new Act such as reiteration of the burden of proof issue, and so forth, which make the defense on behalf of his employer more difficult?

B. Schram: My understanding, and anyone else out there that's reviewed it, I don't think so. I think that the substantive defenses and claims are for the most part the same. I'm trying to think whether other than the statute questions that we've talked about and the inclusion of more securities. I think you for the most part on the claimant's side will have your same causes of action and we will for the most part have the same defenses. The old Act is not, to the best of my knowledge, is not substantively different than the other seventeen states that we have now replicated with regard to defending those cases. Does anybody have?

Diane Bissell: Is there an argument that under the new Act though the concept of reliance and causation you typically see in the federal 10b-5 (inaudible). That I think is a change that is going to be more favorable to Savvy Sophie.

A. Trogan: Savvy Sophie? (Laughter)

B. Schram: Yes.

A. Trogan: The reason I'm asking Brad all of these questions . . .

B. Schram: Because he signed me up for this.

A. Trogan: Is because we have this case and are trying to get his answers. (Laughter) Is there an emphasis that you perceive with respect to such items – elements such as reliance?

B. Schram: Yes, Diane is correct. We always would argue of course that presumptive reliance is inappropriate because in each instance Savvy Sophie would have been cross-examined to show that she knew or should have known and therefore that she had actual knowledge.

A. Trogan: Of course you recognize from a practitioner's standpoint and again Eric was clever enough to slip it in there – from a practitioner's standpoint the reliance issue of course is always the alternative burglar tool for defense and it is the vein of the claimant attorney's existence. How do you get them to say the thing that requires them to lose all of their pride and confess to being something sub-human (laughter) – someone who is not smart enough to think for themselves – and insulting their intelligence, which of course is the big advantage that the defense attorney always has because with a few questions that pride will resurface and most customer claimants can be induced to "well of course I knew that" or to at least get to that frame of mind. Now, under the new Act though I think there is no reliance requirement if you can get in under MUSA. Is that what I'm hearing you saying or?

B. Schram: Well, that's what Eric was going to discuss with us. Bill?

Audience: I can read a paragraph that says:

Finally, the logic is inescapable of the Michigan Legislature. When it drafted and enacted the Michigan Uniform Securities Act, it was no doubt very familiar with the concept of reasonable reliance as an element of common law fraud and as an element of a claim under SEC Rule 10b-5, yet it did not include such an element in the express language of the statute governing state securities fraud claims.

That was the language of a state circuit court judge very recently. Now Hugh, do you want to comment on that since you were in the drafting sessions?

Hugh Makens: The drafting part that I was most heavily involved in was actually the drafting of the Uniform Act itself before it came to Michigan and it was intentionally omitted, so.

R. Henney[101]: Tony?

A. Trogan: Yes?

R. Henney: Tony, the original Act never had a reliance section. It always had intentional "did you know/did the investors know?" Reliance has never been part of the Michigan Uniform Securities Act and that's just a carryover in the new Act. The other distinctions from the federal Act is

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101. Mr. Raymond W. Henney, a partner at the Detroit office of Honigman Miller Schwartz and Cohn LLP, has many years of experience in litigating a wide variety of securities cases, including representing major corporations in class-action shareholder suits, individuals and entities before the SEC, and brokerage firms in customer disputes and before regulatory organizations. Additionally, Mr. Henney has appeared in various state and federal courts and before arbitration tribunals in numerous states. A Certified American Arbitration Association mediator and arbitrator, Mr. Henney has substantial experience in advising brokerage firms concerning supervision and compliance issues. Mr. Henney earned his B.A. with honors from Michigan State University in 1980, and his J.D., *magna cum laude*, from Wayne State University Law School in 1983.

not only do you not have to show reliance, you don't have to show scienter.

A. Trogan: That was my next question. Why don't you.

R. Henney: That's a carryover too. The essential elements for a misrepresentation claim under the old Act and the new Act are the same. So you have the advantages from the claimant's side with respect to not having to show scienter, not having to show reasonable reliance. You just have to show that they didn't know – they subjectively did not know.

A. Trogan: As long as we have more participants, do you mind Brad?

B. Schram: No.

A. Trogan: My question would be this – again, from a defense standpoint, Ray, do you agree or disagree that the articulation of the claim in the new substantive fraud section is much better than it ever was under the old Act?

R. Henney: Well, I think it is better. And certainly the definition of "security" is better and I also think with respect to "control persons," while I don't think it's changed the parameters, the articulation is clearer with respect to who has that secondary liability and the due care defense that they have.

A. Trogan: And the shift in the burden of proof?

R. Henney: I think that its clearer, but I think most practitioners understood that or understand it's the same that it was under the old Act as the new one, but it is articulated better.

A. Trogan: I agree. It was always there, but there was always a hurdle sometimes. Not always sometimes, but there was frequently a hurdle. Finding that within the Act and then persuading someone that it meant exactly what it said. The other thing that is nice about the substantive fraud section is the articulation of the 10b-5 language in this section, which clearly imposes a private cause of action. Something a practitioner and claimant can rely upon.

R. Henney: But only against investment advisors, not against broker-dealers.

A. Trogan: Well, we'll see. (Laughter)

R. Henney: There is no we'll see, because subsection 6 says investment advisors can be for manipulation and all the 10b-5 language. That is an exception for broker-dealers, the exception that is for the Investment Advisor's Act. The misrepresentation claim is you have to say that is not a manipulation. You have to have said a misrepresentation. And so that still carries on. What is new though is, you're right, for investment advisors–to the extent you can stick a respondent as acting as an investment advisor–is that you get the manipulation section of 10b-5.

A. Trogan: Now if we could go back to the outline, I could find my place. There was another element in here. Oh, the remedy, um, I don't think we are seeing anything really different in terms of the remedy. With the exception again that we're seeing the articulation of a damage calculation in a plainer way and the adoption of a damage calculation which is probably the one which is most frequently used in arbitrations, at least in my experience. Mainly the recessionary calculation or the damages based upon the same concept. But again, a plainer statement of what it is and again an adoption of I think what a lot people were using anyway.

B. Schram: That by the way is another exemption – the offering of rescission is not deemed to be the sale or resale of a security. It's exempt if, in fact under the Act, you must offer or do offer rescission.

Audience: Brad, did you notice the damage calculations from investment advisors. Do you feel it's different under the state versus the federal law?

B. Schram: No, um.

Audience: I mean you can get actual damages under the state?

B. Schram: You can.

Audience: But I think it would be harder in federal court, wouldn't it be?

B. Schram: Yes, I mean I think that . . .

Audience: It's a defense don't you think?

B. Schram: Well I think the clarification, Tony is right about that. I think under the old Act and under the new Act it was always the same in terms of the investment advisor litigation. I think you have clearly that opportunity to use that measure as one, but you are not barred as you suggest from going after actual, benefit of the bargain, or any theory you may have. And I'm not sure that in fact that you're not precluded under MUSA; that is a remedy. It doesn't necessarily mean it's the only remedy. There are other causes of action typically alleged besides the MUSA violation.

A. Trogan: Of course the problem with other damage calculations is that with the six percent calculation which is thrown into the recessionary remedy – it's tough to beat six percent right now, legitimately, (laughter) and you know Ponzi schemes are all at eleven or twelve percent, but six percent right now is a pretty big inducement and probably not enough for a completely fraudulent scheme but for a questionable legitimate scheme it's not bad. So, and I was kind of surprised when I saw that because I thought I would see some sort of a floater or at least a lower amount. Historically, I don't know where the six percent came from. Do you know Mr. Mackey?

Hugh Mackens: The six percent?

A. Trogan: Yeah.

Hugh Mackens: That's the historic number that has been in Michigan back to the beginning of time.

A. Trogan: I'm curious to know where it came from though- do you happen know?

Hugh Mackens: It predated my first arrival in the sixties – that was eighteen sixties. (Laughter)

Audience: If I could throw out a question to you Diane or to anyone else. Does anyone feel that under the Act that there are any additional burdens on the broker-dealer community in terms of either supervisory controls or any related issues?

A. Trogan: Diane?

Diane Bissell: Well, as I mentioned earlier under that Section 412 where it looks like the action, if it were a disciplinary action involving a high-level personal executive officer or what not that would be revisited upon on the broker-dealer or the IA, although I am not sure that's the same as it. I think it was always out there but it's clearly stated and enumerated in this particular item.[102] And then the joint and several liability, but that was there, obviously, before. One of the things Brad, is that there is, and I'm don't recall if it was in the (inaudible), but there is that express immunity for broker-dealers who, you know, are doing a termination of one of their reps. And they've got that qualified immunity for defamation.

B. Schram: That's a good point. There's limited, and I don't believe there was under the old Act. Now there is a limited immunity although if you look at the language of the Act you merely need allege that the firm didn't do it in good faith or with reasonable. I forget what the magic language is.

A. Trogan: What was the common law status of that in Michigan?

B. Schram: I thought it was qualified.

A. Trogan: Qualified?

B. Schram: I believe it was a qualified.

A. Trogan: I remember when the issue came up and it was a very hot issue and I never saw how it was.

Audience: It was actually a little bit stronger than qualified. So, I was curious as to how this is going be to read. If it was going to change the common law because the case law had been moving to almost take away the qualified portion of the immunity.

A. Trogan: Well, any other questions?

Audience: Sorry to get away from that. Brad, so when a client who comes with you for a private placement to raise several million dollars wants to use someone to help him find money, now he can only take a broker-dealer?

B. Schram: Yes. It used to be that there was a two-year requirement–that the [broker-dealer] had actually been a [broker-dealer] for two years. The "finder" under the Michigan law, a commission cannot be paid to in order to qualify under the Michigan Act, so it would have to be pursuant to a Reg. D offering – a 506[103] or, I think, a 505[104].

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102. MICH. COMP. LAWS §451.2412 (2009).
103. 17 C.F.R. § 230.506 (1989).
104. 17 C.F.R. § 230.505 (1992).

Diane Bissell: And again, curious that Michigan kept the "finder" definition in when many other states did not. We define it; we didn't have any policy for registration on these people and so it kind of got put in the broker-dealer category. And really Hugh, you weren't here before, but you could probably address it.

Hugh Makens: Yeah, it got moved over to the broker-dealer category from the investment advisor category where it was put in 1979. Part of the reason for moving it that there is two proposals up before the SEC right now and that are also being discussed by NASA that would create either an exemption or a very limited registration for a private placement broker who was doing smaller deals with the idea that we'd try and deregulate and help put more money into the economy. That was based on a task force report from the ABA that came out I think in 2005 in the Business Lawyer. And then in addition, there is a proposal to carve out M&A brokers completely from SEC registration and move them only to state registration as the simplified process. And we are awaiting both of those proposals to come out for comment from the SEC and hopefully before too long. The staff is ready to move on those items so it's just getting the Commission's attention in this time of chaos.

B. Schram: To me it's logical because if it's through a registered broker-dealer there are procedures/requirements that will, in theory at least, protect the individual investor. If you're merely doing it through a finder whose interests may be different and may not be regulated in the same way or as concerned, other than making the commission, there presumptively would be less control and less oversight and less protection to the investor. I think that's the theory.

Audience: You know in this state, we used finders in the past and they had to register under a very simplified procedure. We used them because they were the only ones that you could really to find to help you in a deal from several million to ten million. You really couldn't find a registered broker-dealer to help you and I don't see that that's changed any. So in these small deals, from the two to ten million dollars, there is no help anymore for raising money. That doesn't seem to help the state's economy go.

A. Trogan: Okay, we have two questions left. Yes, sir.

Audience: It kind of follows up on Stewart's question. I'm wondering if anybody's has had any experience or there has been any consideration of this at the state level, or the federal level for that matter, is the use of these angel nets or accredited investor networks, a lot of them are computerized. They are not registered broker-dealers or IAs. They're out there - there is tons and tons of them out there, but, you know, sort of the idea there is that there are accredited investors and you go on and post some sort of little summary of your deal. And there is some fee, it's not transaction based. You end up with a bunch of people asking you about your deal and then you can have it invest or not. Any experience of anybody with that? From the regulatory standpoint, is that a target? There is general solicitation issues there. There is all kinds of issues there.

Diane Bissell: Not to my knowledge. I know that they're out there and we've had some inquires about them, but from the regulatory standpoint.

Audience: Not a focus.

Diane Bissell: Not that I'm aware of.

Audience: The SEC has sent some no-action letters out that they have generally tried to operate under and I think the states have accorded respect to those no-action letters from the SEC. I suspect some are restrained beyond the scope of those. The first one of those that came down was the University of Michigan's Growth Symposium,[105] Dave Brophy's program. That was the first of those letters that came down and then there has been several that require that everybody who is attending has to be accredited, has to have a relationship with this organization. There are limitations on what you can do and what you can convey. If you stay within those you won't be deemed to be a broker-dealer.

Audience: Yeah, the ones that I read and there are several old no-action letters, not new ones. They expressly do not rely

105. *See* Michigan Growth Capital Symposium, http://www.michigangcs.com (last visited May 28, 2010).

on the general solicitation for a private offering. So that's just sort of out there now.

A. Trogan: Sir, did you have a question?

Audience: Yeah, Stewart stole my thunder, but that was my exact question – just how to deal, from an advisory standpoint, in advising clients who want to bring in a finder and find a registration and it seems like it just got filtered in under [broker-dealer].

A. Trogan: So, our time is up. Thank you very much. (Applause)

Elliot Spoon: Let's take a couple minutes. Grab coffee and cookies. We'll be back with our final panel of the day on business and securities.

FINRA UPDATE

Joseph Spiegel[106]: We're going get started. One observation is that in the past twenty years arbitration in the securities field is where the quote-and-quote law has been decided. Although there are no written decisions in arbitration, the panel here has had literally hundreds of them. Because almost all customer complaints are in arbitration, I think that this section, which is going to go through proposed FINRA rules new and old, whose subject to arbitration, motions, arbitration selection, discovery, expungement, and vacature, will bring you up to date as to the latest and greatest both as to a matter to law a matter of rule, and as a matter of best practice. Felicia Fox who is with FINRA from Chicago is going to discuss the FINRA rules - new and old ones. Ray Henney will then speak on who is subject to arbitration. Gary Saretsky will be speaking on motions. Mr. Trogan will be speaking on arbitrator selection and initial pre-hearings. Mark Kowalsky will discussing discovery. Felicia will do a little bit on expungement which hasn't really changed and finally vacature. So we're going to start with Ms. Fox.

Felicia Fox[107]: Thank you, Mr. Spiegel.

Joseph Spiegel: You're welcome.

Felicia Fox: And first I would like to make the same disclosure of my predecessors. Any comments/observations that I'm going to give today are my own; they are not those of FINRA management or my colleagues. I'm going to start with a little status of where we are statistically. Then I'm going to talk about a couple of new programs that we've developed for the public arbitrator pilot program and a program for auction-rate securities. And then I'm going to talk a little bit about the new rules that have become effective in the last year or so, including

106. *See supra* note 7.

107. Ms. Felicia Fox came to the Financial Industry Regulatory Authority (FINRA) from private practice in 1996. She received her undergraduate degree from the University of Illinois, Champaign-Urbana and her law degree from Cumberland School of Law in Birmingham, Alabama. Ms. Fox assisted in establishing Dispute Resolution's mediation program in the Midwest Region. She has worked in a variety of capacities within Dispute Resolution's arbitration program and has administered cases in over twenty cities, including Detroit, Michigan. Ms. Fox serves as a mediation and arbitration trainer at FINRA.

those for dispositive motions, increasing the thresholds for a claim to be heard by a single arbitrator, explained decisions, clarification of the tolling and statute of limitations, composition of industry cases, the extended procedure for promissory note cases, and the limitation on submissions in closed cases.

So where are we now at FINRA in terms of the number of arbitration filings? Well, through August of '09, we've had four thousand nine-hundred ninety-one claims filed. That's up sixty five percent from the same period one year ago. And actually where we were at the end of August is where we ended last year. So we're up quite a bit. Of those claims, customer claims have increased seventy three percent. Claims involving auction-rate securities and subprime mortgages account for a large proportion of that. Also, about a quarter of the cases that we do see go all the way through award. And, through August of '09, of those cases that go to award, about forty five percent of customers have been awarded damages. And that has been trending upward.

Next, I'm going to talk briefly about two new programs that FINRA has developed. The first is the Public Arbitrator Pilot Program, and this gives investors a greater choice in panel selection. It's a voluntary two-year program and in the program investors may select a three-member public panel. Those people that are eligible are those customers who file cases against eligible firms and only name an eligible firm. That panel composition is contrasted to a standard case, which involves two public arbitrators and one non-public arbitrator. In the public program, customers receive the same list that they would receive in a standard program case, which is eight chairperson-qualified arbitrators, eight public arbitrators, and eight non-public arbitrators. The difference being that if a case is in the pilot program, the investor may strike all eight names from the non-public list. In a standard case, they are only allowed to strike four names from that list. Of the statistics that we have so far on this program through September 14th are that fifty-two percent of cases have opted into the pilot. And of those cases, about half of them have kept the non-public arbitrator and half have stricken the non-public arbitrator. We are now in the second year of the pilot as of about ten days ago.

> This year we have increased the number of the firms in the pilot from eleven to fourteen. Five of the firms have increased their commitment from forty cases to sixty cases each. So now we have gone from two-hundred seventy-six eligible cases to four-hundred eleven for the coming year.
>
> Another new procedure that we've got is for those cases involving auction-rate securities. The first one involves the recovery of only consequential damages. So, for plaintiff's consequential damages involved in auction-rate securities filed by customers of firms who have reached regulatory settlements with either FINRA, the SEC, or the States, we have developed these special procedures that expedite the process of the cases, you know for customers looking for consequential damages only, in cases under one million dollars they will have their case decided by a single arbitrator. That arbitrator will be selected from the chair-qualified public roster. FINRA cases with auction-rate securities where customers elect to proceed under the standard FINRA procedures, there are special limitations on the non-public arbitrators who can serve. The non-public arbitrator for an auction-rate securities case cannot have worked for a firm selling auction-rate securities nor can that person have sold or supervised someone who did sell auction-rate securities.
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> Next, I would like to talk about a few of the rule changes that have been passed in the last year or so. The first one is the dispositive motion rule. So, for that Rule 12504[108] and 13504[109] have been adopted. Those rules significantly limit dispositive motion filings. FINRA believes that the new rules will curb future abuses and ensure that investors maintain their right to have their claims heard in arbitration. So the substance of Rule 12504[110] in the Customer Code is that for dispositive motions filed before the conclusion of a party's case-in-chief, the rule specifies three grounds on which a motion

108. Fin. Indus. Reg. Auth. Manual R. 12504, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11405.

109. Fin. Indus. Reg. Auth. Manual R. 13504, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11408.

110. *See supra* note 108.

may be granted. The first one is that the non-moving party signed a settlement and release. The second one is that the moving party was not associated with the account, security, or conduct at issue. And the third is that claim does not meet the criteria of the eligibility rule, which is 12206[111] and 13206[112]. So what has the impact of this rule been to date? Well since it's become effective on February 23, through September 1, 2009, dispositive motions have decreased by eighty-five percent compared to the same time last year.

Another rule change that we have initiated involves the increased threshold for cases heard by a single arbitrator. This rule became effective March 30, 2009, and this one modifies existing Rules 12401[113] and 13401[114]. The rule specifies that a single chair-qualified arbitrator hears cases up to one hundred thousand dollars unless the parties agree in writing to have three arbitrators hear that claim. This eliminates gamesmanship and it removes the prior option of a unilateral request for three arbitrators. By increasing that threshold, we have increased the efficiency in the arbitrator process. We have greater flexibility in scheduling cases, pre-hearings, hearings, and it has decreased the time to do research to select a panel. It has also decreased the cost for an arbitration proceeding. A party can save up to six hundred dollars a day in forum fees by having a single arbitrator as opposed to a three-person panel. And it also decreases the amount of copies that a party has to make to give to the panel.

Another rule involves explained decisions. This one was passed this past year. It's different incarnations that have been batted around for a while, but it's finally gone through. And it provides that arbitrators write an explanation in the award if there is party agreement that is made at least twenty days prior to the hearing. And the

111. Fin. Indus. Reg. Auth. Manual R. 12206, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11477.

112. Fin. Indus. Reg. Auth. Manual R. 13206, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11478.

113. Fin. Indus. Reg. Auth. Manual R. 12401, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=10445.

114. Fin. Indus. Reg. Auth. Manual R. 13401, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=10446.

explanation under the rule is a fact based one. The arbitrators do not have to give legal citations. And they do not need to tell how the calculations are arrived at. The honorarium to the chairperson for writing an explained decision is four hundred dollars and that money is to be allocated by the panel to the parties. If the parties don't request an explained decision, the arbitrator still may write one. In that situation, there is no honorarium to the arbitrator and no fee to the parties.

Another rule change has been that Rules 12206[115] and 13206[116] now clarify that filing an arbitration claim tolls the statutes of limitation.

And then two additional rules have impacted panel composition in industry disputes. The first one for employment disputes involving an associated person, in cases other than statutory employment discrimination claims, the panel must be composed of a majority public panel. This is as opposed to disputes exclusively between member firms where there will be an all non-public panel. This ensures that the type of party involved will control the type of panel that is received and not the type of dispute that's involved.

The second change that's come about for industry cases is expediting the administration of promissory note cases. Generally in these cases, the panel will consist of a single public arbitrator and that arbitrator will be selected from the statutory employment discrimination roster unless the associated person has filed a counterclaim in excess of one hundred thousand dollars, in which case there would be two additional arbitrators appointed. Also under this rule, if an associated person fails to file an answer, the chairperson will enter a decision on the papers filed and, there will not be a merits hearing.

And the last rule change I'm going to mention is the change to Rules 12905[117] and 13905[118], which limits

115. *See supra* note 111.

116. *See supra* note 112.

117. Fin. Indus. Reg. Auth. Manual R. 12905, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=10220.

118. Fin. Indus. Reg. Auth. Manual R. 13905, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=10221.

submissions on closed cases. This was effective on November 24th, 2008. Under the rule, there are only three grounds where parties can submit documents in a closed case: The first one is when it's ordered by a court, the second one is at the request of any party within ten days of notice of the case closure, and that's basically for mistakes to a description in the award, the third ground is if all parties agree within ten days of the case closure. The panel can decline to consider a request made under options two and three. Also under options two and three, if the panel does not make a decision within ten days, the requests are considered denied. And that's what I have to say about the new rules.

Joseph Spiegel: Do we have any questions?

Audience: Felicia, it's been my experience that when you have an industry dispute in the past, it's never been an all industry panel and that's what this rule change has made. How many industry cases do you have now?

Felicia Fox: I can't tell you exactly how many. Statistically, in the last few years the cases of industry disputes relative to customer disputes was increasing substantially. Now it's going back down as the number of customer cases has gone up.

Joseph Spiegel: Thank you Felicia. Well now we know what the rules are. Mr. Henney, you want to tell us who can arbitrate or who should arbitrate or why they shouldn't?

R. Henney[119]: Sure Joe. Thank you I'm Ray Henney. I'm going to discuss who is subject to arbitration particularly the rights and obligations of non-signatories to an arbitration agreement.

This is really a very important theory of the law because of the prevalence of arbitrations and so forth. It's also an extremely dry area of the law and it kind of reminds me of that old Woody Allen joke: There's these two old ladies at a Catskill Mountain Resort and one says, "Boy the food here is really terrible" and the other one says, "Yeah, and such small portions."[120] (Laughter) Well, this is dry, not all that exciting and so forth, but you real-

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119. *See supra* note 101.
120. ANNIE HALL (Rollins-Joffe Productions 1977).

ly do need to know it and probably we should cover it more thoroughly than we are.

We all know that the people who sign an arbitration agreement are going to be subject to arbitration and as long as the dispute is within the scope of the written language of the arbitration agreement, you're going to be compelled to arbitration. Well when you don't sign or when you have one of the parties that don't sign, what are the circumstances in which you can compel them to arbitrate? And really there are three questions: Under what circumstances can a signatory to an arbitration agreement, or to an agreement contained in an arbitration provision, compel a non-signatory to arbitrate a dispute? Secondly, under what circumstances can a non-signatory to an arbitration agreement compel a signatory to arbitrate a dispute? And third, under what circumstances can a non-signatory to an agreement contained in an arbitration provision compel a non-signatory to arbitrate a dispute?

Now we have in your materials an outline that discusses cases and rules and so forth. But the overarching issue with respect to arbitration in the securities context, particularly in the Broker-Dealer context, has to do with the FINRA rules, which Felicia was just talking about. For those students that don't know it, if you're a broker-dealer, you have to be registered with FINRA and you're essentially subject to the FINRA rules regarding arbitration. And with respect to non-signatories, there are two rules that are critical to know. It's [Rules] 12200 and 13200. [Rule] 12200 says customers generally can compel a brokerage firm to arbitrate.[121] Don't need an agreement. Don't have to have anything to do with an agreement. It's the obligation of the broker-dealer to arbitrate when the customer, those that are defined as customers, want to arbitrate. Secondly, disputes between brokerage firms have to be in arbitration, are mandatorily required to be in arbitration, and it is a breach of the ethical rules of FINRA to bring a case in court that should be subject to arbitration between brokerage firms. And finally, 13200 says that disputes between brokerage

121. Fin. Indus. Reg. Auth. Manual R. 12200, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5185.

firms and their brokers, or what they call "associated persons," must be in arbitration.[122] So those generally set kind of a landscape, but there are all kinds of permutations.

We thought we'd do it in a hypothetical form because we're at the end of the day. We thought the old law school way, I don't even know if they still do this. (Laughter) Do they still know *The Paper Chase*? These students' parents were probably only teenagers when *Paper Chase* was prevalent, but we thought we'd use some hypotheticals and work through some of the rules. Again, we've got extensive written materials concerning this.

Our first hypothetical, are you ready? Mr. Spoon, are you ready for your first hypothetical? Brokerage Firm solicits Old Lady to open an account and provides Old Lady with a new account agreement form. The form incorporates the Brokerage Firm's standard contractual terms that includes an arbitration provision. Old Lady signs the new account form, but never receives the standard contractual terms or form. When a dispute arises, can Brokerage Firm compel the Old Lady to arbitrate the dispute? Thoughts?

A. Trogan[123]**:** Yeah.

R. Henney: Mr. Trogan? Why can they?

A. Trogan: She signed it.

R. Henney: She signed on a form, but she never got the incorporated provisions. Does that matter?

A. Trogan: No.

R. Henney: Mr. Trogan is right. (Laughter) I know, it does deserve applause. (Laughter) The Federal Arbitration Act[124] and the Michigan parallel says, all an arbitration agreement has to be to be enforceable is in writing. It need not be signed. It need not be countersigned. All it needs to be is in writing and that the normal contractual rules that would enforce a contract would enforce the writing. So

122. Fin. Indus. Reg. Auth. Manual R. 13200, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5283.

123. *See supra* note 94.

124. Federal Arbitration Act, 9 U.S.C. § 2 (2006).

in this case, incorporation by reference is sufficient even if she's never received them, never saw them, is sufficient to bind her into arbitration. Yes, Mr. Trogan?

A. Trogan: Is it not true that if they put the arbitration agreement on the back of a confirm, with no signatures, there is case law which states that is enough of a writing?

R. Henney: Funny you should mention that. (Laughter) Hypothetical two. And that's actually exactly what this addresses. Broker solicits Old Lady to open an account with Brokerage Firm. Brokerage Firm sends to Old Lady a new account form with standard contractual terms that includes an arbitration clause. Old Lady does not sign the new account form and does not return it to the Brokerage Firm. Old Lady, however, provides the Broker funds to purchase the investments in the account with the Brokerage Firm. The investments are made in the account and a dispute arises concerning those investments. Can Brokerage Firm compel Old Lady to arbitrate her claims? One party had signed, presumably the brokerage firm, but the Old Lady has not signed, has not even returned the agreement, but she has given money to the broker to make investments. Tony?

A. Trogan: Yes. She must arbitrate.

R. Henney: And do you know why she must arbitrate?

A. Trogan: The same reasoning. The cases are extreme.

R. Henney: Well. (Laughter) Some would say it's well developed law in contracts (laughter) that if facts constitute assumption of contract by performance, which is a standard contractual theory. Somebody buys and sells widgets and you send them a contract, they don't sign the contract, but they perform, contract's enforceable. Same situation with the Old Lady or estoppel, that she'd be estopped from denying the contract because of her performance. It's fact sensitive, but there's doctrine regarding that. Second, can a Broker, a non-signatory, compel Old Lady to arbitrate her claims? Brian?

Unknown: Absolutely.

R. Henney: How come?

Unknown: I think the same reasoning applies.

R. Henney: Actually it's somewhat similar, but again the law has different terms in order for us to stay employed. This would be an agency. You cannot, for instance, the Broker has the benefit of the arbitration agreement of his employer with the Old Lady under an agency theory. So she can't sue him individually and avoid arbitration. He is permitted to use the arbitration in both the arbitration agreement under an agency theory. Tony, do you have another introduction for this one?

A. Trogan: Ray, in addition to the agency theory, isn't it most likely that the arbitration agreement itself is broad enough so that it puts the customer on notice that any dispute with the firm or its representatives would be covered by arbitration?

R. Henney: Sure, I mean if the scope of the agreement puts, again all it has to do is be in writing and there be indicia of agreement of what is in writing, so if the written agreement says, "All representatives, associated persons, et cetera, concerning anything that has to do with your account must be arbitrated" certainly that would allow the broker then to rely on the specific language. But even if the language wasn't there, even if the contract was just between the Brokerage Firm and the Old Lady, the agent of the Brokerage Firm is entitled to rely on the arbitration provision.

Hypothetical three. Old Lady opens a brokerage account with Brokerage Firm "A" and signs a new account form with an arbitration agreement, which states that "All claims regarding any transaction in the account must be arbitrated." Broker sells Investment "A" to Old Lady while the Broker makes certain misrepresentations about Investment "A". Broker moves to Brokerage Firm "B" and sells Old Lady Investment "B," which is related to Investment "A." There is no arbitration agreement between Old Lady and Brokerage Firm "B." First, Old Lady commences an action in court against Broker and Brokerage Firm "B" concerning Investment "B" and alleges that in selling Investment "B," Broker made misrepresentations regarding Investment "A." Doesn't this sound like a law school exam? Can Brokerage Firm compel arbitration? Can Brokerage Firm "B" rely on an agreement between Old Lady and Brokerage Firm "A" to compel arbitration? This one's more puzzling, admittedly. In fact, it's under appeal in front of the Michigan Court of Appeals. A lower court has held that Brokerage Firm "B" can compel arbitration because of the broad language of the arbitration provision that Old Lady entered into with Brokerage Firm "A." Remember it says, "All claims regarding any transaction in the account." Well she's claiming that there are misrepresentation with respect to Investment "A," made at Brokerage Firm "A" had to do with her investment with Brokerage Firm "B" and Investment "B." So there's at least one court, one very prominent smart court, that has agreed with our position that indicated that Old Lady could be compelled to arbitration.

Let's switch it a little bit. What if the investment was sold away from the brokerage firm? Can Brokerage Firm "B" rely on that? I think someone said "no" and that's the correct answer. Obviously you can't rely on the arbitration provision because the arbitration provision indicated that "all transactions through the account" and if it was sold away, it's not in the account. Now, can Old Lady if she wants to arbitrate against Brokerage Firm "B", can she compel Brokerage Firm "B," with whom she has no arbitration provision, into arbitration? Someone said "yes" and that's the correct answer and that's because of the FINRA rule. The interesting issue here arises. Let's say Investment "B" is totally away from the firm and Old Lady never opened an account with Brokerage Firm "B." So she never did any investments whatsoever and really wasn't on the books and records of the broker-dealer as a customer. The broker-dealer never heard of her, but she did this transaction through their broker. Can she compel arbitration with the Brokerage Firm? Tony?

A. Trogan: Yes.

R. Henney: In fact, Tony you won that particular case.

A. Trogan: All she has to be is a customer in the industry and all that has to be is a product which is within the scope of the business of the broker.

R. Henney: And actually, some courts have even extended that further. The FINRA rule says you need to be a customer and the dispute has to do with the business of the broker-dealer and the courts have been very liberal to say that anybody in the public is a customer and if supervision is an issue, then that's the business of the broker-dealer. So Old Lady can compel arbitration. Only one more.

Hypothetical four. The employment agreement between Company "A" contains a non-solicitation provision and an arbitration agreement. Employee leaves Company "A" and joins Company "B" and violates the non-solicitation clause. Company "A" commences arbitration against employee and Company "B." Can Company "B" be required to arbitrate? It's a non-FINRA company. Let's say these are commercial companies. Can Company "B"? No, someone said "no". They cannot. There's no principle of contract law or arbitration law that would require Company "B" to arbitration even though there's an arbitration agreement with the employee who they employ. What happens though if Company "B" was informed by the employee? Would that change the dynamic? There are cases that say "yes." Under an agency associated/affiliated person principle. Company "B" can be compelled to arbitration. Again, these are contract principles. What if we go back to the previous hypothetical? What if the arbitration provision with the employee provides that all claims regarding the violation of the solicitation provision must be arbitrated? Would that make a difference? Probably not. Unlike the previous situation, the customer in the former signed the agreement. Here Company "B" didn't sign the agreement. How about if the company is a brokerage firm? Right, people are nodding their heads. Absolutely. Again, that circles back to the FINRA rule. Member firms must arbitrate. That's all I have Joe.

Joseph Spiegel: Ray, let me ask you two questions.

R. Henney: Ok.

Joseph Spiegel: On April 29th, 2009 Senator Russell Feingold introduced in the United States Senate the Arbitration Fairness Act of 2009 and Representative Henry Johnson introduced a corresponding bill in the House earlier that year. Two things. One, they're amending or changing the U4[125] to make explicit this issue of arbitration, correct?

125. The U4 is also known as FINRA's "Uniform Application for Broker-Dealer Registration" *See* FINRA - Current Uniform Registration Forms for Electronic Filing in Web

R. Henney: Yeah.

Joseph Spiegel: What reason do you think that was necessary in an industry setting? And secondly, what is your view of these two proposed amendments to Chapter Four of the Federal Arbitration Act, which hasn't been amended in ten thousand years?

R. Henney: Actually, that's like the third reiteration. By way of background, this is not so much a securities industry matter, but a lot of different kind of consumer products have been slipping in arbitration agreements. Manufacturers have been slipping in arbitration agreements. Automobile manufacturers have had them for years with respect to lemon law and so forth. And that was the genesis for reform with respect to the Federal Arbitration Act, which has been for many years interpreted as requiring arbitration or been very favorable toward arbitration. So the move was to get away from consumers being stuck in arbitration for run-of-the-mill types of products and transactions and because of the climate, with Enron and Ponzi schemes and everything else, there's been various reiterations with respect to whether or not it should be a requirement to arbitrate. Can there be arbitration provisions in securities cases? And really, I'd like to really show, if I might, just switch that question a little bit. I thought it was interesting that Felicia said that in forty-five percent of the cases that are tried that customers are getting awards. And I think that's a remarkable number because the way the industry is, the ones typically, the cases that get to trial, are close questions. The disasters are settled. The cases that have exposure to the firms are settled. So there's a tremendous netting process before a case comes to the arbitrator's door. So I thought that was a particularly high number and when Felicia said it was trending upward, to me I thought that said something, in my mind, about the favorable setting of arbitration. So I thought, in my way of thinking, I don't think that this legislation is needed because my feeling is that customers do pretty well. It's cheaper, faster, and by and large I think the arbitration

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CRD, http://www.finra.org/industry/compliance/registration/crd/filingguidance/p005235 (last visited May 28, 2010).

panels get it right. But I guess that, to me, is the question of whether or not this legislation is needed.

Joseph Spiegel: Anybody on the panel have a view? What do you think the cause was for changing the U4 form to make it absolutely clear about industry arbitration and brokers?

R. Henney: Aberrant decisions from places like Montana, Utah, and there's one other state that was against the forty other states that held that if you signed a U4, it says you have to follow FINRA rules, FINRA rules say you have to arbitrate, therefore, you have to arbitrate. But I think there are decisions, I think that Montana Supreme Court didn't interpret it that way. That Court held to the contrary in order to avoid arbitration.

Joseph Spiegel: Thank you very much. Gary Saretsky is going to talk about motions. And it'll be fairly short given the downward trend. Is this like shooting fish in a barrel?

Gary Saretsky[126]: Well, you could say that there's still one goldfish that's willing to try to file a motion at least. The title of my presentation is "FINRA Motion Practice: Don't Cross the River if You Can't Swim the Tide." My name is Gary Saretsky and by and large the work that I and my firm does is on behalf of brokers, brokerage firms, financial planners, and investment advisors, respondents to arbitration proceedings. And not routinely, but with some frequency, we would file motions to dismiss if and when we thought it was appropriate to do so. Apparently, FINRA thought that a respondent's exercise of its, his, or her legal rights to seek an early dismissal of a claim was abusive. So FINRA's response, in my perspective, is an extreme and unnecessary response. And essentially what FINRA has done, as Felicia has indicated, is effectively censor respondent's rights to seek the early dismissal of a claim, as Felicia has indicated

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somewhere north of eighty percent, of all motions to dismiss have apparently been squelched by the recent revision in the rules. And while Felicia's presentation I thought was excellent, I've been asked to give greater focus to the new motion to dismiss rules. And as you can tell from the title "Don't Cross the River if You Can't Swim the Tide," the point of the current rules of FINRA, the revised rules, is to discourage and limit the filing of motions to dismiss. And the way FINRA has done that is to effectively turn the American legal system on its head and force those who choose to play to have to pay. If you file a motion to dismiss and it's not granted, now there are sanctions that will be imposed upon you for the lawful exercise of your rights. I obviously disagree with that and we're going to talk more about that.

The general motion rule is that motions need to be in writing and filed within a certain time before it's to be heard. One of the new things about the motion rule is that you now have to, as with court motions, seek the concurrence of your opposing counsel before filing your motion. I think that that's a great idea. There are occasions, rare occasions, where opposing counsel will agree and it's a good thing if people can agree and work things out and avoid the filing of a motion altogether. There are several types of motions. I've been asked to kind of focus on motions to dismiss, but there are a wide variety of motions that are impacted by the rule changes. Felicia alluded to many of those. But the primary motions that are filed in arbitration are discovery motions, motions for sanctions, and motions to dismiss. Discovery motions tend to take up a lot of time, unnecessarily. The FINRA Discovery Guide 9990[127] has effectively limited that, but there's still routinely issues and disputes regarding discovery in arbitration, which is regrettable, and our office has a practice when there are discovery disputes of putting together charts for arbitrators to assist arbitrators in trying to understand what the document request is, what is being produced, what's still outstanding, and the basis for the production request. And we have found

127. FINRA - Discovery Guide for Arbitration Proceedings, http://www.finra.org/ArbitrationMediation/Rules/RuleGuidance/DiscoveryGuide/ (last visited May 28, 2010).

that arbitrators love charts and that they find that they're very sexy so we use them all the time.

Joseph Spiegel: Just goes to show you how boring arbitration can be. (Laughter)

Gary Saretsky: The motion for sanctions rules—this is a little bit difficult to read because of the size of the print—one of the things that the rules may just have accomplished is to permit arbitrators greater latitude in sanctioning people who don't play nicely. And there are several examples here of sanctions that are imposed—and it's hard to read—but the sanctions have ranged from a five thousand dollar sanction to a high of, I think, fifty thousand dollars. There's one sanction that's particularly interesting, and that is in the *Dressel v. Edward Jones*[128] case, where a respondent was sanctioned forty-five thousand dollars for failing to cooperate in the discovery process, notwithstanding the fact that the respondent in that case, Edward Jones, actually won the case on the merits. So, it doesn't matter who ultimately wins, arbitrators are rightfully trying to regulate the cooperation in arbitration and the discovery process and that seems to be a fair rule, that sanctions can be imposed against either side. There are four circumstances under which motions to dismiss can be filed.[129] Felicia alluded to them: the existence of a prior settlement or release; the situation where one of the named respondents is not associated with an account or an entity or has been somehow named by mistake; where there is an ineligible or a perceived ineligible claim; and when there's been gross misbehavior by counsel or one of the parties justifying the sanction of dismissal. I don't want to spend too much time on the settlement/release aspect of dismissal motions. Suffice it to say, that if you claim that you are entitled to dismissal because a matter's been settled, you better have that in writing. If you don't have it in writing, the rule just doesn't permit you to obtain dismissal. The next ground for motion to dismiss, if a moving party wasn't associated with an account or a security or the concept at issue, is really for situations where someone has been—a

128. Dressel v. Edward Jones & Co., L.P., 2005 WL 1384721, NASD Dispute Resolution Arb. No. 04-03332 (2005).

129. *See supra* note 108.

claim has been asserted against the wrong person. And just, as a brief aside, Tony have to talk to you about one situation where we might have a misidentification, one of our cases. But these situations, truthfully, are rare, because invariably claimants' lawyers do their homework and by and large get it right. On the eligibility basis for dismissal, for a motion to dismiss, in some sense, this is a rule that hasn't changed too much. You need to be prepared to litigate for some period of time just what it means when the rule says, "No claim shall be eligible for submission where six years have elapsed from the," operative words, "occurrence or event giving rise to the claim."[130] That whole—it seems to be a matter that is frequently in factual dispute, and for arbitrators to resolve. And then finally, the fourth ground, is where there has been just an obnoxious failure to comply with an order of the panel where there's been repeated warnings to a party that if they don't comply that one of the possible remedies is dismissal. And, I think that, while that happens, it doesn't happen all that frequently. Generally prehearing motions to dismiss are, under the new rules, to be decided by the full panel and, interestingly, and importantly, it's only granted by a unanimous explained decision. In the past, majority rule would suffice, now it has to be unanimous, and, in the past, no explanation was necessary, and now it is. Interestingly, for practitioners, you need to file separately a motion to dismiss. We would regularly, for example, include a motion to dismiss in our answer and ask that the arbitrators look at that—you know—sometime at or shortly after the prehearing conference. But now you need a separate motion that is filed and it can only be filed after the answer. And, as the bottom of the slide indicates, you need to be prepared to pay to play. Forum fees can be assessed in the event the motion to dismiss is denied; if that motion to dismiss is frivolous; that costs and attorneys' fees can be awarded as well; and if it's filed in bad faith, the sanctions can be even more severe. The question really becomes, as we'll see shortly, how big a problem really was this for FINRA and the arbitration

130. *See supra* note 111.

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world? Obviously FINRA felt it was a big problem. I don't think that the statistics, the evidence, supports that, but we'll get to that momentarily. For motions to dismiss after a claimant's case in chief, after a claimant has put on all the testimony and documentary evidence that he, she, or it wants to, you can file a motion to dismiss on any basis, on any grounds whatsoever. You aren't limited to the four grounds for motions to dismiss pre-hearing. As Felicia indicated, there was an increase over time, in the filing of motions to dismiss, according to a well-regarded resource, the Securities Arbitration Commentator. It observed that motions to dismiss were filed with increasing frequency, rising from in seven percent of all cases in 2002 to twenty-eight percent in 2006. And there were concerns, to be sure, about abuse. There were concerns about motions being filed on multiple occasions and that motions were used to burden or harass claimants, to brokerage customers. And this shows, visually, that increase, according to the Securities Arbitration Commentator study. However, according to FINRA's own statistics, these being statistics from January 2007 through July 2008, for that eighteen month period, motions to dismiss were only filed in twelve percent of all cases, not twenty-eight percent. And the concern regarding multiple motions being filed and how abusive that was, is, in my view, refuted by the fact that during this time frame, multiple motions were only filed in two percent of the cases. That hardly seems, to me, to justify a significant rule change. And so—

Joseph Spiegel: Let me just make one comment here, that that statistic you gave is skewed because the motion practice started going out of favor. However, it's when the Securities Industry Association had their seminar, their program, everybody comes back and they do something, it's kind of like the strategy of the week. So the strategy of the week for a couple years was motions, and then some of the arbitrators started denying them. And I think that's, that statistic of the twelve may be correct, but I don't think it takes into—Mr. Trogan, what's your experience been?

A. Trogan: Well, as long as I've got the floor. First of all, (laughter) the motions were abusive, because it would—to those of you who don't know this, you should know this—that the respondents would file answer to statement of claim on behalf of so-and-so and so-and-so, comma, and motion to dismiss. And the motion to dismiss consisted of the last line in the answer, which was item number six or number twelve in their request for relief, and it would say, "Please dismiss the case," and, as a practitioner representing complainants, I'm supposed to respond to that somehow. When they have regurgitated the content of their file in unsworn, unverified testimony, self-serving documents, perversion of the facts (laughter) -- and I have to worry about the fact that this is going to go before a panel of arbitrators who might not have real good detectors and might actually believe this stuff. So my whole case, my client's whole case, is at risk in a situation that I can't possibly properly defend except to say, "This is unfair and abusive," and I think the fact that they changed the rule is proof that that, in fact, was going on. Now, there are certainly certain situations and there were certainly situations where motion to dismiss in advance of the hearing was proper. That's not what I'm talking about. And what the rule says is very, very clear; the very first thing in this rule, and I don't know if you have it up there, Gary, says motions to dismiss before the hearing are discouraged.[131] Basically, don't bring them, and if you are going to bring them, there are two situations, really—the third situation dealing with ineligibility's handled somewhere else—but the two are: number one, you have to have a settlement agreement, and it's got to be in writing, they specify, don't come in here and say, "Well, we had a settlement agreement." You gotta have it in writing, and I don't have it in front of me, but does it say "signed?" I can't remember.

Gary Saretsky: Yes.

A. Trogan: Okay. So, don't bother with that one. And number two, is where the named respondent doesn't have anything to do with the transaction. Well, how—I mean, those are extremely limited. The third thing you need to know, if you don't know this, is that almost none of these motions, none of them, were ever granted. So, you know, they were abusive. (Laughter) And the rule says, not on-

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131. *See supra* note 108.

ly can you not do these things, and you can only do it in very limited circumstances, but you can't file it with the answer. You as a respondent, if you're going to do this, you've got to file a separate piece of paper, and file it separately, at a separate point in time. They just, they went right to the guts of the problem and they hit every single issue.

Gary Saretsky: Kind of reminds me of the *Saturday Night Live* spoof of *60 Minutes*, and this is where I'm supposed to say, "Jane, you ignorant [removed]."[132] (Laughter) But, I'm not going to say that, because the biggest proponent of arbitration among the practitioners here, even with the former rules, probably would have been Mr. Trogan, who loves arbitration. It's a great process, by and large, don't you think?

A. Trogan: Yes.

Gary Saretsky: Okay, so, yes things need to be fine-tuned. But what's really happened here? You can't file a motion to dismiss now, effectively. So, what does that mean if you're a respondent? A claim that's filed that includes investments that are twelve, fifteen years old, and perhaps some who are within the six-year eligibility period, have to go to hearing. The claims can't be narrowed by a motion to dismiss. The arbitrators can't give an early look and say, "We are going to make life easier for everyone. We're not going to argue about what happened in between years six and years fourteen or seventeen. We're going to focus upon the claims that really and properly should be before arbitrators." The difficulty that I have, with the revised rule, is that motions to dismiss, if really abusive, would have been sanctioned by good and right thinking arbitrators, and I think arbitrators are generally good and right thinking. So, had there been a serious abuse, arbitrators would have entered orders sanctioning respondents who had filed motions in bad faith. Here what happens is two things. First of all, without a motion to dismiss, the hearing, the arbitration hearing, will inevitably be longer, we will be fighting about more stuff, and the hearing is going to be longer. So the idea

132. *E.g.*, *Saturday Night Live: Weekend Update with Jane Curtin & Bill Murray* (NBC television broadcast Dec. 16, 1977).

that there is some time or cost savings associated with depriving a respondent of the opportunity to file a motion to dismiss I think is a loser and I think time will hopefully prove that correct. The second thing is, and I think that this is just a shame, that abuses were really the exception, the minor, minor exception. And good citizens who are vigorously defending fraud claims against them, because virtually all these claims are claims asserting that a broker or a brokerage firm, people who are hopefully and presumably trying to act in responsible ways in the commercial world are presumed to have been bad faith actors and not equally entitled to a motion practice hearing. So, the end result is going to be that you are going to have brokerage firms and respondents who take more cases to hearing now and settle fewer cases, I believe, because a claimant knows that he or she can file a claim in arbitration, it can't be dismissed, if the cost of defending an arbitration for a respondent is significant, and therefore they have obtained leverage, unfairly, in the settlement process. So, I am in favor, and have been in favor, of some restrictions, I think that the rule adopted by FINRA goes too far and makes it so that the respondents will not want to swim the tide and will go to hearing more frequently, therefore, taking longer for claimants to have their claims resolved and costing more.

Audience: If what you are saying is true, then we will have more motions to dismiss, at the close of plaintiff's (inaudible), we can almost count on it?

Gary Saretsky: There will be more effects.

Audience: Since the rule has been effected.

Joseph Spiegel: Gary, what impact do you think of the concept that an arbitration is a testimonial and not a paper forum, and that it is the only forum that someone can go to express their dissatisfaction with the industry, in other words, you don't have relatively private, you don't have transparency, what impact do you think that has on FINRA, the industry, et cetera.

Gary Saretsky: The goal of this rule change, with respect to motions to dismiss, is to permit, not to permit, is to essentially mandate that customers, investors have the right to have their matter heard on the merits. That everything they want to say or submit to arbitrators will now be heard, and that sounds like a great idea. To me though, the proposition should be that respondents should, in appropriate circumstances, be able to file a motion to dismiss and if the hearing isn't merited, because if the hearing is for example time barred, why go, why spend the time, trouble, and money to prepare for the hearing, when six months of discovery and thousands of dollars in costs for everyone will be unnecessarily used.

Joseph Spiegel: Gary, I am curious about two aspects of this. In my mind it seems as though this were largely the product of the environment we're in, with post Enron, Ponzi schemes and everything else. For two reasons, one is that the claimants bar did a campaign and a comment process to this, a tremendous campaign and the comments to the SEC particularly, with respect to, this rule came out three times, and before there were all these limitations, they were much more as you would say reasonable, and there was a tremendous campaign among the claimants bar, in fact Larry Schultz who is a practitioner in the Detroit area was part of the campaign, to not have motions to dismiss. Tremendous. And it seemed to me that the campaign was largely successful. And second of all, I thought what was remarkable, echoing your words, was that FINRA in responding to industry comments about "how can you narrow this so small," said effectively what Joe said, is that FINRA believes that claimant has a right to a hearing and only under extraordinary circumstances will be denied. To me, I don't know what your thought is, I think that was a product of our environment more than it is another time, a result that would have occurred in another time.

Gary Saretsky: I agree with that. I think people should keep in mind that FINRA is the successor organization to the NASD, the National Association of Securities Dealers, FINRA is a self-regulatory body, meaning the industry is attempting to police itself. In my view, many of the attendees here are lawyers or law students, the securities industry polices itself far better than the legal industry does or far better than the medical profession does. But, the fact is that people at FINRA's predecessor, the NASD, were being severely criticized for being easy on the industry, and I think these rule changes reflect a desire to ramp up that regulation.

Audience: Gary, I like to fish, and you think this way, what about a motion to bifurcate the hearing and take the time barred issues and try to deal with those without having to go into everything else, et cetera, et cetera, do you think that will be work? I've jotted down "request for panel clarification on issues to be tried, humbly seeking guidance." (Laughter) But how about a bifurcation motion, it's not necessarily a dismissal, but it basically says fine, the claimants can have their oral hearing, but we don't want to spend fourteen days if we can try one issue and blow this whole thing up.

Gary Saretsky: That would seem to me to be something that would be attractive to a claimant's counsel. If there is a serious legal issue, I would think that neither the claimant's counsel, nor the claimant, would want to devote their time and energy. So, obviously I would be in favor of that; I would be interested to hear what some of the claimant's counsel would have say about that.

Audience: Disguised motion to dismiss is what I have here.

Audience: Gary, I have a hypothetical and a practice question for you and it relates to Ray's recitation earlier.

Gary Saretsky: Does this pertain to one of our cases together?

Audience: It does not.

Gary Saretsky: Okay, good.

Audience: Hypothetical, claimant gives money to customer of a brokerage firm, the customer has an account, claimant believes that the money she gave to customer went into the customer's account with the brokerage firm, claimant files a FINRA action against the customer, against the firm, and against another brokerage firm, thinking that that customer had accounts with multiple firms. My question is, representing the brokerage firm down the chain, who may or may not have had some relationship with this customer, do you file a motion to dismiss with no nexus to the transactions, or do you file something in court to say FINRA has no jurisdiction over me, brokerage firm down the chain?

Gary Saretsky: I would say that it's a good, the answer to your first question is yes, that's what I would say, that there is no connection to the account, to the security, et cetera, that would be my take on it, and walking into court would be a dangerous invitation. Others might see that differently. I don't know, what do you think? You've obviously thought a lot about this.

Audience: It's actually a case I'm trying to figure out how to handle, not involving a firm.

Joseph Spiegel: There's two different issues, Ryan. One is can you compel arbitration, can you be in arbitration, and the issue is, is the person a customer with respect to the broker-dealer you want to compel. And the Rule 12200 says that a "customer," which is not defined, can compel arbitration of a brokerage firm for the business of the brokerage firm.[133] So if you have a. . .

Audience: Even if that customer is not a customer of my client or my firm. . .

Joseph Spiegel: Tony has been very successful arguing that the rule change, there was a definition for customer, am I getting this right Tony? There was a definition for customer, and now there is not a definition for customer and. . .

A. Trogan: Well, there is a definition for broker-dealer or member, and the definition for customer is that it's anybody who is not a member.

Joseph Spiegel: So, that is like the public.

A. Trogan: That's the public. If you are a public kind of person, then you're a customer.

Joseph Spiegel: So, you could probably easily satisfy that or there is a very strong argument satisfying that, if you take it or work the arbitrator or the court through the rules. The issue that you'll need to succeed on is, is it the business of the brokerage firm. And that issue you know is it supervision, is it that, what kind of claim it is. So, that is the arbitration question. With respect to the motion to dismiss question, that is a separate issue, is whether they have just misnamed, that depends on how they have alleged it.

Audience: Good enough, thanks.

Joseph Spiegel: Thank you, Gary.

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133. *See supra* note 122.

Gary Saretsky: Thank you for the opportunity to whine about something (inaudible). (Laughter) It's really cathartic.

Joseph Spiegel: We are going to switch a little bit. Mark, you're up next.

M. Kowalsky[134]: Thank you, welcome everyone. As we have seen throughout the day, especially in the last half an hour or so, there are a lot of issues as to whether or not the arbitration process is working effectively and, working efficiently and whether there should be rule changes, what rule changes should there be, and are the rule changes improvements or are they really a step back. There are three topics I want to go over today, leaving enough time for the remaining speakers. And there is a common theme for these three topics because each of these topics reflect an effort by FINRA to fine-tune the discovery process of FINRA arbitration, to make it more efficient, to make it more effective. The first item I want to cover relates to a special discovery arbitrator pilot program that has been announced, the second topic is how to handle electronic discovery in arbitration, and the third topic is a proposed expansion of the list of mandatory discovery items. And for each of these items, you should have as part of your packet today background material and the underlying documents that reflect these changes. We know that in the arbitration process at FINRA there are specific discovery rules and specific discovery guidelines. For some time there was a belief that the discovery process in FINRA arbitration was somehow broken, that it wasn't working right, that it was taking too long, that it was too cumbersome, that there was the ability of counsel on one side or the other

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to work the rules to prevent discovery from taking place and, if discovery did take place, that it would take too long and you would be ultimately denied the documents or the information that you would want. In part to deal with these concerns, there was a proposal in 2005 that was enacted by then the NASD, to launch a voluntary discovery arbitrator pilot program to specifically address concerns about the effectiveness of arbitration and whether or not the system needed to be fixed.

In your packet I have included a specific announcement and the rules and the explanation behind this discovery arbitrator project, but let me quickly go over exactly what this involves and if you are a practitioner how you can use this to your advantage to make a case proceed as efficiently and cost effectively as possible. This program was originally adopted and has since been extended for a period of time and is now set to expire at the end of this year. First, this new process is not mandatory. This process is only allowed if both sides agree to participate in this new pilot program. To participate both parties have to sign a stipulation and you will see as part of your packet, I believe on page eleven, a copy of what the stipulation looks like. Now, if both parties agree, FINRA will appoint a single discovery arbitrator, who will resolve all the discovery disputes prior to the time of the hearing. Now, this single discovery arbitrator will not be part of your arbitration panel but is a separate person who is only charged to hear the discovery disputes, and to try to resolve those discovery disputes.

Now, who are these discovery arbitrators? Where do they come from? How does FINRA pick them? The discovery arbitrators come from a list of pre-selected public arbitrators who have been specially trained by FINRA to handle discovery disputes. What happens if you agree to this process, you have a discovery arbitrator selected and you don't like that discovery arbitrator? Under the rules, there are very stringent restrictions on how you can challenge a discovery arbitrator, and you only have a challenge for cause if, in fact, this discovery arbitrator concerns you. If a discovery arbitrator is appointed and there is a discovery dispute you present your dispute to this discovery arbitrator and the discovery arbitrator then has the authority to issue both monetary and evidentiary sanctions against any party for failing to comply with the discovery rule. Now in the old process you would file a motion with FINRA, a hearing would be scheduled in front of the chair of the panel who would consider the matter and make a ruling. Instead of going down that path you now go down a separate path to this discovery arbitrator who should be more readily available to hear this dispute on a quicker basis. The arbitrator . . . Gary had talked about and Felicia I believe had talked about certain extreme discovery sanctions, the idea of dismissing a case, imposing large sanctions, preventing certain evidence from being admitted. The discovery arbitrator has certain limited authority and the sanction of Rule 12212[135] and 13212[136] of the FINRA Code are not available and, therefore, a discovery arbitrator may not dismiss a claim, a defense, or dismiss the proceeding in its entirety. The most interesting part of this process is that once the hearing commences, the discovery arbitrator's authority ceases. You can no longer go back to that discovery arbitrator and ask for clarification as to what was decided, whether or not you get certain documents, whether or not the documents you got were sufficient. You have to go back to the original panel of, most of the time three individuals. Until the hearing commences the panel that is selected may not rule or hear an appeal of the discovery arbitrator. Let me restate that a different way. You agree to a discovery arbitrator. You present it to the discovery arbitrator. You don't like the discovery arbitrator's decision. You do not have the ability before the hearing starts to go to the full panel and ask for a reconsideration. Now if the hearing starts and you are in the midst of the hearing and there is a question as to a prior discovery ruling, the rules provide that the panel may only review the discovery arbitrator's prior rulings on the basis of new facts or circumstances that arose after the hearing started. So, even once you're in the hearing you cannot have, under the guidelines, the discovery arbitrator's decision reconsidered unless you can point to some new rules or new facts and circumstances.

135. Fin. Indus. Reg. Auth. Manual R. 12212, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4118.

136. Fin. Indus. Reg. Auth. Manual R. 13212, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4215.

Let's think about that for a moment. You go through the discovery arbitration process with the discovery arbitrator. The discovery arbitrator makes a ruling. You're now in the full hearing. There is a question as to whether or not you have a full tax return or have full information about a customer's prior investments. Under these guidelines, it would seem that the panel could not go back and revisit that decision. But, for those in the room who have sat as arbitrators and who have been charged with the responsibility of deciding a case in a proper and fair way, it may put the full panel in somewhat of a box because their hands will be tied. That even if the full panel thinks that the discovery arbitrator made a mistake and should have ordered the customer to disclose more about their prior investments, the panel may not be allowed to do that under the rules. They may be forced to decide a case without having all of the information that they believe is appropriate. There has, from what I understand, been very, very limited use of the discovery arbitrator position, and I do not know if anyone in this room has had experience using one. I just got information from FINRA on new case filing, and sure enough, as soon as a case is filed and the material is received, this program is disclosed. You receive a proposed stipulation. You receive the names of the individuals who have been trained who may be available as a discovery arbitrator. But again, there seems to be, at this point, very little use for this process and we will see at the end of the year whether or not FINRA continues the pilot and tinkers with it or abandons it or it comes back in a different way.

The second item that I would like to quickly cover is electronic discovery in a FINRA arbitration. Electronic discovery is a very hot topic in civil litigation. In civil litigation, there are Federal Rules dealing with electronic discovery.[137] There are state rules dealing with electronic discovery. There are countless seminars being offered regarding how to handle electronic discovery, and there are private businesses that have now been established to deal specifically with this subject. You file a case in federal court, you almost immediately get an email from a

137. *See* Fed. R. Civ. P. 26(a)(1), 33(d), and 34(d)-(e).

private company saying that they are here to help you with electronic discovery. So how does this now apply to FINRA arbitrations? There is nothing specifically written in the FINRA rules about electronic discovery, but earlier this year there was a call-in workshop held by FINRA where the president of FINRA was one of the panel members, and this was a call-in workshop to help train arbitrators. And, one of the subjects of this call-in workshop was how to deal with electronic discovery in arbitration. And I have included as part of my packet the material from that call in workshop and I believe that is on page twenty one. That goes into more depth. But let's talk about basically what was covered in this March 13, 2009 workshop.

First, FINRA provided a very cursory review for arbitrators as to what electronic discovery is; primarily focusing on the fact that certain documents may have hidden data in it. How do you produce those documents to show the hidden data? What are your obligations to produce such hidden data? After giving this brief primer on electronic documents and documents in electronic form, the following points were made by this FINRA panel to the arbitrators who were being trained. First, the discovery guide and rules do not distinguish between paper and electronic discovery, and the message was to arbitrators that just because something is in electronic form do not treat the discovery obligations any differently. The second point made by FINRA was the oversight of the discovery is completely within an arbitrator's discretion, and, therefore, if there are electronic documents involved use your discretion as to how to address the production of that material.

After this brief overview and comments, the FINRA panel made the following five suggestions to arbitrators as to how to handle electronic discovery. You will see these are somewhat generic instructions that do not necessarily get to the meat of electronic discovery. The first item is to address these issues early, apply common sense, consider the views of all parties, consider narrowing a request if you think it is abusive, and the most specific guideline given to arbitrators is that when dealing with electronic discovery consider altering your rules and having a prehearing conference scheduled in a short period of time. Thirty to forty five days to take everyone's pulse to see whether or not these documents are being produced and then you can revisit your earlier decision. So take baby steps to make sure that there is not an abusive situation. As we know, it can get very, very expensive, tens to hundreds of thousands of dollars for a firm to go produce electronic discovery and the message is take it by baby steps and try to work it in the most efficient way. In a way that allows both parties to get the documents they need without imposing too much of a burden.

The next item that I will just touch on briefly because it deals with a proposal that was adopted but then withdrawn and from what I understand it is being re-written and we will probably see it again. It deals with a proposed revision of the discovery production lists that are now in place, and primarily to increase the obligation that customers would have to produce information if they choose to file an arbitration against a securities firm. A very brief overview of the process for those who may not have gone through it is that, and I think Gary might have mentioned this, in order to make the discovery process work most efficiently, FINRA has adopted lists of items in certain types of cases that generally should be produced in discovery. And the FINRA rules require that without any panel intervention, without even a request, each party is obligated to look at these lists and to produce the items on the list voluntarily, again, without the panel having any type of input. We currently have these various lists and, if you look at a list, they talk about the type of case that is involved. If it is a suitability case, you produce certain things. If it is a trading case, you produce other things. Unauthorized trading, you produce different things. And there had been some issues raised as to whether or not the burden of producing documents was fair to both a customer and to the industry. And what happened is that there was a proposal in March of 2009, just several months ago, that would substantially increase the burden that a customer would have in the type of documents that would have to be produced. And I will quickly highlight what those items are. One of the items is that a customer would now be required to produce full tax returns. Previously, it was only certain portions of the tax return. A rule was proposed that a customer may have to produce a complete tax return for a five year time period and not just a three year time period. The same was true for a customer's financial statements. Instead of a limited financial statement, it was full financial statements to the extent that they existed for a five year period. The other item that was adopted in the proposal was that to the extent that the customer had made a prior complaint regarding an investment, the customer was automatically obligated to produce copies of those prior complaints. Very significantly, if the customer did not have a copy of the prior complaint in his or her possession, they had to identify to the best extent possible who that complaint was made against, where it was made, and the proposal specifically allowed the panel then to enter an order to allow the firm to go to the source and get copies of that complaint. The obligation also extended to the extent that the customer had to subpoena documents from a third party. Without asking, those documents had to be provided to the other side. Any documents obtained from other sources regarding investments would have to be produced. For example, customer had an account at the ABC brokerage firm and was now suing the XYZ brokerage firm, customer had to provide whatever documents that they had relating to the prior relationship or the ongoing relationship at the ABC brokerage firm. This proposal was made just in March. Then in May, several months after it was made, it was withdrawn and is being redrafted. The proposal also did include additional burdens for the securities firms, and the full proposal is part of my packet along with the announcement that it was being withdrawn.

I wanted to save some time if anyone had any questions or any practical experience with electronic discovery or other discovery topics that they wanted to discuss. But again, those are three efforts to fine tune the discovery process to try to make it work more effectively, more efficiently, and with less intervention from the full panel so that the parties can proceed to an arbitration hearing on the merits. And that is my presentation. Questions?

Joseph Spiegel: Yeah, I have one. Do you see a routine objection to the 9990[138] by the brokerage firms? Have you seen that? Do you see it? And what basis could they have to object?

M. Kowalsky: As the discovery lists have been promulgated for some time there are fewer and fewer objections. I think firms have come to understand that this is part of the process. The production is not always automatic, but it is usually done without the panel's intervention.

Joseph Spiegel: Sort of like Federal Rule 26,[139] where you've got to produce before being asked almost.

M. Kowalsky: Correct.

Joseph Spiegel: Questions? Vacature. Musical Chairs.

Gavin Fleming[140]: Good Afternoon, my name is Gavin Fleming and I'm sorry to say that I'm not John Hubbard for many different reasons. Although some of you might be thinking that's a good thing. But, John could not be here today because he's actually engaged in a FINRA arbitration, so I'm here in his stead. I have the hapless task of almost speaking last today, and so I'm going to make my remarks very brief and to the point but I will tell you in a disclaimer that I'm a trial lawyer and whenever I say either in a deposition or in court I end up going much longer than I anticipate. But, I will keep my remarks very brief. I'm here to talk about, or really present John Hubbard's remarks to you on the issue of vacature and remand of arbitration awards. Now for the benefit of the law students here, in arbitration you don't have a FINRA appellate panel that reviews the panel's award. It's a dif-

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138. *See supra* note 127.

139. Fed. R. Civ. P. 26(a)(1)(A)-(B).

140. Mr. Gavin J. Fleming is a commercial litigator and senior associate at Beals Hubbard PLC. His experience includes litigating breach of contract, business tort, employment law, landlord-tenant, misappropriation of trade secrets, securities, and zoning matters before state and federal courts throughout Michigan and Illinois. Mr. Fleming also devotes a portion of his practice to appellate work at the state and federal level. Mr. Fleming also counsels clients on select gaming and gambling law issues that arise from promotional marketing activities. His experience includes drafting official rules/terms and conditions for sweepstakes and skill contests at both the state and national level and crafting privacy policies and terms of use for Internet sites supporting trade promotions. Mr. Fleming graduated from the University of Michigan Law School *cum laude* in 2003, receiving the International Academy of Trial Lawyers Award for Excellence in Oral Advocacy; he graduated from the University of Michigan in 2000 with high distinction and as a member of Phi Beta Kappa.

ferent process. The process is that you actually have to file an action to vacate or modify the award, and you choose where to file that action, either in state or in federal court. Now, you're then faced with some very narrow grounds on which the court can either vacate or modify the award, and I'm just going to outline what these are. Many of them are set forth in the materials that you have. The basic rules in FINRA under the Customer Code and under the Industry Code, and that's Rule 12904[141] and 13904[142], is that an award that is rendered is to paid within thirty days unless a motion, or excuse me, action to vacate is filed. And it's vacate or modify is filed. And so it's incumbent on the party that believes that there has been some error in the procedure to file that action and proceed in that manner. But, what are the standards of review and how do they apply? Well, Joe approached me at the opening of the presentation this morning and said "really, in my opinion, I don't think there is any way these awards could be overturned." And I said, "Yeah, I actually agree with you." And I open that up to the floor here if anyone has a different opinion. But, basically, as an appellate lawyer working up appeals on arbitration claims I think you're going to have a very frustrating time if you're looking to win. I think it's in a lot of ways an exercise in futility. Now I guess that may change. Felicia talked about the rule change that will now, possibly, result in some written awards being rendered, but only as to facts, not as to law. Right?

Felicia Fox: It's not required.

Gavin Fleming: Not required. So, there's probably not going to be any legal issues presented there *per se*, unless the arbitrators so choose and I think any of you who are arbitrators would probably say that you'd opt not to put your legal reasoning on paper if you don't have to. So it's unlikely that an intermediate court is going to vacate or modify the award. For purposes of providing examples here and some context, we listed the Michigan Court Rule and we

141. Fin. Industry Reg. Authority Manual R. 12904, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4192.

142. Fin. Industry Reg. Authority Manual R. 13904, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4292.

also refer to the Federal Arbitration Act[143]. I'm just going to discuss those briefly, but the Michigan Court Rule provides a framework, if you will, for what the grounds could be to vacate or modify an award. And the grounds are very, very narrow. You've got to have some type, and I'm paraphrasing, but some type of corruption or fraud either in procuring the award, and I would imagine that would be a bribe or something, or you've got to have some kind of showing of partiality of an arbitrator, which again is extremely unlikely. That the arbitrator exceeded his or her powers, which is always a difficult one as well because, frankly, in my opinion I don't think there is a very good definition of exceeding your power. I suppose there could be a circumstance where that occurs, but again it's rare. And then the other ground is that the arbitrator arbitrarily refused to change a date of the hearing or consider evidence. Again, very, very rare under the circumstances. And under Michigan law, and we've set forth several cases, the arbitrator's award is going to be given great deference. The factual findings are going to be given great deference. Really, there has to be some complete disregard, its dead wrong as a matter of law in order for the courts to vacate or modify the award, or there's been some simple error in the math. With respect to the Federal Arbitration Act, the FAA, the U.S. Supreme Court recently came down with the *Hall Street Associates v. Mattel, Inc*[144] case, and that case written by a rather strange majority and by now retired Justice Souter, and for the law students who may or may not be interested, the composition of the majority is very strange. But it was Justice Souter joined by Justice Roberts, Justice Thomas, Justice Ginsberg, and Justice Alito, and Justice Scalia also joining but with the exception of one footnote. He has to dissent even when he's with the majority. That was a really bad joke for any appellate practitioners out there. The dissenting opinion you have Justice Stevens authoring the opinion[145], Justice Kennedy and Justice Breyer joining in that opinion. Basically, the opinion stands for the proposition that the FAA's grounds enumerated in the statute in both

143. Federal Arbitration Act, 9 U.S.C. §§ 1-15 (2000).
144. Hall St. Assocs., v. Mattel, Inc., 552 U.S. 576 (2008).
145. *Id.* at 1408 (Stevens, J., dissenting).

section 10 and section 11 are the exclusive grounds for vacating an arbitration award. While we've seen, because Judges in the Supreme Court, I believe, always are very wary of trying to make a broad brush, especially with this Court, with respect to statutes and at least leave some discretion to lower courts out there, some of the Circuits have leapt upon some of Justice Souter's remarks to make an exception to the rule. The exception to the rule is what's called the doctrine of manifest disregard of the law, and in certain Circuits that I've listed here, there has been some case law out there saying that the manifest disregard doctrine is alive and well. Actually, there are cases in the Sixth Circuit. There is one case which is somewhat unique, but the case is *Coffee Beanery v. WW, LLC*.[146], and it's actually an unreported Sixth Circuit Court of Appeals case. But this is after *Hall*, and this is a AAA arbitration, and in the AAA arbitration the arbitrators did not follow a provision of Maryland law properly, and the Sixth Circuit Court of Appeals vacated the award in its entirety. And, you know, rather a unique decision these days, but that still goes to show that there's at least some discretion for judges left. The last topic that I would exhort briefly about is just remand for clarification, especially as it applies to FINRA or what some still call NESD arbitration decisions. It's the very last page here and the case is *Rich v. Salomon Smith Barney*.[147] The Second Circuit, interestingly, remanded the case or arbitration for clarification of the award. They said the award just wasn't clear enough. You have to clarify it, which is kind of an interesting take on the rubber stamp that we usually see. I would encourage you to read the decision, although it's really not clear where the Court is coming from, what you should know is the Second Circuit is a circuit that has carved out this manifest disregard exception to the *Hall*[148] case. So at least, I guess coming back full circle to Joe's original question, are these awards, you know, air tight. I think predominantly yes, but there's hope in the Second Circuit, maybe, if you file an appeal. I just

146. Coffee Beanery, Ltd. v. WW, L.L.C., 300 Fed. Appx. 415 (6th Cir. 2008).
147. Rich v. Spartis, 516 F.3d 75 (2d. Cir. 2008).
148. *Hall*, 552 U.S. at 576.

wanted to say thank you very much for having me. It's rather like waiting in court and being the last person called. I appreciate your attention, and unless anyone has any questions for me, which I'm sure the answer will be no, I will conclude and just say thank you very much for having me I appreciate it.

Joseph Spiegel: Thank you we have a very brief portion by Mr. Trogan on arbitrator selection and initial prehearing conferences.

A. Trogan: Thank you. Due to the lateness of the hour I'm going to severely restrict the extensive remarks that I have. (Laughter) There is not a lot going on . . .

Audience: And they do have food for dinner?

A. Trogan: There is not a lot going on in the arbitration selection process. It's the strike and rank process that we've been using for a while now. It seems to be working. There are no new proposals that I've been able to identify. There is a lot of griping but that is something that we have always experienced in the arbitration process and it is very often focused on the arbitrators because that's the place where you can focus it. You can complain about your losses and brag about your wins based upon your skill or foolishness in selecting the panel or the unfairness of the system. I would just relate to you one little incident that does not necessarily represent a nirvana but I think is important. It was important to me because I rank a lot of panels. I received over my fax a ranking sheet from defense counsel in a case that I had. Of course, you rank your panels secretly and you send your sheet to FINRA. You don't send it to opposing counsel because theoretically at least he could look at your sheet and then tailor his ranking and striking based on what you've done and stack the panel. Well, I had already sent my sheet in. So when I mistakenly received the sheet from the other guy I said this is going to be fun. So I took his sheet, I got my sheet out, I poured myself a cup of coffee and I sat down and you'll never guess what. And this guy on the other side is no slouch. They were almost the same. We struck out of the ten strikes that each of us used they were almost all the same. There are three categories: public chair, public, and industry. The public and the public chair were both number one, were the identical person, and the industry category I had one and two and he had two and one. So what more could you want than two people who are willing to put their client's cases to basically the same people? It wasn't a mistake. It's not like the other guy forgot, which happens sometimes, and you get all your number ones. It was a very deliberate effort on both our parts that just happened to kick the same people. It's maybe not nirvana but it's pretty close to it. And as far as initial prehearing conference I urge you all to be courtesy. With that if you don't have any questions I'm done and I believe that finishes things off.

Elliot Spoon: Let's thank the panel. (Applause) I thank everyone for coming. This concludes our conference and we'll see everyone next year.