PROCEEDINGS OF THE 2010 MIDWEST SECURITIES LAW INSTITUTE SYMPOSIUM*

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WELCOME FROM DEAN JOAN W. HOWARTH, INTRODUCTION, AND SUMMARY OF EVENTS

Elliot Spoon[1]: We are going to be starting in two minutes.

(Background chatter)

Elliot Spoon: Well, good morning everybody. My name is Elliot Spoon. I'm an assistant dean and professor here at MSU College of Law, and on behalf of MSU College of Law, I want to welcome you to this year's edition of the Midwest Securities Law Institute. We are covering a wide variety of topics today within securities law and we have a wide variety of experts both from private practice and from government to share their insights

* **Editor's Note:** The staff of the BUSINESS AND SECURITIES LAW JOURNAL would like to thank the speakers at the institute for an informative and entertaining afternoon. The following is a minimally-edited transcript of the panel speakers from the 2010 Midwest Securities Law Institute (MWSLI) Symposium, an annual one-day gathering of securities lawyers held at Michigan State University College of Law. 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. Elliot A. Spoon concurrently serves as a Professor of Law in Residence and the Assistant Dean for Career Development at the Michigan State University College of Law. He earned a B.A. *with distinction* and J.D. *cum laude* from the University of Michigan. He is Of Counsel to Jaffe, Raitt, Heuer & Weiss, P.C., where he was formerly a partner and chaired of the firm's Business Transactions practice group.

with you. We hold this conference at the law school so that our students can observe practitioners and regulators and interact with you. Now while many of them are still in bed right now, they will be here in due course, I assure you. (Laughter.) For me, one of the great joys of teaching here and interacting with the students, is to see in development our future leaders, and so we have four individuals I would like to call up, folks come on up, and they have been instrumental in putting this conference together, and will be instrumental in putting together the edition of the Journal of Business and Securities Law, that will contain this conference, so: Justin Bratt, Todd Jennings, Ellen Durkee, and Crystal Kakos. Justin and Todd are the co-editors of the Journal of Business and Securities Law, and by the way we have subscriptions on the table outside.

Todd Jennings: And previous copies.

Elliot Spoon: And selling at a discount (laughter) previous copies. We have two prominent authors Hugh and John are both contributors to earlier editions of the Journal. So, we consider it to be a relatively new, but innovative and needed piece of the puzzle and something that our school can contribute. And Ellen and Crystal are also with the Journal of Business and Securities Law, and all of them are also members of the Business Law Society. So I would appreciate it if you would join me in thanking them for a job well done. (Applause.)

Right now it is my distinct pleasure to introduce to you the Dean of our law school Joan Howarth, who has some introductory remarks.

Joan W. Howarth[2]: Thank you Elliot, and my job this morning is really not a job at all; it's an opportunity to welcome you all to the law college today and to let you know that we

2. Dean Howarth began as dean of the Michigan State University 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 named William S. Boyd Professor of Law in 2003 and 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 earned her A.B. from Smith College and J.D. *Order of the Coif* from the University of Southern California.

appreciate the leadership, and the engagement, and the talents and the experience that you bring to the law college today. As Dean Spoon said, this is a law college in which we are dedicated to not only providing the rigorous and theoretical education for our students to be the leaders and pushing the law wherever it's going to be throughout their lives in the law; but we're also very much committed to making sure that our students' experiences include interaction with and learning from the people who are in our profession, through a variety of different types of contexts leading our profession today. And that's really the context for this event today, so I am very, very appreciative of all of your participation, especially the participation of the speakers and the people who have helped with Elliot to organize this important event.

I also want to let you know that the law college is over ambitious about, I think almost everything. But one of the ways that we are ambitious is to be good hosts for our guests, so we know that the best way for this program today to really have the reach, the potential, that it has, with all the talent we've got in here, is to make sure that all of the creature comforts that you need are very well taken care of. So, if there is anything that you need to be able to have the program go better or the experience go better, please let any of us know. And when I say that, I am saying if you see me in the hallway and you need something, feel free to ask me. Our students have exactly the same spirit, and of course Elliot Spoon does as well. So we want this to be a wonderful day for you.

I think I would be remiss if I didn't take just a moment to let you know that during the day the campus, I think, might become a little bit transformed. This is our homecoming weekend, and as you might know things like football are kind of serious at Michigan State. (Laughter.) So homecoming weekend at Michigan State is a lively affair. And it also occurred to me, I think now I'm in my third year of starting here, so I think this is the third year that I've had the opportunity to welcome you. And it's always, always a pleasure, especially to be able to welcome you in the context of football season. Especially because, as many of you who've been here before perhaps remember, Elliot Spoon is really, he's dedicated to Michigan State University College of Law, but he bleeds blue. (Laughter.) So, that's not surprising really, we have our student body and MSU is our largest undergraduate feeder school but U of M is our second largest and has been for a long time, so we have lots of people with loyalties to the two great Big Ten Michigan universities.

But it also occurred to me as I was driving and getting ready to welcome you all for the third year, that I have been here three years now and every year I have the opportunity to say, "I am sure that it doesn't really feel good when MSU loses to Michigan," but I don't really know what that feels like. (Laughter.) And that kind of carries through to a lot of things, basketball (inaudible). (Laughter.) So . . . the last thing I wanted to say to you is that the Michigan bar results came out yesterday or mailed, so we are about to be getting those in, so I can also report that even more important than football and more important than basketball even, that we were very proud of our MSU students last year. Last year's class, which was at the top of the heap in the bar passage in Michigan, U of M coming in number two; which I think is even better than the football or basketball scores. So, we're looking for great results again this year.

Again, welcome. It's a wonderful program. I am proud of the work that our students do to help produce it and I'm very, very grateful to all of your participation. Thank you very much. (Applause.)

Elliot Spoon: Well I want to thank the Dean, of course you have to remember you can't look at the short term, it's the long term records that matter. (Laughter.) Anyway, it is now my pleasure to introduce my co-chair of this event and really the founder of this institute, Joe Spiegel.

Joseph Spiegel[3]: I read the *New York Times* this morning, and on the front page was an article about Mrs. Bradbury.[4] Mrs. Bradbury bought a house about four years ago for $75,000.[5] She moved out of her trailer.[6] She had a job.[7] She lost her job two years ago.[8] Someone tried, GMAC, to foreclose on that house.[9] When Mrs. Bradbury bought her house, with a $75,000 mortgage on a house that was worth $25,000, GMAC sold that mortgage to an investment company, which bundled that mortgage and sold it to a hedge fund. The hedge fund in turn sold it to a broker-dealer, who then marketed it to accredited investors. The accredited investors thought they were buying something safe and secure. And there was a financial collapse.

What does all this mean? Because, the program today covers suit to nuts Mrs. Bradbury. It talks about the transactional issues that confronted this country. It talks about the investment advisory issues, the hedge funds issues. The program also is going to discuss the regulatory issues from the SEC and state standpoint. It is going to discuss the ramifications of the criminal law. And in my unscientific review of BNA, the sentences range from, on a four million dollar scam of maybe thirty months, we are going to hear that there are sentences of fifty years, seventy-five years, which are, with all due respect, almost equivalent to life sentences for some of these individuals. Now, in the recent movie Wall Street, Gordon Gekko, who is a

3. Joseph Spiegel of Joseph H. Spiegel P.C. has extensive experience in securities, corporate, partnership, and commercial litigation and is the chairman of the Midwest Securities Law Institute. He earned his J.D. from John Marshall Law School and B.A. from Cornell College. JOSEPHSPIEGLEL.COM, http://www.josephspiegel.com/ (last visited February 7, 2011).

4. David Streitfeld, *From a Maine House, a National Foreclosure Freeze*, N.Y. TIMES, Oct. 14, 2010, http://www.nytimes.com/2010/10/15/business/15maine.html?page wanted=1&_r=1.

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

pundit if you will, said twenty years ago "greed is good."[10] Today he said "greed is legal."[11] I'm not sure if that is an accurate reflection of what you are going to hear today.

However, the most interesting part is going to be this afternoon when we have our mock arbitration. Why do I say that? That's where a lot of the rubber meets the road. We're going to have a mock arbitration, and you as participants are going to divide into threes, and after this mock arbitration you're going to be able to issue an award to the people who bought the investments that started out with Mrs. Bradbury. So it's going to go full circle. In other words, from Mrs. Bradbury to an arbitration award you are going to hear today everything in between. So I am going to give it back to Elliot.

SESSION 1: DEVELOPMENTS IN BROKER-DEALER AND INVESTMENT ADVISER REGULATION

Elliot Spoon: Thanks very much Joe. Our first panel dealing with developments and investment advisor and broker-dealer regulation: with us is Hugh Makens from Warner Norcross, & Judd; John Walsh, who is the Chief Counsel of the Office of Compliance Inspections and Examinations of the SEC; and "Bill" Alsover of Alsover Business Consulting. They are going to touch on a number of themes, and one of the themes we are going to hear throughout the day is the impact of Dodd-Frank[12] on all these activities that Joe is referring to. Gentlemen?

Hugh Makens[13]: Elliot, it's a pleasure to be here. I understand that the Dean believes you bleed blue. Actually, I also

10. WALL STREET: MONEY NEVER SLEEPS (20th Century Fox 2010).

11. *Id.*

12. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter *Dodd-Frank Wall Street Reform Act*].

13. Hugh Makens is Of Counsel for Warner, Norcross & Judd L.L.P., and has been involved in the securities industry for over 35 years as an attorney, regulator and adviser. He was a Director at the Michigan Corporation & Securities Bureau for the Michigan Department of Commerce (1972-1978) and was a Trial Attorney with the U.S. Securities & Exchange Commission (1966-1972). For over 25 years he has represented broker-dealers,

understood that last weekend you were totally blue. (Laughter.) It wasn't just the bleeding. You've all heard the expression "you live in interesting times." It's a purported Chinese proverb, though the first time it appeared in public print was in, about, 1937. So who knows how far back it goes. It is lumped, however, with two other proverbs: "may you get what you wished for" and "may you come to the attention of the authorities." (Laughter.) And that's the three, that when you look back at the history of this, those are the three that are matched. In our household there is a fourth one for my grandchildren, "may you be there when your grandfather is practicing his trumpet."

These are interesting times, and for many it's proven to be a curse. We have an unemployment rate in our state of about 15%, on a national basis now over 10%. We've had a loss of about 40% of the value of equities and portfolios. We've had a mortgage foreclosure rate that is overwhelming our financial system, and exacerbated by the impotence at major Wall Street investment banking firms and large lending institutions to deal with the problem. We've seen a collapse of both markets and market participants. The names that we knew aren't there anymore. The failure of corporate management and government on a massive scale has truly been fascinating. Where have the boards of directors been? Where has been the governance? The revelation that the emperor has no clothing has been a shock to a lot of us. Congress, we've seen has been effectively bribed by industries prior to the crash to prevent regulation. And I am talking about the regulation of derivatives, I am talking about the regulation of Fannie Mae and Freddie Mac, I am talking about the removal of capital restrictions on national brokerage firms, and the list goes on, and on, and on.

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investment advisers, issuers, regulatory authorities and industry professionals in conjunction with compliance with securities regulatory requirements, investigations and regulatory proceedings. He is the former chair of the Firm's Broker-Dealer/Investment Advisers Practice Group. WARNER, NORCROSS & JUDD L.L.P, http://www.wnj.com/hugh_makens/ (last visited February 7, 2011).

I have prepared written materials that given the time and John's presence here. I must also preface that the thoughts I express today are my own. It's much more fun to listen to John than it is to me. So, I would urge you to read those materials. We are at a time of chaos, and the interesting thing about chaos and chaos theory is trying to understand what caused the chaos, trying to understand what is the scope of the chaos, and then trying to figure your way out of the chaos. We are beginning to understand the first two pretty well, but we are just at early stage of what do we do about it. How do we answer the question? Congress gave us surprisingly little guidance in Dodd-Frank. But Congress does, or did, what Congress does so well and that is ducked, and in this case they ducked the issues to the SEC in many instances. The SEC has been given sixty-three different areas in which to develop rules. Extensive rules, rules that in many cases people have been working on for years and haven't been able to figure out solutions; now you've got to get them out in six months or nine months, I think eighteen months is your far end, John, of what you've got out there.

The SEC has received criticism for the failure to anticipate and prevent the crash. Now obviously they couldn't have done it themselves, but it is in the middle of a very extensive self-evaluation process, and it probably will never look at itself the same way again. Within the SEC is the team that goes out into the field and finds out what's happening in the firms and in the markets. The Office of Compliance Inspections and Examinations, OCIE, is the unit that does that process. And John, who was acting director for a period of time, is going to discuss some of the changes that are coming, and after his remarks and also some by Bill Alsover, who was on the FINRA board and extensively involved in a number of FINRA committees, we'll commence a discussion centered around some questions relating to current events affecting OCIE and arising from the crash.

You are welcome to submit questions, but I would urge that you to do them in the following way please. We are going to have some formal presentations first, short ones. After that we'll go into the questions. Because the questions are going to be kind of like watching a racquetball game where the ball is flying all over the place, I'd urge you to toss the questions out to us at the time you have a question that's interesting to you, and you can add to it. Do so loudly so everybody can understand, and we'll try and repeat the question as well. I thank you very much. John, fire it up.

John Walsh[14]: Thank you Hugh. Before I do anything else I need to tell you that the views I am about to express are my own and not necessarily those of the Commission, the Commissioners, or my colleagues on the staff; though I certainly hope what I say is not too different from what they would like to hear me say. Before I turn to what I was going to talk about, I was intrigued by your reference to Chaos Theory. I think it's one of the more interesting aspects of Chaos Theory that it has non-linear causation. Meaning that, you really can't predict what the outcome will be from the input. One of the things we've been seeing over the last two years, and speaking as a regulator, that is very much cause for concern, is that you never really know what little thing is going to cause what huge reaction. So as you read the newspaper, and you read about the things that are going on today, you say: "What impact might this have? Might this make the market act crazy? Might this tie up title insurance? Might this do whatever?" That's the kind of thinking you must have in a chaos environment. Absolutely, I think it is of great relevance.

Well, I want to talk very briefly, because we do want to get to the questions and answers. But we are, as Hugh said, at a time of great change and great challenge. I would like to talk about three specific

14. John Walsh is the Chief Counsel of the Office of Compliance Inspections and Examinations of the SEC.

issues in particular. One, of course is the crisis. It is a financial crisis. It has been driven primarily by sub-prime; but nonetheless, it has had ramifications throughout the financial sector. Added onto the financial crisis, we have had major frauds. There have been individuals, we have discovered, who have been able to work themselves into the interstices of the regulatory regime, such as the gap between broker-dealers and investor advisors or the ability to exploit off-shore connections to hide the reality of what they're doing or the ability to move certain business products and processes, into the unregulated portion of a complex. Many of these frauds have come to light and have been the subject of major enforcement actions. Finally, we have this sort of rolling crisis where new issues are constantly bubbling up and people are rushing to try and deal with them.

The second thing I would like to mention, at the macro level, is that we have the solution in the Dodd-Frank Act.[15] It is a huge piece of legislation if you haven't read it. I know people who claim they have read it from front to back. I have, and nonetheless, every time I pick it up I find some new pearl that I really hadn't focused on before. So I think that, actually Professor Spoon you introduced the editorial board of the Law Review here, and it is a fine Law Review I agree, and trust me, you could run the next several years specializing on Dodd-Frank and you would not run out of topics. You could do every issue that way.

Dodd Frank has quite frankly posed a huge challenge to the SEC. Let me just give you one example. In Dodd-Frank, Congress told us we had to regulate the municipal advisors.[16] It told us we had to create an entirely new regulatory regime for non-regulated, previously non-regulated entities that give advice to municipalities, municipalities obligated officials, and so on. To make it interesting Congress told us we had to have this new regulatory regime in place by October

15. Dodd-Frank Wall Street Reform Act.
16. *Id.* at § 975, 1915-16.

first.[17] Between July and the end of September, the Commission established an interim regulatory regime. It created a new registration statement: the MAT. The "T" stands for temporary. It created a registration platform. It got the whole thing through the administrative process. And for the law students who are here, I fully respect the administrative process, but there are various things you have to do and to get all of that done in the time the commission had was really phenomenal. It was all up and running for the new registrants, several hundred of whom registered on October 1st.

Now obviously I have a bias here because I am with the SEC; I work for the SEC. But the next time someone tells you the government cannot get things done and cannot move quickly, you should just say to them . . . Municipal Advisors. It has really been a phenomenal experience and it's just a small piece of Dodd-Frank. By the way, some people have raised some concerns about just how quickly the Commission had to move. The Commission has indicated you can look forward to the full panoply of the administrative process in the coming months as the interim regime is turned into a permanent regime.

There have been a number of other issues related to Dodd-Frank that I think are very interesting and different and have changed how we do things. One, is simply, the Commission has published a public schedule, which you can see on the website, as to when it anticipates dealing with all of the issues coming out of Dodd-Frank.[18] So, you can look out over the coming months and see, for example, Title IV, the transfer of advisors to the states, or a new hedge fund regulation, fiduciary duties, all of the other issues that are under review. Another thing the Commission did is ask for front-end comments. It said, "let's not wait

17. *Id.*

18. SEC, IMPLEMENTING DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT – TPCOMING ACTIVITY, http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml (last modified Feb. 2, 2011).

until we've formulated what we want to do. Why don't you come in and give us advice at the front end?" It welcomed comments and the Commission has received those comments, thousands of them.[19] In fact, I don't know how many of you have been following the comments on fiduciary duties, but it's been very interesting. We actually have both comments and then we have anti-comments where someone will file a comment and say, "here are the five reasons why brokers should be subject to a fiduciary duty." And a day or so later someone else will file a comment saying, "here are the five reasons that previous commenter is out of their mind." (Laughter.) It just goes on and on. The first one, of course, will come back and say, "no, no, no, here is how the second person [is wrong.]" People are actually calling it a regulatory blog. But it's been very interesting. And because of this new transparency, you can actually go on the Commission's website and read all of this for yourself and see . . . what is coming in for the staff and the Commission to think about. And finally, as Hugh mentioned, there is a huge amount of rulemaking going on.

The third thing I'd like to mention very quickly at the outset is at the micro level. As Hugh mentioned, we are dramatically restructuring and reshaping the SEC. This is something that has been going on since Chairman Schapiro came to the Commission in 2009. The Division of Enforcement has gone through a major restructuring. A colleague of mine is here from Enforcement and I am sure he will talk about that. We have a whole new division, a Division of Risk, Strategy, and Financial Innovation that's studying how we can get out ahead of these risk curves. We have a new office of Market Intelligence in Enforcement. It's playing a key role in a number of areas. OCIE, my office, is going through a restructuring as well. So, we

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19. SEC, PUBLIC COMMENTS ON SEC REGULATORY INITIATIVES UNDER THE DODD-FRANK ACT, http://www.sec.gov/spotlight/regreformcomments.shtml (last modified Dec. 1, 2010).

are very different today already from where we were just a few months ago. It's a new agency with Dodd Frank, it's a new regulatory regime and as you said we will probably never look at ourselves the same again. I think that's absolutely true. Here we are part way through 2010, most of the way through 2010, and a lot of change has already taken place. But I want to move on to the questions so Bill, I think you're next.

William Alsover[20]: Thank you John. I really, first of all, my opinions are strictly my own. I worked at FINRA, but it's been two years now since I worked for them, so these really are my own thoughts. I already came up with a couple already, in your introductory remarks talking about Mrs. Bradbury. One of the things I do through my consulting business is to consult with the state of Maryland on loss mitigation of mortgages. I deal with Mrs. Bradburys every day, all day long, in many cases. And, I'm sure I don't have to tell a room full of lawyers that there are two sides to, at least two sides, to a story. So, as we go through this process, I know there's a tendency to try to put blame on one party or the other, but in many cases there is enough blame to go around for many parties. So keep that in mind as you go through this process. Interesting, too, that you mention Chaos Theory because I think the first time people ever heard of that . . . was in Jurassic Park where Jeff Goldblum explained what it was. Well, it's odd because I use a kind of [the] DNA theory that they used, which was you know they had the chain that where they were missing something they just kind of

20. **William C. Alsover, Jr.** is Chairman of Centennial Securities Company, Inc., a full service broker/dealer located in Grand Rapids, Michigan. Prior to joining Centennial, Mr. Alsover was with Fahnestock & Company. Mr. Alsover currently serves as Chairman of the Small Firm Advisory Board and on the Securities Advisory Committee, Office of Financial and Insurance Services, for the State of Michigan. He has served on several industry committees, including the Securities Industry Association (SIA) Investor Education and Local Firms Committees, and the New York Stock Exchange's Committee dealing with day trading and margin requirements. Mr. Alsover is the former Chairman of the SIA Local Firm Committee, and a former member of the NASD Chicago District 8 District Business Conduct Committee. He received his B.A. from Michigan State University. FINRA, http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003058.pdf (last visited February 7, 2011).

filled in with some frog eggs or something. I do that too sometimes, looking at things in the securities industry. That rule changes that may appear not to be associated really are and what drives certain events and certain directions in regulation; there is kind of a continuum if you will.

Just a couple of statistics, I was on the board of governors of NASD when the combination of, or consolidation of the New York Stock Exchange member regulation in NASD took place in 2007. And timing is everything and that was not the best time. Just to give you a feeling of what FINRA is facing and some of the forces that they have to face, the number of firms since that merger or consolidation is down about 7%. That really doesn't tell the whole story . . . since not only is the membership down 7%, but the type of member has changed. When I went on the board in year 2000 there were 5700 firms that were members of NASD; we're now down to about 4648 as the end of September. Branches are down; the number of salesmen are down all since this consolidation took place.

As you may know, FINRA is a nonprofit and they really have done a good job of that the last couple of years. They have lost $672 million since the consolidation took place. Primarily because their revenues are based on what the industry does. They're based on gross income assessments, they're based on a personnel head tax if you will, trading activity fees – those types of things. So FINRA now really needs to find revenue sources that are not based on the mercurial ups and downs of the revenue of the securities industry. I'm reminded of another movie I liked, movies I enjoyed, obviously the fourth quarter of 2008 if you know the gross income assessment for FINRA is figured out at the end of the year and collected the next year. So the fourth quarter of 2008 they don't want to relive again like Groundhog Day. (Laughter.) They don't want to see that again because that took them from what was a relatively stable environment of revenues to a point where now they're looking at other sources; and [they] have been working very hard, of course, to try to get the fiduciary oversight, or pardon me, the investment advisor oversight for newly registered broker dealers and investment advisors. That didn't happen; they worked very hard - lobbied very hard for it.

Again, this is where I connect the dots here. FINRA had a couple of pretty serious black marks against them. Certainly Madoff was one, but the major one was Stanford. And Barney Frank spiked the idea of FINRA being able to handle dually registered firms, I think, because he felt they needed to spend some time in the penalty box. They made a mistake and they had not done things properly so they had to be put in the penalty box for a while. They are now out of the penalty box. And the rumor last week at the FPA conference was because of Dodd-Frank and the extreme load that it was putting on the SEC in terms of their work load that, in fact, the rumor has begun that FINRA is going to get all of the investment advisory oversight . . . . I'm sure the SEC will look at it.

There was quote I read also from the FPA Conference which I thought was good regarding the fiduciary and then we'll get to John. This was from Gary, I'll guess his name, but anyway he is Deputy General Counsel of LPL, Gary Klein (inaudible). And regarding the current state of the fiduciary question, he said, "It's kind of like men my age and their hair. They know there's going to be a change but they don't know what the fallouts going to be." (Laughter.) And really that is, you know, where we are with this. This is taking longer than the Old Testament at this point. And . . . I know we have a fair amount of time left on this. But decisions of firms on, can we continue to do business as usual, or how is it going to change our business after, and what is the fiduciary standard going to be - the states are very concerned. I know Hugh you were there. The states are very concerned through NASAA that somehow the SEC is going to lower the standard for investment advisors so that it can harmonize a lower standard for broker dealers. I don't see that as an outcome. But, I do know by experience, almost forty years in the business; one size does not fit all. We have a very mixed group of firms, and not all of them are going to line up perfectly with one definition of fiduciary responsibility, unless we're talking about major changes in how business is done. Anyway, hopefully we'll get to the changes of what's going on in arbitration and a few other things, but with that let's turn it back to Hugh

John Walsh: Actually Hugh if I can just jump in for a second, let me just join Bill in saying I don't think anybody wants to relive the fourth quarter of 2008 in any way. I wholeheartedly agree with that.

Hugh Makens: Bill, on behalf of the Michigan Bar, I'd like to thank you for not mentioning what happened to the lawyer in Jurassic Park. (Laughter.) And for those of you who don't know, you have to see the movie to understand it. (Laughter.)

Alright, what we're going to do is fire off a series of questions. I'm going to toss up the ball, John hits it, Bill then runs the bases, and we toss up another one. What changes has Dodd-Frank brought about at the SEC?

John Walsh: Well, gosh, that's a huge question.

Hugh Makens: I understand.

John Walsh: Let me say, first off, Dodd-Frank is rolling through the agency really title by title. We have established integrated working groups that combine the different offices: the Division of Trading and Markets, which traditionally has looked at the 34 Act; the Division of Investment Management, which looks at the 40 Act; Enforcement, and the examination program. All of us are working together on making sure that the rules and the processes that we go through are fully integrated and respond to what Congress wanted. There are a number of different rulemaking processes underway. Probably the biggest immediate change in how we do business relates to credit rating agencies. We talked about how Mrs. Bradbury's mortgage eventually ended up in investments that were given a very high investment grade. Well, that was done by credit rating agencies.

We first stepped into that space in terms of doing examinations after legislation in 2006 in which Congress decided it had to do more in this area. In Dodd-Frank Congress created a new regime where every registered credit rating agency, we call them NRSROs will be examined every year and there will be a public report issued at the end. Those of you who are familiar with state insurance regulation, I think there are some similarities to that. Typically our examinations are non-public, but as I understand it, the goal is much like insurance regulators that publish their inspection reports. The public report adds to the credibility of the insurer. In this case adding to the credibility of the credit rating agency outweighs the benefits of confidentiality. So, that's something that's already in place and we already have teams looking at credit rating agencies and working toward our first annual credit rating agency report. But it's transforming the entire agency.

Hugh Makens: An interesting aspect of that is the breakdown in Standard & Poor, Moody's, and the other ratings agencies, was primarily in the due diligence process. There were assumptions made about certain formulas, those assumptions ignored the underlying manner in which mortgages were being generated, the lack of collateral, the dramatic deterioration of collateral, and the challenge that you're going to have is one that lawyers face. And that is: How much due diligence? What kind of due diligence? How do you evaluate the adequacy of due diligence? We do it later on in lawsuits when this collapse keeps John in business over here. The process is a complex one. How are you going to deal with the issue of making sure they're doing adequate due diligence because that's what really killed them?

John Walsh: Due diligence is an issue that goes beyond the credit rating agencies and actually permeates the entire financial sector. One of the critical lessons of the crises, unquestionably, was the failure of due diligence. There was an extraordinarily catastrophic failure of due diligence. I'm very impressed by Mr. Greenspan's testimony and the extraordinary exchange with Congressman Waxman about due diligence. The former head of the Federal Reserve had to confess his own error and say, "I never expected that these large financial institutions would fail to protect themselves, would fail to conduct appropriate due diligence." We've been very interested in due diligence in the months since the crises took place. We are looking at due diligence practices in a number of different firms in a number of different settings and the Commission's enforcement docket has had a number of due diligence cases since then. Just to step back a bit, the way I would analyze it is: we're all familiar with the fiduciary duty and the duty of loyalty that is part of the fiduciary duty and traditionally that's the part we focused on – the duty not to have conflicts of interest, for example.

On the other hand, the fiduciary duty has a second component, and that's the duty of care. The duty of care has come up traditionally in very limited circumstances. For example, with investment advisors, the duty to exercise due care when you vote your clients' proxies. Today, since the crisis, the duty of care has been getting much more attention and it's showing up in the due diligence space. Let me mention a few different scenarios. First, someone claims they're engaging in specific due diligence practices and they fail to engage in those specific practices. The Commission has brought an enforcement action on that basis. Second, someone claims that third parties and affiliated firms are given the same type of due diligence review when in fact they have secret preference for the affiliates. The Commission has brought enforcement cases on that theory as well.

Finally, someone claims that they are performing due diligence and they do a really bad job – for example, while they're claiming to do due diligence the only thing they really ask is, "Well, was this firm able to get bank credit or something like that?" The Commission has brought a case on that theory as well. There is no question that due diligence is permeating the work that we're doing in a number of different areas.

Hugh Makens: It's a rather fascinating time. I lecture each year at the ALI-ABA Regulation D program. And, the area I get more questions in, in two and a half days, is in the due diligence area. How much due diligence do I have to do as a lawyer? What kind of due diligence should I do? And when you're doing it, you now look beyond conflicts. My first advice is [to] follow the money. Start with compensation, get into the depths of that, then build out into about ten different major areas and if you just type on Google you can find the materials and the outline. This is the wrong time [and] wrong place. What internal changes are being made in order to detect or to increase the ability, because you'll never have absolute ability, but what internal changes are being made to increase the ability to catch things that could lead to a crash – react to bubbles, that react to inaccurate assumptions, that react to management systems failures?

John Walsh: We've actually done a number of different things. Part of what we're doing in terms of restructuring the agency is to make sure we do a better job of doing all the things that Hugh mentioned. Let me just talk about some of the changes we've made. When you're looking at the crisis, when you're looking at Dodd-Frank, you're looking at macro changes. Here, we're going to talk about micro changes, management changes, institutional changes.

Let us start with one of the changes we already have in place, [such as] third party verification. Third party verification means that when we receive information from a registered entity, we reach out to some third party to verify what we're learning in our examination.

Now, it's one of those things unfortunately, a year or so ago or during the crisis, there were people who said, "This is easy. You pick up the phone and you're done." In fact it's not easy; it's anything but. In the electronic world, we buy and sell in things with tremendous value, but whose only corporeal existence is a notation in somebody's computer. How do you verify that? The only way to do it is to find another computer that's not affiliated in any way with the first computer, and see what notation is on the second computer. That can get very tricky because finding that unaffiliated record system can lead you very, very far away from things we're used to dealing with. Just international is a whole huge complication, different regulatory regime. Do we have authority to ask the questions? Issues like that. But we are actively pursuing third party verification. We call both "verifying up," which is to custodians, counterparties, depositories. And we have what we call "confirming down," which is reaching out to clients.

Second, we have massively retrained our staff in fraud detection. We set out back in 2009 to make sure our staff would recognize fraud when they saw it. Hundreds of us have gone through a training program and been certified by the Association of Certified Fraud Examiners, ACFEs. I'm one myself now. We said we had to make sure that we're not just looking at the rules. We're not just looking at the calculations; we're asking is there fraud here? We chose the Association of Certified Fraud Examiners, I don't know how many of you here today are CFEs, because we wanted to make sure we had that third party validation that we'd gone through the course, we'd taken the test, we had the certificate. [As an official of the SEC, I do not endorse or recommend any service provider, including ACFE.]

Third, we are recruiting people with expertise. We have a new type of examiner position; it's called an SSE, or Senior Specialized Examiner. If you're familiar with how the government operates - we have numeric levels on the staff. The highest level is what we call a Senior Officer, which is equivalent to a member of the Senior Executive Service. Then the next level is as Assistant Director, which is a seventeen. The SSEs are sixteen's, which means that they are about as high as you can get on the staff. These are people who have expertise in structured products: CDOs, options trading, equity trading, and valuation, all the really nitty gritty issues that you really need to dive into to figure out where the fraud is [and] where the problems are. And that's been a tremendous change.

Also, we are conducting a strategic review, or self-assessment that's going on now. It's looking at bigger questions like: How should we be organized? How should we structure our teams? How should we recruit? And all of that is underway right now. I would like to mention two specific things; I don't want to take up too much time. Two things that I think are going to have a big impact on the regulated community. One: we now have our own Compliance Office within the Examination Program with a compliance officer. And we're doing our own annual review. Basically we're mimicking . . . the examination program - what the industry had to do for years. This is important both to you, because you should expect a higher level of consistency in what you see from us in the future, and it's good for us as well because it gives us a more robust internal control environment.

Over a five year period we do about ten thousand examinations, at the rate of about two thousand a year. So you can imagine, having a good internal control structure is really important in that environment. The other thing we have in place is what we call our TCR system, which stands for Tips, Complaints, and Referrals. This was one of Chairman Schapiro's initiatives. In essence, when she rejoined the Commission, she said, "We've got to get TCRs under control." In the abstract we could take any individual tip and analyze it and say, "Why didn't you do this? Why didn't you look at that?" Those comments would be valid.

The problem is that TCRs flood into the agency like a fire hose. There is a massive flow of information. So how do we pick out the ones that we really need to analyze carefully? Well, the agency has established in the Division of Enforcement an Office of Market Intelligence- all of the TCRs that come into the agency are now collected into a single database. New technologies are being developed to go through a risk assessment process of those TCRs after which they are assigned out to the examination program typically we will do a review - oftentimes just show up without notice and say we're here to talk about this particular issue. The system is making us much more agile and much better at figuring out which TCRs we really need to respond to. A lot of changes.

Hugh Makens: One of the other things that I've observed in the last couple of years about the Commission, and this one John because of what I'm asking, you don't need to comment on. But my sense has been that the SEC –

John Walsh: That, by way of preface, I can guarantee you I won't comment on. (Laughter.)

Hugh Makens: My impression of the last several years at the Commission has been that the Commission has self-operated. That is, each division was concerned primarily about itself and not doing an adequate job of involving other divisions. And I think that has been a major contributing factor to the problems that the Commission has faced.

John Walsh: Hugh, actually, I am delighted to respond to that. I agree, I agree. I thought you were going to go off in another direction. (Laughter.)

Hugh Makens: I go off [in] strange places, yes. (Laughter.)

John Walsh: I guess I have a guilty conscience. I won't tell you where I thought you were going. (Laughter.) I agree. We definitely have had too many silos. One of the things that Chairman Schapiro has done is really to make sure that we break those silos down. In the past, people would cooperate, but it was all informal. Who did you know? You could call somebody up. Well, what Chairman Schapiro has done is to make sure that we're all actually working together. I think the Dodd-Frank response is an example. Dealing with the mega firms is another example, making sure the Division of Trading and Markets, the Division of RiskFin, OCIE, Enforcement, and everybody is pulling together. That everyone is sharing information. No question, this is one of the ways the agency is very, very different today than it was as recently as December 2008.

William Alsover: If I might add, prior to Mary Schapiro heading FINRA, Bob Glauber was the head of NASD, chair and CEO - and he was chair and CEO for five years. And in those five years, he had to deal with five different heads of the SEC. So I think that's probably because . . . the SEC talks about the tone at the top, and we need some consistency at the top. I think also that makes it very difficult when you have a change of leadership so frequently, because staff tends to move along with that. And let's hope that the SEC gets . . . some stability in their senior staff so that we don't have a constant change and those down times in between.

Hugh Makens: Another major problem for the Commission, and it's one to which I don't have an answer, but from roughly 2000-2001 up to the time of the crash, the turnover of senior people of the Commission was very dramatic. They lost a lot of experience and that experience generally went into the industry or went into major law firms. And as a consequence, you had both, forgive the expression, a brain-drain at the Commission of all those years of experience. And secondly, you had the appearance of a lot of conflicts that were coming down. And I know the Commission has been looking internally at how to address that issue of conflict, but that's still sitting on the table. We'll see where that goes.

John, there is a focus now, from what I'm reading on sweeps, with interdisciplinary teams. How does it work? What's the result?

John Walsh: Sure, a sweep is a series of examinations where instead of looking top to bottom in a firm, you pick out a particular issue and look at that issue in a number of different firms. Some people call them horizontal reviews because instead of going vertically up and down the firm, you're looking horizontally across the industry. We have a number of different sweeps that we do. They can range from relatively small sweeps, where you might have ten firms, up to very large sweeps where there may be a hundred or more firms involved in the review. One of the things, Hugh, as you have suggested, that we've been focusing on recently is pulling together different types of expertise together to participate in the sweeps. And this has included pulling together people from different offices around the Commission. In some sweep reviews, we have actually gone onsite at the firm with people from OCIE; the examination program; Trading and Markets - Risk Fin, as we call the new risk division, and even Enforcement people. That always gets their attention, when Enforcement comes along. In other sweeps, it's still just examiners conducting the review. But we're pulling in the SSEs to deliver the new kinds of expertise.

One that I think it might be interesting to mention that illustrates how we're doing this, is our review of collateral management agreements. Now as you know, CDOs often have collateral management agreements with investment advisors who will actively manage the collateral in and out of the pool. We brought a case back in June. June 25th is the filling date. As you probably know, the Commission's website goes in reverse chronological order. So if you're interested in reading the complaint, you can go to June 25th. It's *SEC vs. Mr. Aamer Abdullah.*[21] He

21. SEC v. Abdullah, No. 10-CV-4957 (S.D.N.Y. June 25, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21576.htm.

settled the case and the settled administrative proceeding was posted on August 4th. He was a portfolio manager at an advisor that had a CDO collateral management agreement, and he engaged in various forms of misconduct.[22] Now to find this conduct and to develop this case, of course, required a lot of expertise in CDO management . . . . It [involved] things like engaging in forward transactions where those weren't authorized by the agreement. Valuation of the debt as it was going in and out of the portfolio, giving a higher valuation when it was being sold in from a favored account, a lower valuation when it was being sold out to a favored account - issues like that. So I think it is a really great example both of the focused approach and the level of expertise we're now deploying to these issues. And just another disclaimer: litigation continues against related parties. All of my comments relate to the settled matter against Mr. Aamer, excuse me Mr. Aamer Abdullah.

Hugh Makens: Another thing. When we look at the SEC, we tend to look at Washington D.C., but actually the SEC is a whole lot more than that. The regions are affected every bit as much as what's going on in Washington at this time. Could you comment on some of the changes that are affecting the regions?

John Walsh: Sure . . . I agree wholeheartedly; the regions are critically important. You're fortunate here with the Chicago Regional Office. It is one of our largest regional offices. It's comparable to the New York region, but we have regional offices really around the country. We have been trying to do recently is to make them more a part of the national program. In the examination program, we now have an Executive Committee that governs the program. And that committee is composed both of individuals in Washington, such as myself, and representatives from the regional offices, such as the Regional Director of the Chicago Regional Office. So we're trying to bring

22. *Id.*

them to the table more and make them part of the decision making more.

But a couple of things that they've been doing, Chicago again, to use them as an example, they have a very innovative pilot going. Many people are calling it the "Chicago Letter." It's sort of the opposite of the TCR approach. That is instead of dropping in by surprise, you first contact the firm months in advance and have a dialogue with them and say, "You know, we're thinking of doing an exam of you, we'd like to talk with you, how are you set up, what's your business, what are the challenges you're facing?" So after a very lengthy dialogue, by the time you actually go on site to do the exam, you know the business, you know the challenges, you know the controls, so your time on site can be very focused on the issues, the particular issues that you think you need to address. So the regional offices are very much part of the picture and there is a lot of interesting stuff going on out there too. Absolutely.

Hugh Makens: Of course a tremendous amount of the enforcement that happens nationally emanates out of the regions rather than just out of Washington.

John Walsh: True, both with examinations and enforcement. The regional offices would say a lot of the actual work of the Commission is done in the regional offices.

Hugh Makens: There's a new focus now at the Commission; not only at the Commission, but I think in the corporate world generally. I saw an announcement for a recent PLI materials, and about half of the materials were related in one way or another to risk analysis, and what do boards do about it, what does management do about it, what internal systems [to] put in place, [and] so on. The Commission has now entered the world of risk analysis. What's happening? How are you going to go about doing it? Has it been defined yet?

John Walsh: Well, this is an area where the new Division of Risk Fin is playing an important role and they have been able to recruit some very well known academics. Folks who are very familiar with this processes and they are working on that. The Office of Market Intelligence and Enforcement is also focusing on that. Part of the goal, ultimately now that we have all of the TCRs in one place, and we can actually look at all the information the agency has that might relate to a TCR, is to conduct risk harvesting - to harvest the risk that actually require particular attention. A lot of times, it's not the individual TCR that really tells you there is something there that needs to be done. It's taking an individual TCR and saying, "Well, have related complaints come in?" Or, "Do we have something else in the system that suggestive that this one should be read as a higher level of risk than what might appear on the face of the tip?" And I think that kind of risk harvesting is something that we're working toward and actually takes a lot of money.

These technology projects are expensive and take time, but the agency is working toward a deployment of that system as well. So all of that I think is very important. Now, in the exam program - we also have staffed up our own risk assessment. We have a new risk office that's consolidating in headquarters a lot of the different risk activities. We have algorithmic reviews of registration data and things like that. So it's underway. Throughout the agency, there is a new focus on risk. The key for us is to try and get ahead of the curve. If we have a real problem, if a tip comes in, if a complaint comes in, now we can look at trends, we can say, "here is something that requires our sweep." Our ultimate goal is to be totally risk based; to never do anything just on a cyclical basis; to never go anywhere simply because we haven't been there in a while. When we go anywhere, we want to have a particular risk in mind.

William Alsover: I mentioned FINRA. It reminded me of when you said, "ahead of the curve." They actually had a committee called Ahead of the Curve, it was really original. Anyway –

John Walsh: I met with that committee. I think Mary Schapiro was the chair of that.

William Alsover: Yes, she was. Anyway, FINRA has tried to remodel their examination program as well to look at a risk analysis, and they have been working on that for quite some time. And they have made, I think, tremendous inroads to look at those firms because of the types of business they do, because of the type of salespersons that they are employing, and various other metrics, complaint letters [and] et cetera, have kind of built a profile and they look for outliers. And that's what attracts them to dig a little deeper into what's going on at a particular firm or group of firms. And it's as John said: a very expensive process. And it takes, I think, quite a long time but I think they've come quite a long ways on it. I know Chairman Schapiro has had experience with that, so I'm sure that it's gaining from her knowledge of it as well.

John Walsh: I think a lot of the firms in the private sector are doing it as well . . . . They're now saying, "Well gosh, what happens if a tip comes in about conduct in a particular branch office and we don't understand the gravity of it? We don't understand that here is a tip that somebody at headquarters has to respond to." So I think a lot of the private sector firms are working with exactly the same kind of issues that we are in the public sector.

Hugh Makens: There is a massive amount of data that flows out of the brokerage firms and it flows into clearing firms. It flows into regulatory reports. What are you doing now to capture some of the data from firms and having it affect the way that you do your inspection?

John Walsh: Well, we actually proposed, as part of the Dodd-Frank process, that we would have new surveillance authority. Unfortunately, that particular part of the legislation was not successful. So, while we were hoping if that had been passed, we would be able to design more of a continuous surveillance structure. As part of that we also had a confidentiality provision that would have protected the surveillance data. For some reason that particular part of the statute seemed to get more attention than some others. I don't know why.

But at the end of the day, we did not receive that. So we are thinking carefully about what we can do. One of the things we are doing is contracting for private sector databases. There's a lot out there that you can buy and look at if you're willing to spend the money. It's less reliable, because of course, when someone tells a consultant or a survey that something is the case, that's different. It doesn't have the penalties and so on that come along when telling the government that something is the case. But nonetheless, we're doing what we can to gather information that we can use for this kind of risk assessment, working with FINRA as well and with others, DTC, and so on.

William Alsover: I should mention that not too long ago, I became likened into more of the New York Stock Exchange. It's completely their takeover of FINRA. FINRA is now - when the consolidation took place in 2007, the New York Stock Exchange kept their market surveillance. That is no longer the case. That has now been folded into FINRA as well so there is no longer two market surveillance programs running at the same time. Hopefully, there will be some improvement because of combining that function.

Hugh Makens: And that by the way is how we usually catch - that's how insider trading is very, very often caught. I had one case where I was asked to defend somebody. They had been at a company in the morning, seen some information, [and] traded in the afternoon. This person called me the next morning and said, "I've got a problem." I said, "Well, what's your problem?" And he said, "Well, I think the SEC thinks I've engaged in insider trading." And I said, "Well, how would you think that?" And he said, "Well, they called me at six o'clock last night." (Laughter.) So, if you want to understand how fast this stuff works. It really does.

John Walsh: It's pretty amazing the sophistication of the surveillance. But probably the biggest development in this area to enhance that is a rule proposal called the

Consolidated Audit Trail.[23] The consolidated audit trail proposal is an effort to establish a clear structure where we will know the beneficial owners of trades; we will know what that individual trade is throughout its entire life; and, we'll know the identities of traders and whatever broker-dealer they are working with. The irony is - I had the opportunity to work with some foreign regulators and they already have this. This is something that many foreign markets already have in place. When they hear what our system is like - all the steps we have to go through to try and put trades next to each other and investigate them to figure out who the beneficial owner are, they are stunned. This rule is in the proposal stage. But, if something like that is adopted, it will go a long way toward modernizing our system. No question.

Hugh Makens: John, in my house I have a small Australian Sheppard dog and a small cat. In your house, you have a herd of elephants. We call them mega firms.

John Walsh: Yes.

Hugh Makens: How in the world do you go about getting your hands on what's going on at a Morgan Stanley, at a Merrill Lynch, at a, well, I should mention Goldman Sachs, (Laughter) any of those firms? How do you get your hands around the magnitude of risks and problems?

John Walsh: Well, our ethical rules forbid me to say anything about specific firms, so what I'm about to say, I expressly disavow in anyway talking about any firm that you named or any others. But there are some big firms and they do pose special review oversight issues. One of the things we're doing there, first off, is to make sure that at least everybody inside the agency is on the same page. Actually, my former colleague Marty Dunn is going to be here to talk about Corporation Finance. Corporation's finances play a huge role. The division has established new specialized units looking at, for example, financial firms. They're very much a player with the examination program, the Enforcement

23. Consolidated Audit Trail, 75 Fed. Reg. 32556 (proposed June 8, 2010) (to be codified at 17 C.F.R. pt. 242).

program, Trading and Markets, and so on. Getting together and making sure we're all in the same place and we all know what's going on. We have active sharing underway with the Federal Reserve as well. There's been a lot of joint work with the CFTC. I'm sure you've seen on the announcements as the agency has set up different groups to get together with them and to work together on issues of common interest. So, the short answer is to try and make sure that everybody who has a stake in the oversight of a particular firm [and] who has information on a particular firm can get together in the same place at the same time and make sure everybody is heard and is coordinating. We've actually done reviews where we'll go to the firm and be onsite for a meeting or whatever it might be and take people from different offices. And that again is to make sure everybody's there at the same place and at the same time and we're all working together. It is a big issue. It's a big challenge. There's no question about it.

Hugh Makens: One of the major problems that the big firms exposed was the creation of special purpose entities, variable interest entities, special investment vehicles, whichever term you wanted to apply. In essence, the creation of different pools – first of mortgages, then of mortgages with subprimes, then with mortgages with really bad subprimes, and finally, when the amount of mortgages started to dry up they started to create synthetic products. How do you get your hands on what they're creating and try and prevent the runaway problems that we had with badly deteriorating products?

John Walsh: Well, I think you really put your finger on one of the key issues that everybody has been wrestling with at the congressional level and in Dodd-Frank. I think you can see it in Dodd-Frank in a lot of the provisions regarding the regulation of execution facilities, the regulation of, derivative products and the regulation of hedge funds. A lot of the regulators of both congressional and federal are focusing on how to do this. The answer covers the whole gambit. Pretty much everything I've said up to this point could, in fact, have relevance here ranging from new laws, new rules, down to hiring people with the expertise who can actually walk into a shop and look at one of these things and say, "This is not right. This is not the way it is supposed to be run." There's no question that finance today has gotten so much more complex than simple equities. You know, buying and selling equities on a stock exchange . . . were the good 'ole days. We're way past that now, I'm afraid.

William Alsover: And with FINRA, 2008 was a year to learn from as well. The *Stanford*[24] case illustrates one of the challenges. And that is, FINRA many times had what they thought were jurisdictional issues. They wouldn't go in certain parts of brokerage firm's businesses because it was outside of their jurisdiction. It may not have actually been within the broker-dealer. It was out in one of those special purpose vehicles that they put together and so forth. FINRA now is much more apt to continue to follow that out. The depth of the examination process is much, much . . . deeper now than it used to be.

Hugh Makens: One of the bits of nonsense that came out of the problems that contributed to *Stanford* and *Madoff* was the idea that we don't have any jurisdiction in this area. NASD Notice to Members 94-44 clearly laid out what the NASD at that point in time believed was the clear ability to extend their jurisdiction to look at investment advisors or to look at other affiliated entities, where because of the affiliation there were risks that could come back to the broker-dealer.[25] And we've moved away from that . . . . Yet, it's still as far as I know good law today. I was amazed to learn that the NASD at the time had backed off the *Stanford* case. Stanford was, for those of you who are

24. SEC. v. Stanford Int'l Bank, No. 3:09-CV0298-N, 2009 WL 2371432 (N.D. Tex. April 17, 2009).

25. NASD, NASD NOTICE TO MEMBERS 94-44, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1439 (comment period expired on February 15, 1995).

unfamiliar with it, Stanford was selling certificates of deposit based in - I think it was Jamaica.

John Walsh: Antigua.

Hugh Makens: Antigua, thank you. And as a consequence they stopped. They got to the door and stopped, which was a horrible mistake. I was just baffled at the subsequent testimony before Congress that said, well "we couldn't go there." And I'm looking at 94-44 and saying, "wait a minute. There's s a major disconnect here!" And speaking of interesting places to go - talk a little bit about hedge funds and where they're going. This is a new world.

John Walsh: Do you want to talk at all about the other question before I jump into hedge funds or are you all set?

William Alsover: Well, just that [it] is unfortunate. I can tell you that, again not telling tales out of school, but that whole idea of jurisdictional issues came up several times amongst the NASD, not specifically about *Stanford*, but just in general where they felt that there were certain areas where they did not have jurisdiction. I think now that attitude has changed. I think that they are now feeling that if they can connect this to the broker-dealer, then they can go there . . . . I think that's a very positive thing.

John Walsh: Hedge funds, from the Commission's perspective, have had a similar track where at first the Commission tried vigorously to extend its jurisdiction to cover them and was defeated in that effort in the courts . . . . Now Congress has come back and said, "Yes, you should have this jurisdiction." So as part of Dodd-Frank, going forward I think that we will have much clearer jurisdiction over them to be able to do what we need to do. I would add that we actually have a fair amount of experience in this, and the reason is that many registered advisors manage hedge funds. So we have actually been looking at hedge fund practices among the registered advisors for awhile. So this is one of those areas where I think that we are in pretty good shape to expand our jurisdiction into this area based on our past reviews and our past experience.

Hugh Makens: There are two developments I think that are of interest. Two days ago, the SEC put out an announcement that a proposed rule relating to family offices and when they are required to register as investment advisors – that release is on the SEC's website.[26] The other issue that I think is going to be addressed fairly shortly is: what happens with venture capital firms? Do you include venture capital firms within the rubric of hedge fund? Do you carve them out, [and] if you carve them out, [then] to what degree? I've been on the phone with two securities regulators around the country that are debating exactly the same issue. What do we do? How do we do it? If we setup a hedge fund program, how do we go in and inspect? What do we look for? Well two final words, because Elliott says we are just about out of time, and those words are "flash trading" and [the] flash trading reporting. Please comment.

John Walsh: Well, the report is on the Commission's website;[27] I would urge you to take a look at it. Obviously, what happened is something that really caught our attention as it did everyone else's and an in depth review was done. But again, this goes back to our discussion in the very beginning of chaos theory and nonlinear causation and in an environment where you can have not thousands, but tens of thousands of trades measured not in seconds, but in fractions of seconds. It's making regulation extremely challenging. It's fun; it's interesting; but it is very challenging as well.

Hugh Makens: One part of that is that roughly 90% of the orders that were going in electronically were never executed, and, in fact, were withdrawn within milliseconds of the time they had been entered into the system after the first of an order had been cancelled. We also are in a world where New York Stock Exchange, the paradigm of tradition. [It] does about 40% of the trades on the

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26. Family Offices, Exchange Act Release No. IA-3098, 17 C.F.R. 275 (Oct. 12, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3098.pdf.

27. Elimination of Flash Order Exception from Rule 602 of Regulation NMS, 74 Fed. Reg. 48632-01 (proposed Sept. 23, 2009) (to be codified at 17 C.F.R. pt. 242), *available at* http://www.sec.gov/rules/proposed/2010/34-62445.pdf

floor and about 60% electronically, and that trend is going to do nothing but accelerate. So, we're in a time of having to manage very, very sophisticated electronic trading techniques, some of which are actively designed to hurt the John Doe investor.

John Walsh: Hugh, I would recommend that if you're interested in this area, FINRA issued an enforcement case (or a disciplinary case) in September – I believe it was mid-September, September 13 called *Trillium*, and it's a fascinating case.[28] It's a case in which FINRA alleged that the firm essentially was designing layered trading. Layered trading is where you put a real order on one side of the market and then you layer non-bone fide orders on the other side of the market, basically to trick other firms 'algos' into executing against your real order. And they were flipping back and forth.[29] They dis it on one side of the market, and then on the other side of the market for, as I recall in the enforcement action, forty six thousand times in short order, which again shows you the volume and speed. But what's fascinating to me about it is that it's a manipulation case in which 'algos' were designed to trick other 'algos.' It is a fascinating reading if you haven't seen it, but I think . . . that is the wave of the future. That's where we're headed.

Hugh Makens: And we have only five hundred questions left to go. (Laughter.)

William Alsover: I was going to say, the SEC just had a case, didn't they, on quote stuffing also as well?

Hugh Makens: I thank the panel very much for the work that we've put in, and what we did in the time we got.

Elliott Spoon: Let's thank the panel for a very informative. (Applause). Alright we're now, we're going to setup the next panel right away, and we're going to have a break right after the second panel.

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28. Letter from Trillium Brokerage Services, LLC, et al., to FINRA, Letter of Acceptance, Waiver and Consent, 20070076782-01, *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p122044.pdf.

29. *Id.*

SESSION 2: SEC "TRANSACTIONAL" HOT TOPICS

Elliott Spoon: Alright folks, we are going to get started again. We are going to focus on what we call SEC Transactional Hot Topics, and these are going to range from the subject of proxy access to a much deeper dive on the Dodd-Frank Act and various aspects of that Act. With us: Patrick Daugherty of Foley & Lardner, "Marty" Dunn from O'Melveny & Myers, Mark Metz from Dykema Gossett, "Bob" Hudson from Butzel Long. And this is very much a PowerPoint panel. Each of the participants has their own PowerPoint. The copies of those PowerPoints are in your materials, for your information. I think that we're starting off with Marty.

Martin Dunn[30]: I thought we had to have a PowerPoint; I didn't know that was an option. I was supposed to go from 10:00 to 10:15 on access, so it's good to see you guys. (Laughter.) One might ask, "Why we are going to talk about proxy access this morning when in fact it has been stayed and probably will not apply for this year?" But I just wanted to lay out the basics of how it would work and "tee up" the big question that everyone is going to have to figure out during the stay. So, we're not going to spend forever talking about how access would work . . . . I am going to go over the basics of it just because I don't think it will be in place for this season, but it's important to know how the SEC laid it out so you can follow the litigation a little bit better and follow along as to how people are reacting.

The first thing is: How does it work? See the slide behind me. It's very basic, and it says every company that is subject to the proxy rules has to comply with

30. Martin Dunn is a partner in O'Melveny's Washington, DC office and a member of the Corporate Finance Practice. Prior to joining O'Melveny, he spent 20 years in various positions at the US Securities and Exchange Commission (SEC), most recently as Deputy Director, and former Acting Director, of the Division of Corporation Finance. As Deputy Director, he supervised that Division's Offices of Chief Counsel, Chief Accountant, Mergers and Acquisitions, International Corporate Finance, Rulemaking, Small Business, and Enforcement Liaison. He earned his J.D. from the Washington College of Law at American University and B.B.A at the University of Notre Dame. O'MELVENY & MYERS L.L.P, http://www.omm.com/martydunn/ (last visited February 7, 2011).

this new Rule 14a-11 that the Commission adopted.[31] And, while it's every company that it applies to, they gave it three year extension until it applies to smaller reporting companies, which is $75 million and under companies (based on their public float).[32] So, the basic notion all along was you can't opt out of Rule 14a-11, and it says, "so long as shareholders have a right under state law to nominate directors, those directors have to be included in a company's proxy statement, if."[33] Now why is this such a big deal? Well, everybody's always had the right under state law to nominate people for the board. Unfortunately, if you can't get the proxies to vote for them, you can walk in and nominate to your heart's content and they're not going to get elected. So the debate that's been going on in the Commission for the brief period of 1942 to now is when and where these nominees should be included in a company's proxy statement. When should the company have to basically pay for a contest? That's how this would work. And, the Commission up until this point in time has never said that the company ever has to. So, that's why proxy access is such a big deal . . . . What it says is, "If your shareholder have a right under state law to nominate someone for director, the company is required to include the name of that person on the card, include information about them in the proxy statement, and include your up-to-500-word supporting statement - if."[34]

The big "if." You have to have owned as a shareholder or group (you can form a group for this purpose) 3% of the company's voting stock for three continuous years.[35] And, an interesting thing the Commission said is, "What does it mean to own?" Because you know, we have all these borrowed shares [and] empty voting -everything that people are debating nowadays. And they said, to own it for this purpose, you had to

31. 17 C.F.R. § 240.14a-11 (2010).
32. *Id.*
33. *Id.*
34. 17 C.F.R. § 240.14a-11 (2010).
35. *Id.*

continuously have voting power and investment power.[36] Both, not either, which is the usual test for beneficial ownership – both, for three consecutive years. So, if you borrowed shares, you don't count them, because you couldn't sell them. If you've loaned shares, you can only count them if you can call them back in time. So, there's the first time you see the Commission delving into a little bit. What does "ownership" mean? You can have a change in control purpose, you can only have the intent to include this number of nominees that is permitted under the Rule that I mentioned, and you can't have an agreement with the company with regard to including the nominee. Why is that there? Well, the company could go to a 3% holder and say, "Why don't you ace everybody else out and put in a nominee that we like?" That really probably wouldn't go too well; it kind of defeats the whole purpose. So that's all it really is: 3% holder, no change in control, intent, for three years. If you meet that and you nominate somebody, the company has to put him or her in.

What does the nominee have to do? [He or she] can't violate the law; can't violate stock exchange rules, [and] has to meet the objective independence test at the stock exchange, not the subjective test – the part where the board has to say, "we subjectively have determined," because there is no way for the shareholder to know that.[37] Again the nominee can't have any agreements with the issuer, and the nominee is allowed to have any relationship with the nominating shareholder it wants.[38] A big debate has always been: won't these always be special interest directors and isn't that a bad thing? The Commission decided, "Once they are elected, they have fiduciary duties to everybody; we're not going to worry about that." So that's how they handled that problem, which was pretty much by blowing it off.

36. *Id.*
37. 17 C.F.R. § 240.14a-11 (2010).
38. *Id.*

The next thing: how many nominees are we talking about? If I'm a little hopped up, it's because my wife is running a half-marathon tomorrow and I decided I'd walk here – it's like a half a mile, right – and I got lost and I had to run over here at the last minute, so I'm still . . . I'm barely an adult. (Laughter.) The number of nominees that you have to include are up to 25% of the board, but not less than one, so it's always the greater of one or 25%.[39] Interestingly, this has led a lot of folks with 12 member boards think, "Should we really have 11?" You know, so that's something to think about. I think that's a pretty radical approach.

The priority of nominees - it was proposed that there was going to be a race to the post office for this purpose. As adopted, whoever is the largest holder wins. So, if I get the maximum number of nominees from a 4% holder and the maximum number of nominees from a 5% holder, the 5% holder wins and the 4% holder just loses. It probably encourages them to work together.

What is the disclosure part of it? The shareholder would be required to file a notice on its Schedule 14N with the Commission with the company.[40] Basically it gives information about the shareholder and about the nominating folks. The equivalent of what you'd see in a contest – a lot of background stuff that you'd see. It has to come in between 150 and 120 days prior to the anniversary of when you mailed last year.[41] So, to give you an example, the Rule was scheduled to become effective November 15, which means that if you mailed last year before March 15 (basically 120 days), there was no window to get a nominee in. So it really was applying to people who mailed after March 13, or 15 [if] it was a weekend, in 2010. So that's how that applies.

To exclude a nominee, everybody knows shareholder proposals in 14a-8 - there's this huge staff process, the

39. *Id.*
40. 17 C.F.R. § 240.14a-11 (2010).
41. *Id.*

way it works. Pretty much the same process came up for nominees – they've interjected the staff in there, you have to get a notice to the staff and the proponent within 80 days before you mail, you have to give them a chance to cure defects – it reads just like 14a-8.[42] The staff will give you a No-Action Letter – agreeing or not agreeing – and then just like with 14a-8 that doesn't hold any water and you may have to go to court anyway.[43] So that's a little dream come true, and it created exemptions to form groups among the shareholders, because if you didn't have an exemption from the proxy rules, you could only talk to less than 10 people. If you don't own 3%, it would be tough to form a group of bigger than 3%. So, the Commission adopted an exception from the proxy rules for forming groups and soliciting in favor of your nominee. So, [it is] very friendly as far as to shareholders and their nominees. What's the next thing?

Patrick Daugherty[44]: Not friendly to activists, though. I mean if you want to seek control to influence change in the company, you can't use this, right?

Martin Dunn: Depends on your definition of "activist."

Patrick Daugherty: Yes.

Martin Dunn: If you have an intent to control the company, the Commission is still going to call that a regular proxy contest and you have to pay for it, [but] if your intent is to be an activist and get a member on the board and agitate a little bit, [it is] very friendly.

Patrick Daugherty: What if you certified that you're not going to seek control, you get on the board, then some significant change of control transaction comes along, you support it and the others don't. Does that cast doubt on the viability of your election?

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42. *Id.*

43. *Id.*

44. Patrick Daugherty is a partner of Foley & Lardner L.L.P., 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 30 years of experience in major markets to customize solutions for business executives and financiers. FOLEY & LARDNER L.L.P, http://www.foley.com/people/bio.aspx?employeeid=18264 (last visited February 7, 2011).

Martin Dunn: That was always part of the debate. How do you know because you're just saying what you intend to do? Intent can change. I think the Commission gave a lot of flexibility into that. I think unless somebody could show that you were lying when you did it, but even at that point you've been elected under state law, not federal law. So there's a lot in this Rule – and this is a good point Pat brings up – there's a lot in this Rule that assumes everyone is just going to behave properly, and we know that in proxy contests that never happens.

Patrick Daugherty: Yeah. (Laughter.) Right, right.

Martin Dunn: There's a lot here. Why do you think Rule 14a-8 has 20 members of the staff who work three months on nothing but working out the issues on 14a-8, and that's just about precatory proposals – that's not even about somebody sitting on the board. So . . . everything in here just kind of assumes the world will be great; everybody will be happy to work together to get everything right.

There were a lot of other rules that got adopted along with it; they've all been stayed as well, and these are kind of smaller, so we don't need to hit on those. The next thing would be Rule 14a-8,[45] which is the same old shareholder proposal rule, but you remember 14a-8(i)(8)[46]- the Commission changed the rule in 2007 to say you can exclude a proposal company if it says "I want to nominate Marty to the board." We've always been able to exclude that one because it's not really a proposal, that's a proxy contest. But it also said you can exclude any proposal that would create a process whereby next year I could say "nominate Marty to the board."[47] And so clean that, clean that right out. Well, with this they completely reverse that and said, "Nope, you have to include those proposals, unless they would limit 14a-11."[48] So the Commission has this very, to

45. 17 C.F.R. § 240.14a-8 (2008).
46. 17 C.F.R. § 240.14a-8(i)(8) (2008).
47. *Id.*
48. *Id.*

my mind, paternalistic view of this, which is: we're going to create a federal right of access and we're going to allow a federal right to expand it. But even if the majority of shareholders want to contract it, no – you can't do that. And that got a lot of people up in arms and led to a little bit of the discussion at the beginning of the Commission meeting that I just want to read to you for a second. The Chairman phrased it this way, "Nominating a director candidate is not the same as electing a candidate to the board; I have great faith in the collective wisdom of shareholders to determine which competing candidates will best fulfill the responsibilities of serving as a director. To me, the critical point is that shareholders have the ability to make this choice."[49] [It is] kind of hard to argue against that; it's kind of apple pie, right? I mean it's good –

Patrick Daugherty: Uh huh.

Martin Dunn: And then you get Commissioner Casey who didn't quite agree as much, and she has what I think is one of the best two sentences I've ever heard in an open meeting. "In conclusion, I believe this Rule will find itself in the pantheon of ill-conceived Commission actions - firmly nestled beside the Commission's recent rulemaking relating to short selling and its interpretive guidance relating to client risk disclosure. In each case, I believe that we have abdicated our responsibility to act on the basis of empirical data and sound analysis, and instead have simply reacted to overwhelming political pressure."[50] So, not everybody was in agreement on that; it went three to two, everybody knew from the day this was adopted that it was going to be litigated.

Late in September – the very end of September, first of October – the BRT and the Chamber of Commerce brought an action in the Court of Appeals for the D. C.

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49. SEC, *The SEC Adopts New Measures to Facilitate Director Nominations By Shareholders*, http://www.sec.gov/news/press/2010/2010-155.htm (last modified Aug. 25, 2010).

50. SEC Commissioner, Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Director Nominations (Aug, 25, 2010), *available at* http://www.sec.gov/news/speech/2010/spch082510klc.htm.

Circuit, seeking to overturn the adoption of 14a-11, on grounds that have worked frequently in the D. C. Circuit in the Court of Appeals there, which is it was adopted in an arbitrary and capricious manner and not in compliance with the Administrative Procedures Act.[51] Personally, as a person who wrote rules for fifteen years, litigating under the APA always annoys me very, very much because there is no perfect way to do an economic analysis – what everybody calls the "back half of the release." We all read the beginning, and then we read the rule and we skip over two hundred pages in the middle that the Commission wrote, and then everybody sues on those two hundred pages because they can't sue on the substance. I was never a big fan of that, but the fact of the matter is that you have to have satisfied the APA, you have to have a cost-benefit, [and] you have to have an economic analysis. And so the BRT and the Chamber brought an action and said, "We don't think that they properly considered all they have to under the APA."[52] And one of the things they said is, including "We think that they've arbitrarily preempted state law and they don't have the right to do that, and they haven't shown why they needed to," and on.[53] Go ahead.

Patrick Daugherty: Marty, the last time the Commission went into the proxy area was Rule 19c-4, where authority was unclear; this was the way it's been. The BRT sued and won. I figure they're likely to lose this time because Congress in Dodd-Frank[54] gave the SEC clear authority; Does that not -

Martin Dunn: Well, there are two things. The 19c-4 action was the one share/one vote in 1989-90, where the SEC adopted a rule that said, "Exchanges, you have to adopt a rule

51. Business Roundtable, et al. v. SEC, No. 10-1305 (D.C. Sept. 29, 2010), *available at* http://www.uschamber.com/sites/default/files/press_release/1009stamped petitionproxy.pdf.

52. Business Roundtable, et al. v. SEC, No. 10-1305 (D.C. Sept. 29, 2010), *available at* http://www.uschamber.com/sites/default/files/press_release/1009stamped petitionproxy.pdf.

53. *Id.*

54. Dodd-Frank Wall Street Reform Act.

that says each share has one vote."[55] And 19(c) limits the Commission's authority to make the exchanges do anything; it's always this kind of dance that you have to do, where you suggest it and then they choose to do it because you can't make them unless you're granted specific authority.[56] And so in this one, the Commission was granted specific authority to adopt an access rule, but the manner in which it was adopted and the way it interacts with state law I think is still subject to the litigation. So, Dodd-Frank helps them, it does.[57]

Patrick Daugherty: So, they're essentially saying, "You didn't consider this carefully enough, Commission, even though Marty wrote the rule twice, commented on it a third time, it's been pending for about ten years and talked about for sixty years." You didn't give this enough process.

Martin Dunn: Yeah, basically. You didn't think about it.

Patrick Daugherty: I predict the Commission will win this one.

Martin Dunn: I'll take that. The interesting thing is as after - so - that went - I'll get to the interesting thing in a second. I'll talk about the boring thing first, which is that they went to the court and said, "Stay the effectiveness of these rules pending the litigation, or Commission you do it." And on October 4, the Commission came out with a release – [it] didn't announce it anywhere.[58] Just if you go to the rulemaking now, it says, comments available, final rule, stay. You know, this little thing at the bottom that you can click on. And so they stayed the effectiveness of all of these rules the changed to 14a-8, to new 14a-11, all the related stuff pending the litigation. And they did it on their own. They said that it's the best way to do this. And everybody pretty much knows now that it's not going to apply for this proxy season. Even the Commission has said they figure it'll be late Spring before this gets worked out.

55. 17 C.F.R. § 240.19c-4 (2005).

56. *Id.*

57. *Id.*

58. Order Granting Stay, Exchange Act Release Nos. 33-9149, 34-63031, 40-29456 (Oct. 4, 2010), *available at* http://www.sec.gov/rules/other/2010/33-9149.pdf.

So, why are we talking about it? Well, everybody had started trying to figure out what they were going to do about their bylaws, and what they were going to do about their director qualifications to make them comply to these nominees and how best to do it, and how did state law interact with federal law, and there was a lot of gnashing of teeth because it really seemed like there was just this federal law right that had been created, but we don't really care unless it's prohibited under state law. If you are not going to seat this director, we don't care. They have to be nominated, they have to be put on there. And, they even say, and I'm going to read you a couple of these things where it says: "but if you are not going to seat them because they don't meet qualifications we think that is an important disclosure matter." Well, how in the heck would that work, right? So, everybody kept trying to figure that out. So, after the litigation the interesting part came up. And, I'm going to tee it up by reading you a couple things from the release and then telling you what the Commission is now saying. First off, four quotes from the release. "While we are not aware of any law in any state that prohibits shareholders from nominating directors consistent with proposal, a company to which the rule would otherwise apply will not be subject to rule 14(a)(11) if applicable state law or the company's governing documents prohibits shareholders from nominating candidates for the board."[59] Okay, good enough. That's there. "Commenters were divided on whether companies and shareholders should be permitted to adopt alternative requirements for shareholder director nominations."[60] Okay, we get all that. Then we get to the good stuff, which I am flipping to. "As noted, the only exception is if state law or a company's governing documents

59. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56668, 56678 (Sept. 16, 2010) (to be codified at 17 C.F.R. 200, 232, 240, 249).

60. *Id.* at 56679.

prohibits shareholders from making director nominations."[61]

So we get all these points, and we are reading it and saying, "But nobody prohibits anybody from making shareholder nominations." Sure you have advanced noticed bylaw provisions that say here's how you do it. And, maybe I have director qualifications, which say I won't seat you if you don't meet these. But, nowhere is it prohibited from nominating. And it seems like it's this general prohibition. And, there is a footnote 374 in the release that talks about a 1930 case in Delaware.[62] They said that if you look at director requirements, they have to be met at the time you are seated, not at the time you are nominated.[63] So they said, even if you wouldn't meet them when seated, that doesn't prevent the nomination.[64] So, everybody reads this and thinks, "Okay this just overrides everything." And you see this in the litigation as we go along. Well, then September 20, just before the litigation comes out, Commissioner Walter is giving a speech and she says, "In that regard, I want you to know one practical point to keep in mind . . . . As you know access is only available when you have a right under state law to nominate directors. Many companies have requirements in their by-laws that are applicable to shareholders seeking to nominate a director. These apply to an access nomination or a traditional proxy contest nomination. For example, a bylaw may require that the D&O questionnaire be submitted for each nominee."[65]

Okay, well that seems to now say that if the advanced notice by-laws say you can't nominate somebody unless you meet the requirements of it, that that would

61. *Id.* at 56680.
62. *Id.* at 56704 n.374.
63. *Id.* at 56704.
64. *Id.* at 56704.
65. SEC Commissioner, "What's Next?": Remarks Before the 2010 Fall Meeting of the Council of Institutional Investors (Sept. 20, 2010), *available at* http://www.sec.gov/news/speech/2010/spch092010ebw.htm.

in fact would override 14a-11[66], which seems very different from the release. In fact, Commissioner Walter talks about D&O questionnaires. And, in the release they said, no part of 14a-11 would require a D&O questionnaire to be provided.[67] It says that in the release.

So, where are we? How does this work, and where is everybody? Well, everybody had started looking at this and started to change their bylaws to do what everybody has done after the Delaware cases a couple of years ago and seen it. Remember after that everyone distinguished, here's a 14a-8 proposal and how it works. And here's a just – "I'm going to raise this at the floor proposal and how it works," and made clear that they were two different things. So people started looking at their advanced notice bylaws for director nominations and saying, "14a-11 is its own animal and this is our process under state law." And they had already started differentiating the two. And a couple of people have already adopted those changes in the bylaws, filed 8-Ks and said it. And I had a lot of people who were about to do it at their November board meeting. And all of a sudden you've got the staff now saying, and they've put out 'interps' to this effect, "The distinction is do you have to meet your advance notice bylaws or your director qualifications or anything else in order to nominate the director, not seat the director."

So, if I have director qualifications that are in my guidance, you know, my principles of corporate governance or even in my bylaws that say you can't be a director if you don't [have] x, y, and z. That's not good enough. That would be a disclosure question. But, if I change my bylaws to say a shareholder can only nominate somebody to be a director if the nominee meets x, y, and z. Under the new statements the Commission staff is making to clarify what was in

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66. 17 C.F.R. § 240.14a-11 (2010).

67. Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56668, 56704-05 (Sept. 16, 2010) (to be codified at 17 C.F.R. 200, 232, 240, 249).

the release, and they're insisting that it was always there although none of us saw it. That latter thing would basically override 14a-11 and would override proxy access. The Commission said - made a big point of saying, "no private ordering." There is no private ordering under federal right of proxy access. Nothing is going on. And now they're all saying if something is valid under state law and it limits the nomination then that's what we were talking about from prohibited from nominating.

Patrick Daugherty: Well, this is a really important point because the release - it makes no suggestion of that at all. In fact, it is quite to the contrary that there will be no private ordering, that this overrides any inconsistent bylaws, etc. So, what do you do?

Martin Dunn: So what do you do right now? We have the benefit of - that's where I was going to finish.

Patrick Daugherty: Oh great. (Laughter.)

Martin Dunn: We have the benefit of the stay giving us time to figure out what to do. I think the Commission has the benefit of the stay figuring out what it is they meant. (Laughter.)

I think what you will do is - what you will see is a lot of companies that were planning on making bylaw changes are going to start spending time over the next month or two looking at their bylaws and figuring out how they can fix them, to focus on the nomination process and not the seating process. And, I also think you will see a lot of companies take their director qualifications and their subjective or objective enhanced independence requirements that go beyond the exchanges and move them from their corporate governance principles into their bylaws and then into the nomination part because I think that has the effect of overriding access in a lot of ways. Now, will shareholders hate that? I think because all it says is we've been holding ourselves to this standard all along, and now we are going to hold every nominee to this standard. I don't see it - of course activists will hate it no matter what - but rationally I don't see how that can be a problem. And, I think you are going to see people over the next few of months figuring out the best most effective way to do that. Sometimes it will matter on your shareholder base. There will be something's that matter of course. But, I think you will see more and more movement towards the nomination part of it.

Patrick Daugherty: Couldn't you put in your bylaws something that said, in order to be nominated, you know, you have to hold the stock for five years, ten years; something like that?

Martin Dunn: Yep. You could. The question is whether under state law, the state courts would find that to be a reasonable standard. And, so you have to look at the reasonableness.

Patrick Daugherty: Can you say, if the nomination comes from outside, not from the board or the nominating committee, it must be submitted on behalf of not less than 10% of the shares outstanding, something like that?

Martin Dunn: You can do that. I don't think you'll see people do the 10% and 5% because that's a direct "we're trying to override access" kind of thing.

Patrick Daugherty: Yeah, yeah.

Martin Dunn: And, I think that activists and Risk-Metrics and the people who care about such things would make your lives miserable for doing that. So, what I think you will see people focusing on is we want to make sure we are getting the right directors and the right information about nominees because they're more likely to pass the reasonable test at state law and the 'smell test' with and Risk-Metrics and activists. So that is probably what you will see. The people - we have a few months to figure this out and also to look at the litigation. But, that is where we are now. So, your clients, your company, be looking at your bylaws and be thinking about how to do that.

Mark Metz[68]: And you're expecting companies to be doing that in the interim before the case is finalized?

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68. Mark Metz is a member of Dykema Gossett P.L.L.C, and provides general corporate and securities representation for many of the firm's publicly-held corporate clients in areas such as defensive planning, directors' duties, periodic reporting, disclosure, the

Martin Dunn: I think what you will see is a lot of people having it up and pushed right to the edge. But, just in case the SEC loses I don't think you'll see them doing it because why stick your neck out if you don't have to. But, I think there will be a lot of folks preparing to do it and figuring out how to go there. And, I actually think that there are parts the SEC could lose on. The authority part they are dead solid [on]. But, the other part, the APA part I'm not sure. You're next.

Mark Metz: I'll take the mantle of responsibility.

Elliot Spoon: We're going to get your PowerPoint.

Mark Metz: While we're doing that, let me just tell you quickly what I'm going to talk about. We're going to slide over to some of the more nitty-gritty stuff of Dodd-Frank. And, I'm going to focus mostly on proxy disclosure items coming either this coming proxy season or the following proxy season. And then Pat is going to take some of the miscellaneous Dodd-Frank. So here is a list of what I am going to be talking about: the couple of compensation committee items on independence, new independence standards, and advisor independence, the three say on-pay issues, the other proxy disclosure items - I don't really have any other good way to talk about those, and, then finally I just want to briefly mention changes to the broker uninstructed voting rules, which we talked a little bit about last year. That is a lot of ground to cover in 15 minutes, so let's get rolling. First, just some overview on the Compensation Committee issues. The rules described in the next couple slides relating to committee independence and advisor independence will be implemented primarily through exchange listing requirements. So, if you represent companies

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responsibilities of corporate insiders, stock-based benefit plans, insider trading rules and Board special committee representation. 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 a member of the firm's Public Company subgroup, advising clients on various corporate governance and compliance issues and monitoring related legal developments. Mr. Metz also provides representation and guidance to privately-owned businesses. DYKEMA GOSSETT P.L.L.C, http://www.dykema.com/bio/display.asp?empID=155 (last visitied February 7, 2011).

that are over-the-counter companies not listed on NASDAQ or NYSE or other national security exchanges, these rules won't apply to them. Timing-wise, even though I noted there (in the slide) it could come sooner than July of 2011. Based on the SEC website right now, the schedule is for the final rules to come out in the second quarter of next year, which means they probably won't be in place for the 2011 proxy season.

As you can see, the Act will impose membership and heightened independence requirements for compensation committee members of exchange-listed companies, the new rules will impose a higher independence standard on the directors who are part of the compensation committee and will require that the compensation committee members all be directors, which is actually just a codification of what exchanges generally require. Interestingly, the Act leaves it to the exchanges . . . whether to require a committee or not. And, you may be familiar with the fact that the NYSE requires each listed company to have a compensation committee, but the NASDAQ does not. And it allows compensation decisions at the board level to be made by the independent directors. It will be interesting to see when the rules come out whether the SEC or the NASDAQ will eliminate that flexibility for those few companies that do use that; and, whether they'll impose the same heightened independence requirements on the independent board members who make compensations determinations. And, I guess there is one other observation and that is the heightened independence standards that will have to be met. [It] will probably look a lot like what we see for audit committee members today. That is that they cannot be affiliates and they really can't receive any compensation from the company at all except for board and committee fees.

A couple of things that the Act doesn't require- to set up this next slide - the Act doesn't require that a consultant or an advisor be hired by a compensation committee. It doesn't require that they be independent if they are hired. But, the Act will require that the committee have authority and funding to hire advisors, just like audit committee does after SOX, and if the committee decides to hire advisors, it must consider the independence factors to be determined by the SEC. The Act lists five factors, which I will leave for you to read on your own. But, the committee doesn't even have to base its decision on hiring on whether the advisor is independent or not. Interestingly, there is then a disclosure requirement that goes along with this that says that if you hire a compensation consultant - consultant, not a legal advisor, not a lawyer, not some other sort of advisor, but a compensation consultant - you have to disclose that. That's actually a codification of existing rules. But, if you hire somebody who has a conflict, then you have to disclose the nature of the conflict and how it is being addressed. That's new and different and the new rules will flush out how exactly you will have to say all of that. I think we can move on to the next slide.

Okay let's turn to say-on-pay issues. And, a lot of this I'm sure, if you've been following the press, you know already. There's been dozens and dozens, if not hundreds of law firm memos that have circulated on this. But, let me just give you the basic background information on say on pay. First, there is a requirement that at least once every three years each public company must include in its annual proxy a non-binding resolution asking shareholders to approve the compensation of executives that's disclosed in the proxy pursuant to Item 402 of S-K. That is pretty similar to what TARP banks already have to do and to what some other companies have adopted voluntarily or sort of voluntarily due to shareholder pressures. Second, at least once every six years, each company has to include a non-binding resolution asking shareholders to decide how often to have a say-on-pay vote. Now, there are a lot of interpretive issues that are raised by these provisions, especially the second one about the 'say when' proposal, which is what most people are calling it today. How to count the vote, for example? How to structure the resolution - do you give shareholders all three choices and have them pick one? What happens if they don't get a majority vote on any of those three? Lots of interpretive questions. The SEC has promised to have rules in place by the first quarter of next year. So, we should know how this is all going to play out for our next year's proxy statement. But, regardless of whether they get those rules out or not, Congress has said you have to have this in your proxies next year. So, if the SEC doesn't come through for us, we're going to be left in no-man's land.

Martin Dunn: And, really no-man's land because if you put out a proposal right now that says "Do you want one, two or three years?" that violates 14a-4[69], which says you have to give me a yes or no choice. So, you can't give them a pick a, b, or c. And, also the SEC rule right now would require everybody to file a preliminary proxy if you've got a say-on pay event. So, there's motivating factors for them to fix that. (Laughter.)

Mark Metz: That's my next point actually, they have to change 14a-6 or they are going to get deluged with preliminary proxies. And, they did include in 14a-6[70], about a year ago, they included an exception for TARP banks who had to do the say-on pay proposal pursuant to the relevant statute. That won't apply broadly to what's in Dodd-Frank. And so, hopefully they'll expand that or they're going to get preliminary proxies from every public company. It's also important to remember that even though these proposals are non-binding, ignoring a vote against a compensation say-on-pay proposal will be done at your own risk. And, I say that because RiskMetrics and other proxy advisory firms will penalize you by recommending a vote against your directors in the next annual meeting. And, it could also even rise to the level of generating

69. 17 C.F.R. § 240.14a-4 (2010).
70. 17 C.F.R. § 240.14a-6 (2010).

activists who say "well let's put our own slate out there because these directors aren't listening to what the shareholders are saying." So, it could have some negative consequences. It remains to be seen what effect these are going to have. TARP banks and the others who had voluntarily included such proposals, you could probably count on one hand the number of say-on pay proposals that were voted against last year where the pay went down to defeat.

But, I think because of some changes to the broker uninstructed voter rules that I'm going to talk about in a minute, there may be some more of those proposals that get defeated just because the way that it's going to give more voting power to institutional shareholders and these proxy advisors. The last say-on-pay issue is the say-on-pay requirement that in any proxy to approve an acquisition of the issuer after January of 2011, the issuer has to disclose change of control payments to be received by NEOs and include a non-binding resolution to approve those payments.[71] But, (and this is a big exception) the separate vote requirement for change of control payments, does not apply if the compensation arrangements have already been submitted to shareholders for approval.[72] So, you have a disclosure requirement imposed by Dodd-Frank, but I think most companies when they are doing a merger proxy, probably already have included information on change of control payments because there is already a requirement that, in a merger proxy, that you show interest of insiders that are different than shareholders' interests. So, I know in the last one that I did, we took the compensation, the change of control compensation information from the proxy, from the last annual meeting and dropped it right into the merger proxy. I think a lot of companies do that.

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71. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities Act Release No. 33-9178, Exchange Act Release No. 34-63768 (Jan. 25, 2011), *available at* http://www.sec.gov/news/press/2011/2011-25.htm.

72. *Id.*

Robert Hudson[73]: Mark, what if there is a binding contract that the board had entered into previously and that the shareholders vote no?

Mark Metz: Well, that's actually a great point. And, I was going to make the same point. Between the fact that you have binding contracts and you have really no consequence to voting down the compensation because there won't be another annual meeting where Risk-Metrics can say don't vote for the directors, my conclusion is this probably won't have a lot of effect on changing behavior of companies, which I think is really the point of all this – changing compensation behavior at companies. And, if you guys disagree with that or see something else.

So, this was probably just more of a visual thing that I think Congress got into the Act, but I don't think ultimately it is going to change much of anything. And, I'm sure officers who are losing their jobs aren't going to be excited about decreasing their pay because shareholders' sales.

Robert Hudson: Possibly. I guess you could have the advisory firms, such as Risk-Metrics, criticizing the acquiring company, if it's a public company, and maybe try to use that. But I agree with you. I think that it's much weaker.

Mark Metz: Okay, well let's move on to some of the other proxy disclosure items. And, the first thing we talk about here briefly is the pay versus performance. Issuers will be required to disclose in the annual meeting proxy information that shows the relationship between

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compensation actually paid and the issuer's financial performance. That's the statutory language.

Audience Member: What does "actually paid" mean?

Mark Metz: Well, that's exactly right. What does that mean? If you look at the summary compensation table in any annual meeting proxy, there is a lot of information there about compensation that isn't actually paid. It's a -

Audience Member: - It might be paid.

Mark Metz: It might be paid. It's an accounting measure of what they think will be paid. But, it isn't actually paid. So, that's just one of a number of interpretive issues that come out of this. Another, is how will the SEC decide what issuer financial performance is? Is that EPS? Is it return on equity? What is it? How do you decide? Will the SEC give a range of ideas to companies, or will they just give companies the ability to say "this is what we think is the best for us," and put that in their proxy statement? Will they require an expansion of the five-year performance graph – add a couple of lines on company performance? Lots of different ways that this could come down. We just don't know. And, we won't know, most likely, until sometime next year - probably this time next year because proposals, according to the SEC website, are not expected until the second quarter of next year. They've got a lot on their plate to do before that comes.

The internal pay ratio is the next one. Issuers will be required to disclose in each SEC report subject to SK Item 10(a), and I will tell you what that means in a minute. First, the median of annual total comp of all employees other than the CEO; second, the annual total CEO compensation; and then, the ratio of the two amounts. That's the internal pay ratio. And this is suppose to explain to shareholders whether there is internal pay equity – whether the CEO is being paid too much or not. This requirement, I guess first is it's going to be nearly impossible for many companies, especially large multi-national companies, to calculate who have thousands of employees spread over a number of different countries who are paid in various currencies. That will create problems for them. What do you do with partially owned subsidiaries or affiliates? What do you do about part-time employees? How do you value union benefits? Lots of issues here for the SEC to try to put into some concrete methodology.

The second problem here is that Congress said that total compensation is to be determined based on Regulation SK 402(c)[74] - that's the summary compensation table requirements in effect in July 2010 – right before the Act came out. So, if the rule ever changes, the company is going to have to go back to that old rule to make the compensation calculations and they are going to actually have to do two calculations for their executive officers to decide whose compensation ends up in the summary comp table. So, some issues there to sort of look at as the SEC goes forward.

And then finally, the statute requires disclosure be included not just in the proxy and in the 10-K, but in every filing that is subject to S-K 10(a)[75], which is 10-Qs, 8-Ks, 10, tender offer documents, 33 and 34 Act registration statements, and going private documents. None of these, well almost none of these, have compensation information normally. Hopefully what the SEC will do is - they will say put it in your annual proxy statement, incorporate by reference in all these others with just a line or something that says, "The information from such and such document, our annual meeting proxy from the last year, is incorporated by reference" so, that they don't have to be repeating all this information over and over and with no context around it. The Act requires exchanges to impose an obligation on listed companies to adopt clawback policies. I am not going to spend a lot of time talking about clawback policies other than to tell you that it is a policy that requires the issuer to recover compensation in certain situations where there has

74. 17 C.F.R. § 229.402(c) (2010).
75. 17 C.F.R. § 229.10(a) (2008).

been a restatement of financial statements, and there is a disclosure requirement. It is not clear where exactly that will end up, but my guess is that it will be treated a lot like the code of ethics requirement was after SOX, since there will be a proxy disclosure that describes the policy and so forth. Pat is going to give us more detail on that in a few minutes.

Internal hedging policies will also have to be disclosed now, and, that is whether the company has a policy allowing directors and employees to protect themselves from declines in the stock value. And, if you don't have a policy - this is okay - and the company still has a choice whether to have a policy or not. But, if you don't have a policy you have to explain why it is a good idea not to have a policy. If you do have a policy, you have to explain what that policy requires. Then there is also a requirement for leadership structure disclosure. But, this requirement basically just codifies what's already required in S-K item 407(h)[76]. So, I'm not looking for any rule changes here. But, it is interesting, as you probably have noticed, that in a number of cases Dodd-Frank [is] just codifying or sometimes codifying and expanding requirements that are already in SEC rules.

Martin Dunn: And, a little bit of that is a number of the things in there are kind of wish list items that have been out there for a long time, and the SEC had already taken up a number of the wish list items in the last year and a half. And, so you saw them being pushed on both fronts. And, now it's just going to pile up.

Mark Metz: Just a couple of other miscellaneous disclosure items. The first is that the Act contains what I would say is an invitation to the SEC to modify the 13(d) and Section 16 beneficial ownership requirements as they relate to some of the "swap" and other interesting financial instruments that have been covered by the Act. There is no indication at this point whether the SEC's going to take them up on that invitation, but just keep your eyes open. And that would impact your proxy

76. 17 C.F.R. §229.407(h) (2009).

statement because 13(d) is where you go back to for your beneficial ownership requirement definitions.

And then one last issue, which is actually something that wasn't adopted for those of you who were sort of following it in the *Wall Street Journal*, what was going on with Dodd-Frank. One of the things that was in the proposed bill for quite a while was a majority vote requirement for directors. At the last minute, that was taken out. So, if you haven't seen that and wondered whatever happened to that -that was not included in the final bill. It came out as part of a compromise towards the end. So, your plurality vote requirement that most states have - most companies have - still applies unless you have adopted something higher.

Then the final point I want to touch on are just some changes to the uninstructed rule for voting rules. If you were here last year, you remember me sitting up here telling you about something called New York Stock Exchange Rule 452[77]. And, you remember that last year 452 was modified to eliminate the ability of brokers to vote shares that they hold in record ownership, but don't have beneficial ownership, if they haven't received instructions from the client that holds the beneficial ownership of those shares. The Act, again, codified that change, but expanded it as well to include any compensation item, including the three say-on-pay issues that we mentioned before, and also gave the SEC an invitation to include other significant matters. And so, in the interim since Dodd-Frank was adopted, New York Stock Exchange Rule 452 has been expanded to conform with the new Dodd-Frank requirement to cover director - I'm sorry, it already covered director elections - but to cover all of the compensation related matters including the Act's say-on-pay. And the NASDAQ, which has a similar rule, has adopted, or has proposed conforming rule changes that will, basically, make it the same as Rule 452 to cover director, uncontested director

77. *See* NYSE Rule 452, 1996 WL 34424015 (2009).

elections, as well as the three say-on-pay compensation related proposals.

One other point just to make clear is that the SEC's proxy plumbing initiative may have a bit of an effect here going forward, as one of the ideas that's been floated is whether to allow brokerage clients to give standing directions to their brokers to vote for or against management nominees and proposals. The idea here is to cut down on the number of uninstructed shares, and the hassle factor: if a customer always wants to vote in favor of management, they can simply give their broker that instruction, and so those shares will no longer be uninstructed and will be voted. But, what is likely to happen in the interim, before we get any rules on that, is that institutional shareholders and their advisors, like Risk-Metrics, are going to have much greater power because with the number of uninstructed shares not being voted, it's going to make the denominator in the fraction, determining whether you have a majority vote on something or not, it's going make that smaller and its going make the institutional shareholder's holdings have more power.

Robert Hudson: Or a quorum.

Mark Metz: Well, yea. You can still get that though with something like an auditor ratification. But, it will definitely give Risk-Metrics more power, which, in my view, they didn't need. And, let me pass the baton over to Pat now.

Patrick Daugherty: Oh, okay. Thanks.

Student: Just one second and I'll get you going.

Patrick Daugherty: So, Marty and Mark talked about the really interesting stuff. And, I'm going to cover miscellany in three areas. First, what Congress considers "improvements" to Sarbanes-Oxley. I put that in quotes because, and I'm amazed that we're two hours into this program and it hasn't been mentioned yet. Dodd-Frank was enacted on a party-line vote. This is a very political piece of legislation. And, whether it's an "improvement" or not is therefore very much a function of where you sit. I'll have more to say about that later. But, there were at least three things in the law that had antecedents in Sarbanes-Oxley, and here they are. One is the treatment of the internal control audit requirement for all public companies that was enacted by Sarbanes-Oxley[78]. It's always been a problem for the smaller companies. It's a problem for the bigger ones, too. But, they have more resources with which to deal with it. So, one piece of good news for those who favor free markets, in fact probably the only good news I have here, it's the only deregulation measure, is that there is now a permanent exemption for the smallest of public companies from this audit requirements altogether. If you have a market cap, a float rather, of 75 million dollars or less, you're exempt from this audit requirement. That was long expected and it's now permanent. And, you know, whether a company that small ought to be public or not, but this certainly facilitates it because it eliminates a major expense item. It does not eliminate internal control requirements altogether because the company itself, and its management still have to install internal controls and attest to them, but you don't need to hire an auditor to that as well. So that saves, probably, seven figures. It gets worse after that. Like I said, this is the only piece of good news.

Whistleblower bounties: there were whistleblower provisions in SOX, as well. The "improvements" are to require the SEC to reward whistleblowers with anywhere between 10 to 30 percent of the amount of any case with sanctions above a million dollars: so, 100K to 300K or more as a bounty to a whistleblower for any case now, not just insider trading. It could be foreign corrupt practices, to internal controls, anything. And, there are additional protections against retaliation for whistleblowers. You're not bound by a pre-dispute arbitration clause, you can go directly to federal court; you do not have to go to the Department of Labor anymore. After SOX was enacted, all these people went to the Department of Labor and the labor

78. Sarbanes-Oxley Act of 2002, 18 U.S.C. 7201 (2002).

and employment lawyers in my firm would come to me and say, “Why are these whistleblower inquiries coming in on SEC names?” I would say, “Well, Congress passed a law, it has to go through DOL.” Not anymore. You go to federal court. You get a jury trial. You know, all kinds of “good things” here for the trial bar. And so, you can expect more whistleblowers. And, the general counsels of companies that I advise absolutely expect more whistleblowers, which may be a good thing or bad thing, depending on where you sit.

Enhanced clawback. I won’t get into this a whole lot. But, there was a claw-back provision in Sarbanes-Oxley. And, we now have new and improved clawback, which says that every company has to develop and implement a clawback policy, according to which, the company will recover incentive-based compensation paid to any executive officer on the basis of erroneous data arising out of an accounting restatement due to material non-compliance with any financial reporting requirement.

Let me simplify that for you. Whenever there’s a restatement, it’s because there was material non-compliance with financial reporting requirements. So, you have a restatement if somebody had incentive-based ‘comp’ and that someone is an executive officer. It doesn’t have to be the CEO; it doesn’t have to be the CFO. It could be the head of some major product line with a revenue target. For example, sell this many cars in Europe and you get a bonus with us, okay. And, if you were paid some incentive-based ‘comp’ - a “bonus,” based on the erroneous data, the company has to claw it back. You don’t have to show misconduct. It’s no-fault. And, you know, this is why I think Congress did that because Sarbanes-Oxley[79] required a showing of misconduct out of a very few cases; I can only remember one. If there were two or three, forgive me because I am getting old. I forget. But, I know there was at least one and maybe not long ago. It was at least five years after Sarbanes was

79. *See generally* Sarbanes-Oxley Act of 2002, 18 U.S.C. 7201 (2002).

adopted before the first claw-back case was brought. So, they said fine, we'll eliminate the misconduct requirement and broaden this out to all executive officers. And, by the way, it's now a three-year look-back, not a one-year look-back. I think this is going to - here is what I foresee happening. I foresee economic harm to innocent executives who have nothing whatsoever to do with the restatement.

Robert Hudson: Are there such things? (Laughter.) That was Joe's question.

Patrick Daugherty: Well, if I get a bonus based on selling so many cars in Italy, and I never look at financial statements, and there is an error by the finance department, you know, misstating the revenues for the corporations, I think I'm innocent because that was some other part of the corporation that erred. I had nothing to do with it. But, I would have to give my money back for up to three years after I earned it.

Mark Metz: But, doesn't that enhance your fiduciary responsibilities, to look over everything?

Patrick Daugherty: Yeah, well, it's true. Every time you eliminate a requirement of scienter or fault it enhances your responsibility because you can't avoid liability on that basis so of course it does. I mean, strict liability would enhance it even more.

Martin Dunn: Pretty much what it is, isn't it?

Patrick Daugherty: Well, it is very close to strict liability. I mean, you still have to show some causation. You have to show that you were paid based on the erroneous data, you know. And one thing that I predict will happen here will be executive 'comp' packages will be redesigned to steer them away from the financial statements somewhat so that it won't be so obvious.

Mark Metz: Which basically reverses, it reverses the trend towards performance based. If I have to - if I get a bonus and I have to put it in the bank for three years just in case there was a financial statement restatement, that's a huge risk.

Patrick Daugherty: That I had nothing to do with because I'm busy selling cars and I'm not paid to look at financial statements or don't know how.

Martin Dunn: The two questions I'd ask on this is -

Patrick Daugherty: - Sure.

Martin Dunn: One is facetious, which is, are there also claw-forwards? Which I think is a good question. Apparently there aren't. If it turns that you would have gotten more of a bonus, well you're out of luck. (Laughter.) The other is, what about folks who have been gone less than three years? (Inaudible). How are you going to get it back from them? I think people are just going to have to ride that out.

Patrick Daugherty: Here's what I see coming. I think there's going to be some reluctance by the company to assert claims against people that they consider innocent. I think that there will then be derivative claims that are brought where demand will be excused because they will say, "Well, this is some kind of cover up inside this company." So we'll have derivative claims. I predict that there will be independent investigations performed and independent directors will be called upon to pass upon these issues and decide whether claims can be brought or not. That's all going be litigated. It's a boom for the trial bar.

And, then there'll be other issues that arise, such as, what about indemnification rights? Many executives have indemnification rights from the company. Do they not count anymore? What about insurance policies? What if there is a D&O policy with "side A" coverage for directors and officers in the event that economic loss is asserted or claims are asserted? What happens there? I don't know the answer to that. And I don't think other people know. I think this is going to require a lot of focused attention. You know. And unfortunately, there's no "stay" here. This is coming online now.

Third -and by the way, I don't pretend to have the answers to all this. I'm just pointing out that it depends very much on where you sit, you know. When everyone of one party votes for it and everyone of the other party votes against it, you can be pretty sure politics are involved.

So, that's enhanced clawback. Let's talk for a minute about some of the things on the Agency's agenda given to it by Congress. And here, I want to flag several things, again, just to make my main point. So, section 342 says "every financial regulatory agency, including the SEC, will have an Office of Women and Minority Inclusion."[80] So, this is something the SEC is establishing.

Skip down the page. Section 1502 says there will be a concept release regarding conflict mineral disclosures.[81] You know, what happens in Sub-Saharan Africa – [the] conditions there? What are public companies going to have to disclose? What they have to do with conflict minerals? Section 1503 says that there will be rules regarding disclosure of mine safety information.[82] So, here, this is the mining industry, a very bad industry. You understand? And then, Section 1504, a concept release regarding resource extraction issue or disclosure.[83] That would be the oil industry, another very "evil" industry.

So, now I just say, looking at those four provisions. I ask you this question: how many people think that the 2008 stock market crash was caused by the failure of agencies to have an Office of Women and Minority Inclusion or (laughter) defective conflict minerals disclosure, or any of these provisions, or the recession for that matter? How many people think it was caused by that? I take it that you agree with me, therefore, that this has nothing, whatsoever, to do with the 2008 stock market crash or the ensuing 'Great Recession.' And, that there may be some other political agenda at work, possibly. So, that's my sole point. And, by the way, I'm not saying this is good or bad. I'm saying these

80. Dodd-Frank Wall Street Reform Act, § 342 (codified at 12 U.S.C. § 5452).
81. *Id.* at § 1502 (codified at 15 U.S.C. § 78m).
82. *Id.* at § 1503 (codified at 15 U.S.C. § 78m-2).
83. *See generally* Dodd-Frank Wall Street Reform Act.

provisions have nothing to do with the ostensible purpose for which the Act was enacted.

Martin Dunn: And do not sleep on section 1502. (Laughter.) The conflict minerals part of that is massive. It is, if any part of any of your product contains minerals, you have to prove that they did not come from the Democratic Republic of the Congo, or related areas, and you have to get a third party audit to prove that. It is a massive undertaking. It's not [in the] rules yet, but that's what the statute says.

Patrick Daugherty: I'm one of those poor fools who doesn't have a life. So, I actually read the entire Act. Which is more than I dare say any Congressman did. I started out on Saturday morning and I took time out for meals and I took notes and I finished Sunday evening. And it is a compilation of work that permanent staff for Congress and the Senate have had on their wish list for years, and they just saw an opportunity to get all the things they wanted to have for a long, long time. And, so they all found their way into this bill. But, do not think that this is about the stock market crash or the 'Great Recession.'

Here are some other things coming up. The SEC will establish an Office of the Investor Advocate. Huh? I looked at the website and on page one it says, quoting William O. Douglas, "We are the investor's advocate," close quote. (Laughter.) It doesn't say, "We have an Office of the Investor Advocate." This is a slap at the Agency by a Congress which was itself, in the view of many, very responsible for the economic problems we've had in the last couple years. Here's an interesting thing that will not happen when they call the Chairman of the SEC to testify before Congress. Here's what she cannot say. She cannot say "It's your fault." You know why? Because they write the checks. If she said that, then her agency wouldn't have any money next year. So, there's no true accountability of cause and effect blame for this crash within government. They beat up on the SEC because they can. That's why they do it. And, this is a slap at the SEC.

So, we're going to have an Investor Advocate appointed by the Chairman. This is a person "experienced in advocating for investors," close quote. This person is allowed to retain an independent counsel for his or her own staff. The job is to assist retail investors with the SEC and the SROs; to identify problems with Wall Street brokers, dealers, [and] financiers; to analyze rules from the investors' perspective. So far, I'm wondering, "yeah, what's new?" But, and, has full access to all SEC documents; is to make (sighs) an annual report to Congress, including a report on the responsiveness of the SEC to the Investor Advocate's suggestions. Okay. And, here's best of all: there's to be no prior review of this report by anyone at the SEC, including the Chairman. So, you now have, essentially, a fourth column, or a fifth column, installed inside the SEC reporting directly to Congress about the agency itself with full power to roam everywhere within the Agency.

Not a happy place to be. They already have an I.G. And, as if that's not enough, the Investor Advocate is going to appoint an ombudsman. I've always thought, and I've practiced law for thirty years, that when you see an ombudsman, you have a troubled organization. That's what I believe. But so, and the job of the ombudsman is to be a liaison between the retail investors and the SEC. Excuse me, I thought that's what the Investor Advocate does, but apparently not. So, then we go and we have a Whistleblower Office, which will make an annual report to Congress on whistleblowers and the SEC's response thereto, so you dare not drop the ball, I guess, in any respect. There will be a new Office of Municipal Securities. I actually think this is a very good idea. I believe with Commissioner Walter, that the "muni' market is a deficient disclosure venue and that there are very severe problems brewing there, which you will not find in official memoranda collected by the MSRB.

So, I believe this is long overdue for attention. There have been political pressures to stay away from it, but this is coming back now. One of the first things they have to do is propose permanent rules to register municipal advisors.

Sometimes this stuff hits close to home. I read just last week, I just about choked on my Cheerios when I was reading the morning newspaper- I read that a municipal securities advisor in Southfield, Michigan had been indicted for running a Ponzi scheme where he was taking money from local school districts and supposedly investing it in CDs and very safe 'munis;' but he was using it to buy jewelry, among other things. You know, upwards of 10 million dollars. And, what really made me choke was the principal victim of this was my very own high school. Mona Shores High School lost three and a half million dollars out of a recent bond issue this way. The guy is unregistered; the business is completely unregistered. And that was lawful. But no one ever checked his books and records. Ever. There was never an audit at all because none was required.

989(g) says even if you have more than 75 million in market cap, if it's 250 or below we still think maybe, just maybe, you should get some internal control audit relief.[84] So, there needs to be a study of this.

You know, Hugh, in questioning John earlier, brought out the fact that the SEC, now, is subject to internal controls itself and must report on them annually to Congress. It is sort of like "eat your own cooking," if you will. And, by the way, I will say, very many of the reforms that Hugh and John were talking about, you know, may be laudatory. They all came about as a result of this bill. Those were not voluntary activities on the part of the SEC. They were told they have to do it by Dodd-Frank. So, that's why it's happening.

You know, we've covered the rest of this. I could talk about credit ratings and rating agencies.

84. *See generally* Dodd-Frank Wall Street Reform Act.

Robert Hudson: Yeah, but you can't because we're out of time. (Laughter.)

Patrick Daugherty: But, I'm not. I'm not. I'm not. (Laughter.) And, it is not as interesting anyway, unless you happen to work with rating agencies a lot. Get me on the coffee break and I'll tell you what you missed. But, Bob why don't you go to it?

Robert Hudson: Thanks, Pat. I've got minus ten minutes, so - (Laughter.) But, anyway. I'm talking about a little different aspect of Dodd-Frank, of course, which you heard something about earlier today on the first panel, of course, and that's the concern about hedge funds. And, a quick history for those of you who may not have had the background. Starting in 1998, the National Securities Improvement Market Act bifurcated federal and state authority and basically established a setup where, and I'm going summarize quite a bit, if you had under 15 clients you did not have to register with the SEC. [85] That was one basis for an exemption. If you had over 15 clients and you had assets under management of under 25 million, you did not have to register with the SEC. Between 25 and 30, you could, if you wanted to, register with the SEC. And, over 30, you had to register with the SEC.

Well, we've had about 10-11 years experience with that Act, give or take. And, of course, we've had a number of scandals. We've had Bernie Madoff. We've had Allen Stanford. We had others. And, so this has been a very hot issue. A few years ago, the SEC - I'll get to them in a second - but the SEC adopted a rule that would say for clients, you have to look through your funds. If you're an investment advisor to a fund, you had to look through the fund and count through the number of investors in the fund as the clients, which would obviously put many of these funds, which had up until then been exempt from registration, subject to registration because they had more than 15 investors, typically, in these funds. That was eluded to

85. National Securities Markets Improvement Act of 1996, 15 U.S.C. §§ 77-z3, 78mm, 80b-3a (1996).

earlier. The *Goldstein*[86] case came; the SEC lost; the court said you exceed your authority; you were not able to do that. So, when Dodd-Frank, the whole financial scandal occurred, there was a lot of motivation on the part of legislators [to] regulate these funds, hedge funds, and other funds. So, now we've gotten a law, frankly, that represents a lot of compromises. It raises quite a few questions. I'm not so sure it's an improvement. I don't know. It's responsive to state regulators who wanted more authority. But, one of the keystones of that act was the elimination of the exemption for people with under 15 clients. Obviously, that, again, had been used by - that was the principal exemption used by private funds, such as hedge funds, advisors to funds who would have a fund, many funds sometimes with a large number of people, but each fund being one client and therefore they were able to escape registration. So, that has been taken away and replaced with a further regime.

The assets-under-management test has changed now, also. This slide talks about the prior rule that I just described to you. There was also what they call a multi-state rule, which we won't talk about right now. You can look into it; it's not that relevant to our discussion today. But, essentially, Dodd-Frank has changed the landscape and has revised the bifurcation between the state and the federal government, in terms of assets-under-management. And, generally, I say generally because, believe me, this is highly complicated. To understand exactly what regime would apply to a given advisor, you practically need a chart to analyze the various aspects of it because there are conditions associated with a number of these categories. But, generally speaking now, if you have under 100 million in assets you register with the states; over 100 million in assets you register with the SEC. So, that obviously is going to shift a great deal more regulatory jurisdiction authority on the part of the state

86. Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006).

regulators, which is what they wanted. I know some of them now are saying, “Now that we got this now what do we do?” They have to start examining and looking, and they are going to be exposed if there is a scandal. If there is another scandal like *Stanford* or something, and the person is not registered with the SEC, of course, it is the state that is going to get the primary blame. The interstate exemption - there is also an interstate exemption, where again, if all you clients are in one state and you didn’t furnish advice in regards to national security exchanges therefore presumably you didn’t have an impact on interstate commerce. That has been taken away. Again, another effort to get at the private funds, some of whom were organized on an interstate basis. There is a new rule for foreign advisors.

Again, I will simplify this a little bit. The significant thing here is that that, while the slide talks in terms of exempted conditions for foreign advisors, the biggest news in this actually is that any advisor that holds itself out in the United States as an investment advisor [that] has more than fifteen clients, or very significantly has over twenty five million assets under management that is related to US clients, will have to register. So that is going to bring in, again, more of these funds that have been so far escaping registration under SEC jurisdiction. I predict, some of these funds will close the doors to US investors because they don’t want any part of the regime. Venture capital funds – this was an interesting compromise. The SEC is to define what a venture capital fund is, and once it defines it, those funds will be exempted from registration. They will not be exempted from the record and reporting requirements that are coming up, but they will be exempted from registration. Interestingly, there was debate and argument whether private equity funds should be exempted, and that battle was lost. They are not exempted. So, even though there is a lot of similarity, I think a lot of people would say there is quite a bit of similarity between a private equity fund and –

Patrick Daugherty: (interrupting) Bob, do you have any ideas on how the line should be drawn there. I mean, a lot of these funds overlap and sort of merge into –

Robert A. Hudson: (interrupting) Pat, this is one of the really great questions, and I think this has been a lot of the debate. What is this definition going to be? And, you are right. Can you change your charter, or your stated purpose, or your limited partnership agreement to fit in one or the other. It's up in the air right now. People really don't know. There is a mistake on here, everybody. It says "exemption for family offices." It's actually an *exception* for family offices. That just came out two days ago. The point being, if you excepted from a law, you are not in it at all. You're not an investment advisor who has been exempted, you are not even an investment advisor. So if your family office as defined a couple days ago, I'm not going to go through that –

Patrick Daugherty: (interrupting) But it does not pick up multifamily offices, right?

Robert A. Hudson: It does not pick up multifamily offices.

Patrick Daugherty: And that is a growing industry.

Robert A. Hudson: It is. It is. It is another area that I think is going to get more common and steady. But if you are a family office, if you met the final definition that is going to be adopted, you will be out of the entire registration schedule entirely. This is kind of an important one too. This gets back to the complexity I told you about. The general rule I mentioned was a hundred and fifty million. That rule does not apply, excuse me, a hundred million, that rule does not apply if you are an advisor solely to private funds. If you don't have any managed accounts, you don't do any regular customers, if you just manage funds only, then the threshold is a hundred and fifty million to be with the SEC. And, so there are some funds that I think that will escape registration because if you are under a hundred and fifty million you may find there are state exemptions available. A number of states have exemptions available for example, for institutional investors and things like that. So, some of these funds may escape registration entirely. There are extensive record and reports that are required – there is a listing of them there. Interestingly, it is not only that you have to provide access to the corporate records, but the SEC can order you to create reports for them. That is something new. So, for those like Pat that believe that more regulation is a good thing, there is a lot to cheer about. (Laughter.) They have also gone into talking about, I am trying to get past so we can get you folks out to break and then to lunch, or to the next program I should say. There are some new limitations on advisors. Performance fees, previously performance fees were, you could get out of, they would be applicable only to qualified clients. But if you were not registered then you could escape that situation. Now, those exemptions are gone. So, every fund really is going to be limited to having qualified clients, which are super credited investors, in order to get performance fees. And they have to review the standard of what are those, of what qualifies as a qualified client every four, excuse me, every six years. Such as my comment, that obviously, they are going to have to be careful now, and you are going to have to look at your clients and make sure that they are qualified clients.

Again, bureaucracy, the number of rule making studies and reports which are going to be coming out is totally incomprehensible, it really is. So, I just say stay tuned. There are going to be a lot of them that are going to be related to funds. We've got your office that will be getting more but, my God, it is an amazing amount of legislation. Another important item that was tacked on, frankly because what does it have to do with funds? Not that much. The Accredited Investor Standard. I think everybody knows that that standard was adopted in 1982. It was a million dollar net worth with regards to any assets that you had. There had been talk for quite some time that that's out of date - that people's net worth has increased. Home values have sky rocketed. We all know that. (Laughter.) So, you know, now you may not include the value of your home. Actually, in a perverse way, maybe this will increase the number of accredited investors. I don't know. (Laughter.) I don't know. And you do have to deduct the debt that you have on your home. So, this went into effect immediately.

Patrick Daugherty: But the SEC clarified that – not below the value of the house. So, it doesn't become a negative number.

Robert A. Hudson: You don't have to go negative. That is right. So, again, they are going to review this every four years also. And this is effective right away. Everything else that I have been talking about is not effective until July, 2011. But, this one is effective right away, so anybody who is doing private placement, obviously you have already presumably revised your revision. So that is kind of it. There is a disqualification for bad actors. Again, that was thrown in to kinda have the same kind of bad boy provisions that existed already in regulation A. In conclusion, what does it all mean? Got me. I am not sure. (Laughter.) You know, I am dealing with it obviously, and addressing it with clients and all that, but frankly there is a lot of head scratching. A lot of people are not sure about a lot of it. And, it will be interesting working with the states for some of the funds that will just now be getting into some of these issues.

Patrick Daugherty: Well, the truth is that very much of the rule making has been deferred. Congress basically spent twenty-four hundred pages saying, "We don't know. Agencies, you figure it out. Conduct a lot of studies, and pass a lot of rules, and come back and explain it later."

Robert A. Hudson: And they had the votes to do it, Pat.

Patrick Daugherty: Yes, they did. And there will be an election in three weeks.[87]

87. Editor's Note: The 2010 Midwest Securities Law Institute convened on October 15, 2010.

Elliot Spoon: Let's thank the panel for a great presentation. (Applause.) We are going to set up for the next panel.

SESSION 3: SEC ENFORCEMENT ISSUES

Elliot Spoon: We are now going to turn to issues regarding SEC enforcement, including the impact of Dodd-Frank on SEC enforcement issues. With us is Steve Klawans from the Chicago SEC office; Joe Papelian, Deputy General Counsel for Litigation for the Delphi Corporation; and Rocky Pozza, from Miller Canfield. And I believe that Steve is going to be starting off.

Steven Klawans[88]: Thanks Elliot, and Joe, and everyone who puts on this program. Before I begin I am required to tell you that the views I express today are my own, and not necessarily those of the Commission or its staff. As Elliot said, I work in the SEC's Division of Enforcement in the Chicago office. As most of you know, the Division of Enforcement is the Commission's law enforcement arm. We are responsible for litigating and investigating violations of the federal securities laws in both district court and administrative courts. I want to spend just a little bit of time updating everyone on some of the changes that I spoke about last year, changes with respect to the Division of Enforcement. I will spend the rest of the time talking about the Dodd-Frank bill as it has been covered much today, but there are specific powers that were granted under Dodd-Frank with respect to the Division of Enforcement.

Again, last year I reported to you many of the changes the Division of Enforcement undertook that helped us become more strategic, swifter, and smarter about how we investigate securities law violations and how we were becoming more successful. Many of those changes were just getting underway then. They are now fully implemented. I want to give you a quick update on those. The national specialty units are fully

88. Steven L. Klawans is an Assistant Regional Director in the SEC's Chicago Regional Office.

operational now. These specialty units are designed to help the Commission investigate the most significant and challenging cases that the SEC looks at. Those would include: a unit that addresses market abuses; a unit that addresses misconduct by asset managers; a unit that addresses new and structured products; a unit on municipal securities fraud; and finally, a unit dedicated to investigating Foreign Corrupt Practices Act violations. We have also streamlined our management. An entire level of management throughout the country in the Division of Enforcement has been eliminated. Those folks are now out on the ground investigating cases. We have hired more attorneys, more trial counsels, and specialized subject matter experts. I think it has also been mentioned today that we have established the Office of Market Intelligence. Part of the market intelligence unit's responsibilities is to manage and triage the thousands and thousands of tips and complaints the SEC gets every year. In fact, I was just reading our director Rob Khuzami, who used to be at the department of justice several years ago, his testimony before Congress. He was lauding the Office of Market Intelligence and also had disclosed to Congress that there is an FBI agent actually embedded within the SEC's Office of Market Intelligence. As you can see, this is one of the many examples of how the SEC and the Department of Justice are working together.

And finally, there has been an incredible streamlining of our processes to put more autonomy in the hands of the local offices and the attorneys within the Division of Enforcement to do what they need to do. For example, no longer do we have to get Commission authority to get formal order power. Formal order power enables us to issue subpoenas for documents and witness's testimony. Also, we don't have to go to the Commission to get approval to file contempt charges against those that violate court orders; we can do that at the local level. And also, before there was this long drawn out process for us to be able to share information with other law enforcement agencies called a grant of access. Now, grants of access can be approved at the local level; you can just walk down the hall and get a signature. So, these things have really helped. I would say, in the ten years I have been at the SEC, these are the most significant and well received changes that I have seen in the Division of Enforcement. There is no doubt that our attorneys and accountants are much better equipped now to do what they do best, which is to investigate and stop securities fraud. A few examples of our success over the last year in the Division of Enforcement: we have brought over six hundred and thirty five enforcement actions; forty-five TRO's; we have gotten fifty-six asset freezes. These are numbers as of toward the end of September. We have obtained \$2.5 billion dollars in disgorgement and penalty orders and distributed over \$2 billion dollars to injured investors from Fair Funds.

There have been lots of changes in the Division of Enforcement, and now, we have to deal with Dodd-Frank as the other offices and divisions within the SEC do. But thankfully for us, most of these powers that have been granted under Dodd-Frank to the enforcement division are effective upon passage. I will go through some of the highlights of the Dodd-Frank bill as it relates to the Division of Enforcement, but keep in mind that these powers, most of these powers, we are able to use immediately. I would also say that, going through these slides, I am going to summarize these provisions, but it is no substitute for actually reading the Act. The Act, everyone said is this monstrous act, but just this little packet right here is what relates to the Division of Enforcement and is included in the materials. I would encourage you to actually read the rules yourself.

Nationwide service of subpoenas. When we litigate in district court we can now under Dodd-Frank serve subpoenas to compel witnesses to testify at trial anywhere in the United States. Previously we were limited by Federal Rule of Procedure 45, which placed a hundred mile limit on a distance a witness was required to travel to testify at trial. This caused us to take a lot of video depositions and use those at trial. Anyone who has tried a case with video depositions can imagine how pleased we are with this rule change. But of course, the defense presumably would enjoy this same ability in SEC actions as well.

Extraterritorial jurisdiction. This relates to a recent Supreme court case, called *Morrison v. National Australia Bank*, which held that the SEC antifraud actions apply only in connection with the purchase or sale of a security listed on a U.S. exchange or in connection with a purchase or sale of a security purchased or sold with the United States. [89] Dodd-Frank now gives the U.S. courts broader jurisdiction over the antifraud provisions, or the antifraud actions that we bring to include conduct within the U.S., where a significant step in furtherance of the violation, even if the transactions occurred abroad or involved foreign traders. The U.S. courts have jurisdiction over SEC actions where the conduct occurring abroad had a foreseeable, substantial effect, within the United States. So this is a much broader set of actions that the U.S. courts have jurisdiction over now.

Next, is the collateral bar provision. This one is really important. Dodd-Frank expands the SEC's authority to bar regulated individuals from the financial services industry. Dodd-Frank now permits the SEC to suspend or bar a regulated person who violated the law in one area from serving in other capacities in other areas of the financial services industry. Let me give you an example. If the SEC brings an action against an individual who works at a broker dealer, the Commission can now bar that individual not only from associating with the broker dealers, but with an investment advisor, a municipal securities dealer, a transfer agent, and some other employer. Essentially, now we can just get the bad actors out of the industry.

89. Morrison v. National Australia Bank Ltd., 130 S. Ct. 2869 (2010).

Aiding and abetting authority, Dodd-Frank amends the securities laws to include recklessness as well as knowledge to satisfy the mental state requirement of our aiding and abetting actions. This statute under the Exchange Act previously stated that a person is liable if he knowingly provided substantial assistance to another's violation of the law. Some courts interpreted the knowledge requirement to exclude recklessness. So, now the statute has been amended to state that aiding and abetting, which is knowing or reckless, will be a basis for the violation. And this kinda clears up some quirky cases that we had where for the primary violator we had evidence of recklessness to establish their own primary violation, but the secondary actor, the guy who helped him, we had to prove the case by showing that he knew there was a securities law violation. So there was a higher burden for the secondary actor than the primary violator. It didn't really make any sense. Dodd-Frank has cleared that up. Let me skip a slide to slide eight.

Control Person Liability. Dodd-Frank makes explicit that control person liability applies in SEC actions and not just in private causes of action. Also, the SEC can seek joint and several liability against control persons and the persons they are responsible for controlling. This is also interesting. A control person, even if no judgment is entered against a control person, that control person can be held liable to pay disgorgement and penalties in certain circumstances with the persons under their control that are ordered to pay disgorgement penalties.

Skip again to fair fund amendments down to sharing information. This, I think, is my favorite one. Under Dodd-Frank, when the SEC shares information with other law enforcement agencies, or those law enforcement agencies share information with us, that transmittal of information will not be deemed to be a waiver of any type of privilege. Now really what this means is, in the past, for instance the U.S. Attorney's Office and the SEC would routinely share information, but we were very reticent to share work product with another agency for obvious reasons. But now, under this bill, it appears that we are free to do that. And I think that will make parallel investigations a bit more efficient. It can come up in various ways. The SEC might do an analysis of the bank record tracing in an offering fraud, and want to share that with the Department of Justice but that includes our work product. There maybe be an analysis of trading in a market manipulation case that we do, and now we can share that with the Department of Justice. So, I think, this provision will definitely help.

Audience Member: Steve, what about with the new whistleblower office, or the investor advocate, or the ombudsmen? Share with them also?

Steven Klawans: Yeah, well those offices will be within the SEC. The ombudsmen, I am not that familiar with that. I think there are still some rules that have to be promulgated with respect to that. But the whistleblower office will be within the division of enforcement, so there won't be any privilege concerns there.

Audience Member: I find it interesting that this allows the sharing without the concern of a waiver of work product and all. Yet companies will often times try to enter into an agreement with either the SEC or the Department of Justice for a confidentiality provision and in a situation where the company will want to selectively waive the privilege and produce that information to get the benefit of it. And certainly, even with a confidentiality agreement that states that this waiver won't be construed as a waiver as it relates to third parties, in particular within the Sixth Circuit, they have set forth the position that we reject selective waivers in any of its various forms. You can't be a little pregnant, as you certainly are under this statute now, and kinda get the benefit of sharing the information without the fear of what is going to happen down the road.

Steven Klawans: I call this the statute of limitations for investigation, so the Dodd-Frank bill isn't all bad for defense counsel and security law violators. This one is sort of a selfimposed discipline where once the SEC Division of Enforcement gives a Wells Notice, which is our notice that we intend to recommend charges against an individual or entity that within 180 days of that notice we have to file an action against that individual or entity. And if we don't, then we have to seek special approval from the higher-ups in Washington within the Division of Enforcement in the Commission to do that. Certainly no one wants to go to the principal's office and explain why it took so long to bring the case. So it is a good internal discipline in my opinion and we welcome it in Chicago.

Lastly, we touched on this a little bit, the whistleblower protections, but put a little more meat on the bones. Here is how the whistleblower program is going to work. In any case where we collect a million dollars or more, the SEC has to give an amount equal to ten to thirty percent of that amount collected to a whistleblower who provides original information to the staff. Original information to the staff - what does that mean? Well, the information must be derived from the independent knowledge or analysis of the whistleblower. The information cannot be known to the SEC from another source. We expect at the SEC that this provision is going to generate a lot of tips and a lot of information regarding firsthand knowledge of securities law violations. I think this is going to be really significant over the next few years, after the whistleblower program gets up and running and staffed. I think this will help our enforcement investigations quite a bit. I want to bring in the panelists again to talk about the whistleblower statute.[90] From the corporate perspective, do you think there is going to be, I think there will be, do you think there is going to be a lot more whistleblower tips? And then, as an attorney for a large company, how do you deal with the influx of whistleblower complaints?

90. *See* Dodd-Frank Wall Street Reform Act § 922.

Joseph E. Papelian[91]**:** We'll just have to hire more lawyers. (Laughter.) It's interesting. Yesterday, I pulled this before the presentation, a *Wall Street Journal* report that the SEC is getting one whistleblower bounty seeker Foreign Corrupt Practices Act tip per day since the Dodd Frank provisions went into effect. So, if that's an indication I think it's going to be pretty busy. From a corporate standpoint, I mean, put yourself in my shoes, I mean what do you do to try to prevent someone, an employee, from seeking the benefits of a whistleblower going directly to the SEC, but instead encouraging the employees to use what a lot of companies have, like an ethics line or a hotline to make a report to give the company an opportunity to address the issue, and I think it's going to be a huge disincentive for good corporate governance, and I think employees will see this as an opportunity to make money, and I think you may have mentioned that there is some protection for whistleblowers who make a report and so what do you do to try to encourage employees to make the report? You know, some companies, and again my views are my own now, not necessarily Delphi's, have instituted kind of an annual conflict of interest questionnaire, where it's fairly detailed where employees are kind of required to attest if he or she is aware of any conduct, for example accounting or foreign corrupt practices act, and to certify that if the employee is aware of it, to report it, and then to have a mechanism in place to show that the company takes those allegations seriously and to investigate each allegation and to you know really run it to ground. The other question then is, if the company actually takes one of those issues and finds that there is some truth to it, what does the company do? Does the company make the disclosure to the SEC or simply

91. Joseph E. Papelian is the Deputy General Counsel for Litigation of the Delphi Corporation. Prior to joining Delphi, Mr. Papelian was prosecutor for Oakland County and later in the United States Attorney's Office in Detroit. Later, he joined General Motor's legal staff and remained with Delphi after it was spun off in 1999.

try to simply resolve the problem and not make the disclosure?

Audience Member: How do you deal with the conflict between the internal investigation and the necessity of getting another lawyer involved for the employees, as opposed to this whistleblower which really gives that employee an outlet where he doesn't need a lawyer, as opposed to the internal issue, he may need a lawyer if he's going to refer something to the internal office?

Joseph E. Papelian: Well you're taking some from my presentation which is great, I mean anytime you do an internal review and when you talk to an employee, and there are cases that suggest that sometimes internal counsel or counsel representing the company failed to do that, you've got to give them what I call kind of like the Miranda rights, that you go through that you advise the employee that you represent the company, not the employee, that the conversation that you're going to have is protected by an attorney client privilege, that the privilege belongs to the company not the employee, which means that if the company wants to waive the privilege and disclose it to a third party like the government or someone else, they can do so without coming back to the employee. And then I always add in "by the way if you lied to me and we end up turning over our report to the government, the government may turn around and charge you with causing a false statement to be made. Now don't you really want to cooperate with me now employee?" Now that's a really tough go, and there are provisions in most companies bylaws that provide that if an employee is named or counsel is necessary, that the company you know will indemnify under certain circumstances so long as the employee is not acting in bad faith and is not inconsistent with the company's goals, and there's indemnification provisions, so there are ways in which separate counsel can be retained for the employee.

Clarence L. Pozza[92]**:** Steve, when you posed that to our panel earlier in the week, my view is that we'll probably see a large number of disgruntled employee whistleblower cases which have historically happened, a problem employee or someone in trouble in the workplace comes up with a whistleblower aspect. So I think there will be a number of those and those I would put in the "maybe not legitimate whistle-blowing but a defense to the employment termination" type case. But I do think there will be an increase with the bounty, 10 to 30 percent is attractive, reinstatement two times base pay, attorney fees and expenses, I mean there is some real monetary award here and I think we'll see situations where the whistleblower is actually primed by an outside law firm, who identify an issue and then try to find an employee to become a whistleblower. I hope that doesn't happen, I hope I'm absolutely wrong. But I think the system is such that some whistleblowers will really be found by an outsider and set up to bring the claim.

Joseph E. Papelian: That's exactly what's happened. There was amendment to the False Claims Act[93] for key (inaudible) provisions that provided for, they're called relators under the statute, to bring these kinds of suits but those suits were actually filed under seal on the name of the United States and then they're filed under seal and they go to the US Attorney's Office for purposes of whether the government wants to intervene or not. But they have very similar provisions where they have protections for the relator, they have awards for actual attorney's fees, which will I think create a cottage industry for this type of action.

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92. Clarence "Rocky" Pozza, Jr. is a principal at Miller, Canfield, Paddock and Stone, P.L.C. For more than three decades Clarence L. Pozza Jr., a Fellow in the American College of Trial Lawyers, has handled complex business, commercial and securities trials, arbitrations and mediations with distinction across the United States. His principal practice areas are commercial, corporate, financial, securities and insurance litigation, regulatory representations, alternative dispute resolution and preventive counseling. A past chairman of the firm, Clarence served as a managing director of Miller Canfield for 10 years and was head of the Litigation Group for eight years.

93. False Claims Act, 31 U.S.C. 3729 (2010).

Steven Klawans: Once the corporation learns of a whistleblower complaint there is obviously some desire to find out what's the topic and what can we do as management to address the issue. But I'd imagine there's a competing concern that the more effort you take to identify the whistle-blower, to communicate around management of who the whistleblower is and what his complaint is, do you open yourself up to a possible environment where there's retaliation against the employee? How do you balance those two concerns?

Joseph E. Papelian: Generally, if there's a whistleblower and almost all likelihood there's going to be a lawyer that's representing the whistleblower and it's almost the opposite of what might be the natural tendency to identify and punish the whistleblower – you don't want to do that. You really almost want to insulate them and I think that what we'll find is some of the whistleblowers will be employees who may be on the verge of being you know pushed out of the company for a lack of performance and they use this as a way to protect himself or herself, and I think that it will be a very effective tool. But I think you really want to create a good record of reaching out to the whistleblower's attorney, seeking cooperation, seeking the information that was produced in an effort to try to address what his concern is. There's another issue that kind of popped up for public companies, when, whether it's a complaint that's been brought to the company's attention, whether it's a formal order that you've received from the SEC or it's a subpoena, and companies have to go through is that a material event for purposes of a form 8K? And you know no company really wants to go out there and make it look like we've got this internal investigation started from a whistleblower.

Steven Klawans: I think that's a good lead in to your presentation.

Joseph E. Papelian: Actually I'm going to go through some of the slides really quickly. I think actually more can be really gleaned through just the discussion with all of you participating. First I must say that the views expressed are mine and not necessarily those of Delphi. A lot of the things we've talked about is you know what do you do when you learn that there is an investigation and that comes either from a friendly phone call from a lawyer from the SEC asking for information perhaps on an informal basis, or to call you and say "congratulations you've been invited to a party and here is a subpoena." (Laughter.) It might be a situation that we just talked about where you learn of a complaint that hopefully the company has fairly robust process and you either get an ethics line complaint or someone makes a report in an exit interview, or you just happen to find it from an internal audit that you've got, for example, a possibility of a foreign corrupt practices issue, so what do you do? And I think whether it's done formally from the SEC or whether the company finds out internally, I think really the form and the procedures that you take up front can really help you a lot later on. For example, it's not up there on the slides, if there's an internal review, there are kind of standard memos that can be used where either high ranking business person directs that a legal review be conducted to kind of cloak this all in the attorney client privilege and you've got a letter that goes out there. You've got a letter that goes out to the employees that tells them that there's an investigation going on. And then it's important who actually is controlling the investigation? If it's a significant investigation I think a lot of companies have the audit committee take control of that. There's a direction from the audit committee indicating that the lawyers who are involved in the review, in the investigation, whether its outside, inside, or both, are reporting directly to the audit committee and the audit committee is seeking legal advice for the purpose of making some decisions. If there's a retention of an auditor, make sure the auditor is retained either by outside counsel or by the audit committee, and there's a clear direction that what the auditor is doing is under the protection of the attorney client privilege. The biggest issue, and let's assume that we've got a formal order, I think is certainly you want to understand what the company's status is. You want to establish a rapport with the SEC. You certainly want to find out if there's ability for the SEC to really stand down and to let the company kind of conduct its internal review. And Steve, what is the response that you've had when you've had counsel that have contacted you in response to a subpoena, asking the SEC really to stand down?

Steven Klawans: No. (Laughter.) I usually say it nicer than that. No I mean I would say on a case by case basis you know we'll look at it. There's certainly no policy that the office has so it is a case by case analysis. I would say that, you know, what I look at is how would standing down during the course of an internal investigation benefit our investigation? And that's the lens that I would look at it through and I would say in most cases really any delay in our investigation is detrimental to our case, but perhaps there is room to think of ways or circumstances that it could be beneficial, such as when maybe it's a case where we really don't know much at all. We really don't know more than maybe a tip or complaint that really has no meat on it, and so learning from the internal investigation is really our way to move the investigation forward. That would be the one area where I'd say we would probably seriously consider doing that.

Joseph E. Papelian: From a company standpoint I would certainly want to argue to you that you know that Steve I know the company certainly better than you do or will from issuing subpoenas and taking testimony. I can get the information to you faster, I am willing to share you know, for example, if you have a subpoena to get you documents on a timely basis, to kind of let you know the people we're talking to. But then I come close to what truly is a very hot topic certainly from inside the company, and that is the privilege issue and that's mentioned in some of the slides. And that is a huge topic. And mentioned it earlier during Steve's presentation I mean the concern from a company standpoint obviously is you'd love to share the information. At least a lot of the companies would love to share the information with the government agency and the SEC. And even to the extent including the results of interviews of witnesses, work product and all, the fear is less disclosing the information to the SEC, and the big fear is what happens afterwards. What happens generally afterwards are the third party complaint, the class action lawsuits. I put in there it's hard to be a little bit pregnant. You can't disclose to the SEC without having it deemed as a waiver of the attorney client privilege, and that is such a huge, huge detriment to the company. Often times I think if you go to the audit committee, my experience has been audit committees, you know they want to wear the white hat. They want to be fully cooperative with the SEC, they want to show that they're committed to doing this. That they're committed to rooting out whatever problem existed at the company. And so the audit committee will generally direct the lawyers at least it has been in my experience, to fully cooperate with the government agency, which includes waiving the attorney client privilege, and I think that really causes for problems down the road. Have you seen that Rocky?

Clarence L. Pozza: I have, and when you mentioned the ultimate use of the information, I have been involved in situations where we assumed we were going to turn over to the government the factual report. When we asked the government to stand down, let the company do their internal, they did, under a theory "follow the facts wherever they lead," that was the mission, so the document that was created was pure fact, it had no attorney client, no work product in it, under the assumption it would ultimately end up in the plaintiff's hands in the class action. So I guess my point and I think what Joe is saying is [that] early on you have to think all of this through and know that your assumptions may be incorrect. But assume certain information is going public, and if it is, write it up in a way that preserves the privilege if you're simply providing factual material, et cetera. There are a lot of things to think through.

Joseph E. Papelian: One of the issues was certainly with the Justice Department. They used to demand that if the company wanted the benefit of cooperation, they'd have to waive the privilege. And the SEC, I understand they're apt to change that view, but also had the view that there's a carrot and there's a stick, and we've got the stick here, we're going to beat you with subpoenas and cause all sorts of problems with you. There's a carrot there you can really help yourself and you get the benefit of the full cooperation which you even include: if there eventually was a complaint filed, that there's no fine; there's a statement because of the extensive cooperation by the company, you know, it's resulted in no fine; and, there's only an injunction not to violate the securities laws further. No admission as to liability and you know the audit committee might think you're home free, but you're not. And so, while there's no formal demand like there used to be to get the benefit of cooperation, there is perhaps sometimes a wink and a nod that your cooperation is certainly welcomed and then the company then volunteers the waiver of the privilege. Maybe it's a distinction without a difference. There's a couple other little things that I think are important to do up front when you start an investigation whether it's because of an SEC subpoena or order. You've got to get a document hold out there; you've got to find out who are the witnesses who are really critical to understand the facts; you need to get a search memo out there. And another thing I think is really important is you really need to advise the employees the possibility that they might be contacted by a representative whether it's from the government [or] whether it's from class action plaintiffs and all. This is where I think you've got to walk a fairly fine line. I mean you certainly can tell the employees that you want them to contact you if they're contacted by a third party. But in my view, I don't think you can direct them that they cannot speak with a third party and maybe Richard Zuckerman can talk about that in his presentation. I think the government might take a view that you're coming close to obstructing an investigation if you're telling employees that they cannot talk to a government representative if they contact them. But I would certainly encourage them to contact you beforehand, and if it's an appropriate – if you're contacted by a third party – you have no duty to speak with an agent. I think that's really important to get that out there.

We talked a little bit about parallel proceedings. With all the amendments that came with the recent Dodd Frank bill, I kind of wonder with all the closeness now that there is with the government agencies working, if you're representing an individual who's testifying before the SEC and there's a lot of risk for that witness . . . I think you've got to ask the SEC what's the involvement of the DOJ? Is the DOJ involved in the investigation? Or if your client's testimony is pretty egregious, I think you're almost forced to seek some type of immunity. But what happens, Steve, if I'm representing a client that you've subpoenaed . . . [and] I ask . . . is the Justice Department involved? I think my client really is a perfect one to get immunity. What do you do next?

Steven Klawans: I mean, my practice in response to that question is to first say that you know I'm not representative of the Department of Justice so I can't comment on that ongoing investigation that the Department of Justice may or may not have. But with that said, I would remind counsel that we've given them a form, SEC Form 1662, which says that we can share information with other law enforcement agencies, including criminal law enforcement agencies. And I'll also tell counsel or pro se witnesses that they should just assume that there is a criminal investigation. And that way they're on notice that they need to do whatever they can do to make that determination. Now maybe they can call the logical U.S. Attorney's Office and ask them that question. I don't know that they'll get very far. It's not a very satisfactory answer, but that's what I'm permitted to inform counsel, because we cannot disclose another agency's investigation. It's not our place to do that. Sometimes I will, when I get that call, call the Assistant U.S. Attorney or the FBI agent and say, "here is the question that I've been given, can I go ahead and tell them?" And sometimes they say "yeah, that's fine. There's no cloak and dagger here. We're not running a covert operation. That's fine." But sometimes they'd rather lay in the weeds, so it's not up to us to disclose that.

Joseph E. Papelian: Do you have the witness testify Rocky?

Clarence L. Pozza: That's Richard's question, but that's a significant question. And it can impact the institution, the union, the trust fund, et cetera. Personal counsel to the individual might say "no, Fifth Amendment," just in case. That really can run afoul of what the company is trying to achieve in working things through, looking at it. That has always existed though, even before parallel proceedings; that's been there a long time.

Joseph E. Papelian: I found this case, this *Galleon*[94] case, kind of interesting, where they have criminal defendants who received information from the Justice Department about wiretap information and the SEC subpoenaed the wiretap information from the defendants. I think that case is still kind of pending. The district court ordered the information be produced and then there was I think a reversal. Now they're challenging the petition for the wiretap. But I thought that was kind of interesting because it's kind of a dichotomy between criminal law which has kind of limited discovery, and you've got civil law which has this very broad discovery. So, to the point I think we're all making here, I think you've really got to be mindful to the fact that the Justice Department may be lurking in the background.

94. SEC v. Galleon Management, 683 F.Supp.2d 316 (S.D.N.Y. 2010).

Well, we've talked a little bit about privilege. I think a question that often comes up is, if you're doing an interview with an employee and you've gone through all these wonderful rights with them, and of course the employee is now just really eager to cooperate with the company, what happens if the employee kind of declines to cooperate? I mean, what do you do then? And there's an interesting case we'll get to in a minute . . . but I mean, what do you practically do? Rocky, if you're representing an employee and it's a civil matter, and I'm interested in learning what your client has to say, and I've already told your client that I represent the company, not him, it's our privilege. Do you have any sense of cooperating at that point?

Clarence L. Pozza: Rarely have I. I've been more on the company side, and I have had instances where counsel to the employee has said "sorry, we're not going to talk." And of course then from the company's perspective, we can take steps with respect to your employment. You really have to cooperate. And they just say, "Fine. Do what you have to do, but we're not going to." I've never provided an individual counsel on that, so I'm avoiding the question. (Laughter.)

Joseph E. Papelian: Okay, Okay.

Audience Member: Rocky was that, what about the whistleblower protection?

Clarence L. Pozza: Well, under the new act the retaliation is always an issue, but very often when I've been in these situations, the employee is to a whistleblower, just a witness. And, but they have something they're worried about. Maybe they're a participant, not a whistleblower. So the anti retaliation provision really wouldn't apply.

Joseph E. Papelian: What sometimes happens is that there is counsel representing the employee and he comes in and says "well that's okay, but we want to own the privilege too," and what that does is prevents the company - or could prevent the company, from actually waiving the privilege and disclosing to a third party that's also the privilege of the employees. Sometimes we're in a situation if there's no counsel involved and you tell the employee look, we need your cooperation and the employee says "jeez, you know I just don't think I'm going to provide the information." There [are] all sorts of bad things that could happen to an employee. You can certainly take it up with management, they could be suspended, they could be discharged for failing to cooperate, and then who knows, maybe they run to the SEC and become a whistleblower. A lot we'll see will happen. A lot of argument about waiving the privilege, I mean I think from my view, is by having employees believe that the company is going to automatically waive the privilege and disclose information to the government or to third parties. There is really no incentive for employees to come forward and report it if they think that they may end up in some kind of trouble down the road. I think that it does kind of impede our ability to provide effective advice to the company.

Other comments here . . . that kind of chills cooperation. I mentioned that if there is actually misrepresentation in an interview, but with a company lawyer, that interview is passed on to the government, they can actually charge the individual with a false statement. The AOL case, which talks about the employee actually having attorney client privilege[95], and one of my favorites is Nigerian Barge case where they had three employees that, two of them decided not to cooperate and they were summarily fired by Merrill, and this Daniel Bayly decided to cooperate. All three of them were later named in the SEC complaint, but the person who cooperated, Bayly, was later charged criminally. So, no good deed goes unpunished. He went to trial he was convicted; he got 30 months. It was reversed, and he recently settled with the SEC. Anyway, arguments in favor of course, that we're a good corporate citizen, and that want to be able to state in a 10K that you've been cooperative, joint defense agreements, I'll leave that to kind of the

95. In re Grand Jury Subpoena: Under Seal, 415 F.3d 333 (4th Cir. 2005).

criminal discussion that comes up, as well as the Sentencing Guidelines, and then this is a 6th circuit case, the *Columbia* case, that unlike the Eight Circuit, that at least gives some appreciation to selective waivers. I mean that's the quote: "after due consideration, we reject the concept of selective waiver, in any of its various forms."[96] So, I don't think it sticks here in the 6th Circuit.

Clarence L. Pozza: But, it's just too bad. You have a universal situation. It's just too bad. We ought to have selective waiver.

Joseph Papelian: There was proposed, I think in Rule 502, but it was never passed.

One other thing I wanted to mention to you has to do with the bylaws most companies provide for indemnification. I think the catch phrase is: "so long as the person didn't act against the best interest of the company." There is a difference between indemnification and advancement of fees and expenses, and most of the provisions under Delaware law have the ability for the company to have the option to advance fees and expenses. And it generally has an agreement that you got to. The employee has to repay those fees and expenses if it is later determined that the person wasn't entitled to indemnification. But there is no right; generally, to the advancement of fees and expenses as a right of indemnification, but the decision whether to indemnify is generally made at the end of the matter by the board to determine whether the employee was entitled to indemnification. So, most of the time, I think companies do advance fees and expenses with written agreement to repay but the audit committee or the board generally makes that decision at the end.

A couple other things that I wanted to mention. One, check the insurance policies. And with the D&O coverage . . . I think sometimes there is one view about insurance companies wanting to sell you an umbrella when it's a beautiful day and when it's raining they want to take it back from you. So, I mean,

96. In re Grand Jury Subpoena: Under Seal, 415 F.3d at 302.

I think it's really important to check the D&O coverage because some policies have a fraud exclusion. There is an exclusion if there is a finding of fraud on certain individuals like [the] CEO, CFO, [or] General Counsel that may void the whole policy. So [it is] something to take a look at.

The last point I wanted to raise with you is if there are employees who are kind of at risk. The one thing I think works pretty effective is to actually, if you have counsel who represents the employee who is at risk as opposed to just making a judgment by making a presentation to the audit committee. The audit committee often times will kind of overact and say that employee has got to go and are summarily fired. I think what works better is to actually have a kind of a due process where that employee with counsel comes before the audit committee and the counsel for the audit committee acts much like the prosecutor in presenting the evidence and it gives the ability of the employee, often times with counsel, to answer the charges, and the audit committee making kind of more of an intelligent decision. I've seen that work pretty effectively, and some people that you thought really were at risk turned out to not be at risk at all.

Joseph Spiegel: Ok, Thank you.

Clarence L. Pozza: I'm going to start before my PowerPoint is up. I know that everyone is a little hungry and my section is really more of a tail and a specialty item. But I wanted to start - I just push which one? Right here? Does that do it? Oh, I "x'ed" it out. (Laughter.)

Audience Member: Ok, I think it's this one.

Clarence L. Pozza: That one, alright, good, good, good. I want to say thank you to Elliot and the College of Law. This is an energetic law school. Friend and attendee Steve and Joe, I am honored to be on the panel with you. Joe Spiegel, thank you very, very much, you have done a great job here, and all of the friends and attendees.

For a practitioner right now, this is really one of the most amazing, exciting times to be involved in this area. There is so much law change underway, so many studies underway, helping clients through this, kind of predicting where it's going. We're seeing, we're in the middle of the law and formation. And for me, and for those of us who really lost federal court involvement back in the seventies and early eighties with arbitration, it's an amazing time. So for the students here, there are opportunities if you like this area you can really jump into it. And if you jump into it deeply you will have a great career. If you are a humorist or cartoonist, Dodd Frank can lead to all kinds of humor. I mean, the logo for the whistleblower could be a giant whistle with a blower. Or if you look at it from the bounty hunter you could use the Star Wars bounty hunter guy with the beat up helmet. Investor advocate - imagine Warren Buffet kind of laying on the ground. He's an investor, you know, oppressed with maybe Elliot Spitzer up there with a shield. All kinds of stuff.

I join Pat Daugherty I think in heart. It's too bad all of this has happened. The SEC did not create the crisis. Congress had an involvement, a desire for massive home ownership, which is a good thing etcetera, etcetera. There were a lot of reasons and the SEC delivered outstanding work for the American financial system for decades and decades. But, we're in a new era.

Okay, my topic. Enough of the speeches, it's really Ponzi schemes and a few issues that have arisen for the investors and the investor fights with respect to the recovery of funds. And I see Tom Cox, my partner, Rob Morad from our office. Tom, Rob, and I collaborated on an article in the Michigan State College of Law Securities, or, Business and Securities Law. [97] We've got some reprints here. I see Matt Leitman [who is] also a partner. He has written a broad survey of everything going on. And our topic here was really investor recovery disputes between investors.

97. Thomas R. Cox, Robert J. Morad, & Thomas R. Cox, *A Review of Recent Investor Issues in the Madoff, Stanford and Forte Ponzi Scheme Cases*, 10 J. BUS. & SEC. L. 113 (2010).

And we cited *Madoff*,[98] *Stanford*,[99] and a third case, *SEC v. Forte*.[100] I'm going to abbreviate a little bit. The, *Stanford* [case], and you heard a little bit, involved Stanford International Bank and fake CD's, that were purchased by investors. [The] money went to Antigua, but it wasn't under the U.S. jurisdiction. So, the Securities Investor Protection Act didn't apply because it wasn't a U.S. institution, and secondly, because investors actually got a certificate and they paid real money over, SIPA didn't apply. So we take SIPA out of the way there.

Stanford is still in litigation. Allen Stanford hasn't been convicted as of yet but that case is grinding along. The *Forte* case, is interesting because of what a U.S. District Judge said about investor recovery. And then *Janvey*; Ralph Janvey was the receiver in the *Stanford* case, and he took some positions which I'll go to right now. The real issue on the investor recovery, the pots are typically small. Over the decades, money has been paid out to early investors and so there may not be a lot of money in the Ponzi schemer pot at the time it's uncovered. Some of the money is wasted. Some of the money has been spent on operations. Madoff had a large operation he had to pay for. So you have a group of folks who have put money in, and the topic of our article is really the fairness of who can recover in a claw back.

What do I mean? Investor One puts in a million dollars and never gets a nickel out. And that money sits there for twenty years; they pay taxes; they get account statements showing profits and gains but the money sits. Investor Two puts in a million but over a period of time withdraws half a million from the pot. Pays some taxes but gets some money out. Investor Three puts in a million; gets out a million. Investor Four puts in a million and takes out two million.

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98. In re Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122 (Bankr. S.D.N.Y. 2010).
99. Janvey v. Adams, 588 F.3d 831 (5th Cir. 2009).
100. SEC v. Forte, 2009 WL 4809804 (E.D. Pa. 2009).

The general position of the receivers in *Forte* and in *Stanford* has been to try to recover back from any individual who has taken money out - whether it's over the amount that they put in or less, has tried to claw it all back - and put it in a pot and equitably distribute it to everybody. The SEC has actually opposed that. And one of the topics we address in our little article is really is that the fair way to approach it? And the practical argument is we only want to recover the overage. If you put in a million and got back a million and a half, we will go after the $500,000, but you can keep the million.

Our article suggests that maybe there is a better way because that leads to a fundamental unfairness. The day before the Ponzi scheme is discovered, Investor One, who put in a million, pulls out their million. Under current thinking, and the approach of the government and frankly the courts, they get to keep that million unless they were a knowing participant or had information on excluding them. The investor, who put in a million the day before the scheme is uncovered, [and] then it's uncovered, is left holding the bag. The million he or she put in might have paid off an earlier investor. The earlier investor can keep the money. Because there is no surplus, the later investor is left holding the bag. Our article suggests that that is fundamentally unfair.

In these cases, the concept of winners and losers comes up; winners being people who get money out or a surplus, [and] losers being those who don't get all of their money out. But unfortunately, these labels tend to prejudge, in our view, some of the results because really many of the folks called winners are actually losers. I put in a million but I got $800,000 out. I'm a loser to the extent of $200,000 plus return of principle or return on the amount invested. Someone, however, who put a million in didn't get anything out is a super loser. These labels really are not appropriate and in our article we talk about that. We say the courts should really drop that kind of terminology.

Now, the courts are laboring under common law, statutory law, SIPA, and FDIC, and concepts that are not designed to apply to Ponzi schemes. Common law fraudulent conveyance- if you get money out without knowledge you're okay. You can keep it. Statutes of limitations apply to claw backs. So, receivers and the courts and the SEC battle about how far back a trustee or receiver can go. The bankruptcy code interacts with all of this. Common law unjust enrichment comes into it. So we have a lot of sources of the law for these cases but none of them in our view fit and none of them lead to really a fundamental fairness determination. And the way they all interact allows that investor who put the million in the day before to get zero and go into the after scheme pot. And the investor, who just through the luck of the draw, got the million out the day before, they get to keep it.

There is some tax relief Congress passed in March '09. Tax relief allowing a deduction for losses not capped at $3,000, but that is of little benefit . . . when someone if they don't have any cash coming in they really don't need the tax relief they need the cash. So, our article kind of challenges the thinking on this and says, really, you know, the SEC maybe should rethink this. And ultimately, the only thing we could come up with, with respect to a better approach, and that is some type of legislation that gets the court involved [in using] gorilla equitable powers to do the right thing; to do a fundamental fairness approach; to do claw backs as appropriate - not just amounts over the amount you put in. You get your million back plus $500,000. They claw back the five hundred, maybe clawing back the million; some type of avoidance of statute of limitation issues as kind of an equitable approach to fundamental fairness. And clearly, this isn't you know, with everything else going on, on the top burner, but I can assure you for the investors who have lost their entire life's work, forty or fifty years of savings and then find out they are flat broke, this is about as important an issue you can think of.

So, comments. Steve, Joe?

Steven Klawans: Well, you know, in a perfect world, clawing back all the money that went to investors in a Ponzi scheme and then redistributing it back to everybody is obviously ideal. The problem is, putting aside the challenges that are faced with the Uniform Fraudulent Transfer Act and the other statutes that prohibit, at least in some courts eyes, clawing back interest. The practical reality is that the cost that the receiver will incur to litigate all these claims with all these individuals to try to claw back all the money that they got is just going to eat away at the purpose of the fund itself. Plus, then you have a delay in distributing all the money back to investors because of all the litigation. So, that's some of the problem with clawing back all the money that went back to investors.

Clarence L. Pozza: And the practical problems are huge. You can imagine, in the *Madoff*[101] case going back twenty years, when someone who did get their money out and said "look, I gave some to charity; I did this; I did that; I've spent it; I don't [have it], you're going to make me destitute now." There are serious practical problems. When we wrote the article though, we kind of took the view of Congress that the practical problem, let's just say it, and legislate it, and suggest it, and it will work out. But the practical problems are real. However, there are circumstances where the practical problems are not, you know, that investor got out the day before, it's not really a significant claw back issue. And that's why we are suggesting that a judge, with broad equitable powers, with experience and seasoned talent, look at all of this and try and come up with the best approach under the circumstances. Because it is not, I agree with Steve completely, the SEC has talked about the pragmatic issues, and they are real. But for that individual who ends up with zero, any money would be a Godsend. So, Joe?

Joseph Spiegel: Excuse me. Aside from equitable principles, which I agree with, but for someone, who for instance who put

101. Madoff, 424 B.R. 122.

in a million and got out a million and a half but they have been out of the deal for two or three years or even longer, I mean, what's the legal theory for going after them on a claw back?

Clarence L. Pozza: Well, that that is, there are issues. Right now, for example, there are attempts to claw back that excess, the half million in your . . . hypothetical Stewart and sometimes successfully.

But there are huge fights over it. Clearly, in my view, that should be automatic. Even if it is two, three, four, six, eight years back. Because the people, basically, get less than they put in out, or zero, are really just getting hammered compared to that individual.

Judge Sinai: And that's really equitable as you describe it but after all, someone who's received it, $500,000 extra, has already spent it probably. And perhaps in today's world they don't have it anymore –

Clarence L. Pozza: Right.

Judge Sinai: And they're now going to suffer when they didn't –

Clarence L. Pozza: Right. That would be, Judge Sinai, that would be within your equitable authority to balance, weigh, and those are real issues. Now the individual, however, who put that million in two to three years ago and took out zero. I know the million and a half investor makes a real strong compelling sad case there. The one who put the million and a half in that got zero out, it's much worse. So, it's a tough situation.

Joseph Papelian: I think where you stand on the issue really depends on where you sit.

Clarence L. Pozza: Right, right. (Laughter.) Right. Well that is right, and were suggesting that, you know, it kind of has to be whisked away because it doesn't really work. Right now there are statute of limitation limits applied in a lot of these cases that prevent certain claw backs. So –

Joseph Papelian: I think Steve is right though. I think from an altruistic standpoint your arguments are compelling but from a practical standpoint I just think that, I don't know if there is any good solution really. Because it's just going to get litigated and someone is not going to be happy with whatever the result is and litigated so –

Steven Klawans: Every receivership in one of these cases that we had the receiver ask us what we think of the distribution plan. It is always a struggle and we always end up saying, "well this is rough justice, this is the best it can be, we have got to move on, as unfortunate as that is."

Clarence L. Pozza: Mark.

Audience Member: Rocky, this is more than hypothetical's in our area, because in Oakland County there are maybe four hundred actions pending. There is an action against people who got back $200,000 more than they put in that they got back four years ago but they are still spending resources as Steve mentioned.

Clarence L. Pozza: Right, right.

Joseph Papelian: Are they after the delta or the whole amount?

Audience Member: Just the delta.

Joseph Papelian: Oh. (Inaudible.)

Clarence L. Pozza: Right, right, right. Yeah, the delta recovery is . . . [the] kind of been an automatic so far. So, thank you, thank you all. (Applause.)

Elliot Spoon: We have lunch.

Joseph Spiegel: And then we are going to take another short break and divide everyone up into groups of three and we're going to have everyone enter an award based on the mock arbitration. So, pick your partners where or the host of FINRA will just assign. (Laughter.) And do justice. (Laughter.)

SESSION 4: CRIMINAL SECURITIES VIOLATIONS AND PROCEEDINGS

Elliot Spoon: Alright folks, if we could get started please. One of the many consequences of the financial crisis was an increase in the number and visibility of criminal proceedings under the securities laws, and we are fortunate to have with us two practitioners who specialize in white collar criminal work: Richard Zuckerman from Honigman Miller [and] David DuMouchel from Butzel Long. And on this panel, we are very pleased to have Nils Kessler who is Assistant U.S. Attorney with the Western District of Michigan. Gentlemen.

David DuMouchel[102]: All right, well we are going to pass the ball around then. This kind of dovetails with the materials that you reviewed and heard about this morning on a civil securities aspect. Now we're going to talk about what happens when that goes to a criminal investigation, or the hopefully the ways you can stop that from happening. But, I was just mentioning to Joe one of the things that ends up being somewhat odd.

The SEC investigated a case that one of the people was involved in this morning's panel was talking about. They are investigating it for years. Then they turn it over to the Justice Department which is never a good day; I mean it's never a good day. And then they start investigating and things get worse. And then you make the argument to the GOJ that this really should be a civil case, because sometimes that's the best argument you're left with because you can't prove intent; you can't prove enough intent, anyway. So, we were fortunate enough in that case that – it actually was the Delphi case that Joe Papelian was talking about – where . . . the Justice Department ended up agreeing to turn it over to the SEC for a civil fraud case, which we start trial on Monday for the next three months. So, you got to be careful what you ask for. And all the time we are telling them this might be a good civil case, but it is sure as hell not a criminal case. Now, we got to eat those words, too, because we start the civil trial. So sometimes you are working both ways.

The aspects we are going try to talk about now are when you find out either as counsel, or if you're a corporate executive or an accountant, that suspicious things are going on. And what you do about it when

102. David F. DuMouchel is a shareholder practicing in Butzel Long's Detroit office and chairs the firm's Corporate Compliance, Internal Investigations and Criminal Defense practice. He is a *cum laude* graduate of Wayne State University Law School (J.D., 1975) and the University of Detroit (M.A., 1972). Mr. DuMouchel's practice is limited to white collar criminal defense, professional licensure and criminal health care, criminal IRS investigations of both taxpayers and professionals, SEC enforcement of corporate executives, public corruption, as well as grand jury investigations, internal corporate investigations and compliance. *Lawyers & Professionals,* BUTZEL LONG, http://www.butzel.com/dumouchd/ (last visited Feb. 6, 2011).

you have an internal investigation; the results of those investigations; [and], whether they get turned over then to the Department of Justice, which many times they do. It now [has] been complicated. You heard this morning about the Dodd Frank Act, where now the Justice Department or the SEC has effectively deputized another few million people where they can now come in. And you don't have to worry about the SEC investigating or the FBI investigating first; your own employees will do it for you. (Laughter.) They don't have badges, they don't have to have search warrants; they just come in and do the investigation.

And you are doing your internal investigation, if you get asked by a client to do this, and you're investigating someone, and you're questioning people. I know this was mentioned this morning. You bring people in as part of the internal investigation. You're required to talk to them. It's one of the few places we've actually got more power than the government does because if you ask somebody to come in and you're the U.S. Attorney, you are Nils Kessler, you ask them to come to the grand jury, they come in, they count to five, and they go home. If they got a lawyer they count to five and one-half [and] they go home because that's as far as we can go. But they don't talk.

You are doing an internal investigation. You invite them to come in and talk. They say "no, I'm not coming". They go home because they get fired. Well in that instance, we end up having more ability to deal with that then Nils does. Now we're going to have this interesting issue when we call the employee in because we've got this inkling that something is going on. The employee says, "I'm not going to talk to you." [You] say, "Well okay, we'll fire you." [The employee says,] "Oh, thank you very much because I just got this home in Boca that I need somebody to pay for and now it's going to be you!"(Laughter.) You just fired the whistleblower, and under Dodd Frank that's not going be a good thing. It was never a good thing, but now it's going be a real bad thing. So, all of these things are going complicate all of our lives. The SEC's lives may get better; the rest of us may get a little more complicated. I know it was also mentioned this morning, it is worth repeating, that it has been a practice when we have done internal investigations, for example, and the SEC is looking at the same thing, and we are doing this, and we have been able to say to the SEC, "Well, we're doing an internal investigation." Honigman Miller is doing one [and] they're very able' they're very honest' they're very straight –

Audience Member: At least two of the three. (Laughter.)

David DuMouchel: And, we'll find them. And we will end up telling you what we found. And sometimes they've been amenable to that. I think that's probably going to be less likely where they will just stand down and let you go ahead. They would still like to get what you find, and you will still have decisions to make [whether] to give it to them or not, but I think it will be a little bit less convenient. So . . . when you have got information; [when] the government gets information, when you get information; what happens then to lead it toward a criminal case and what you do about that? Go ahead.

Rich. Zuckerman[103]: Thanks. I don't know where he stopped. So, I'll just start where I want to. (Laughter.) The way you know if you are a lawyer, the way you see these things kicked off is really one of two ways. Either a whistleblower and through the hotline of the respective company if the complaint winds its way to the audit committee, they hire a law firm. And then, there are certain things lawyers have to do in order to institute an internal investigation, some of which were talked about this morning. The ones we see most often are stimulated

103. Richard Zuckerman is a shareholder at Honigman Miller and co-chair of the firm's White Collar Criminal Defense and Investigations practice group. He is a former attorney at the U.S. Department of Justice's Organized Crime and Racketeering Section, and has taught at both the Michigan State University College of Law and Cooley Law School. He has been recognized in *The Best Lawyers in America* from 2001 to 2011. *Lawyers & Professionals,* BUTZEL LONG, http://www.honigman.com/richard-e-zuckerman/ (last visited Feb. 6, 2011). His name has been abbreviated here for formatting purposes.

by either an SEC summons or a grand jury investigation. And the first thing that you have to do, if you are the lawyer, you have to figure out who your client is. You have got to keep it very straight as to whether or not you're representing the company or you're representing the chief executive because he is the guy that has contact with your business. And he is the guy that pays the legal bills. And he is the guy that calls you up for help. But notwithstanding all of that, you [must] first, as a lawyer, recognize who your client is because if you don't, there is a whole series of problems that cascade off of that.

Once you recognize who your client is, then you've [must] determine whether at that juncture anybody else needs a client—I'm sorry—anybody else needs a lawyer; everybody needs a client. (Laughter.)

David DuMouchel: And everybody needs a lawyer. (Laughter.)

Audience Member: Nils doesn't need any clients. (Laughter.)

Rich. Zuckerman: No, he doesn't need any clients. He just sits back and watches the rest of us scurry around like mice in a cage. (Laughter.) So, if you are representing a public company, what you might find is that the board wants a lawyer, the audit committee wants a lawyer, [and] perhaps the CEO the CFO, the CFO, [or] the CO want lawyers. And you have this whole panoply of lawyers that all have different clients, different responsibilities, different concerns, [and] different priorities. Off of that comes a different set of tactics depending on whether or not it is strictly at this juncture a civil case, a potential civil case instituted by the SEC, or it's actually a grand jury subpoena, which means it's a criminal case. But even if it is a civil case, you have to strategize as if it were a criminal case because the SEC can certainly refer, or the DOJ, either through a U.S. Attorney's Office or main justice in D.C. might already be involved in the case.

So, one of the things you do is you ask. You may get a straight answer and you may not. But whether or not the DOJ is involved, it then becomes what is called a parallel investigation. Presume it is and act accordingly. The issue of employees and how you deal with them, that itself breaks down into two categories. Former employees, which frankly are much easier to represent, leaving aside whether or not they have some kind of golden parachute or equivalent agreement that puts upon them some form of post-departure cooperation; or, and then, the other category is the current employee. And the main consideration in with respect to the current employee is what do you do if you're his lawyer, and he or he doesn't want to testify or he shouldn't?

And the pressure point between what can happen to him civilly with respect to the company, i.e. being terminated for failure to cooperate, or going in to testify, and then sinking himself and the company besides. And the reason he can do both at one time is not because he is ambidextrous but because of something called corporate criminal liability. The company is responsible for the acts of its employees within the course and scope of their duties - even if it violates the law and even if it violates company policy. And that is how companies get put on the hook when its constituent employees cook the books - because they're obviously doing it for the benefit of the company. So that is kind of like a framework for the issues that arise. And from our point of view, usually before you get to the substance because you know substance comes later, it is multiple representation - who you're representing, keeping that very clear. And Joe Papelian this morning talked about what's referred to as the corporate Miranda warnings. And then the responsibilities you have towards an individual employee that is your client with respect to the tension between the Fifth Amendment to protect him from testifying, and the duty that the company thinks he has to cooperate in the investigation.

So what do you what do you do to hammer both of us?

Nils Kessler[104]: Well, actually, that is one of the first things that we often run into if it is a corporate kind of investigation. And I will start with the caveat of saying that most of the securities fraud type of investigations that I have –

Rich. Zuckerman: Don't you have to say this is not, you know, this is not the opinion of everyone in the government?

Nils Kessler: Yeah right, this is not the opinion of everybody in the government, just me, but I'm not going say anything. (Laughter) See, everybody does need a lawyer, right? (Laughter.)

In the corporate type of case what we do run across a lot is that very thing, from our perspective, where we'll issue grand jury subpoenas. And maybe there had been a lot of grand jury activity already before the corporation or the defendants. The targets even know about it because we've been issuing grand jury subpoenas to banks, for example, and trying to get financial documents and figure out what we can before we even start talking to people. But once we start issuing subpoenas for people in the company, that is usually the first call one of us is going get: is somebody representing them? And we usually start from the position of I'm getting a call from one person who says, basically, I represent everyone. And then we kind of negotiate down from there and figure out who you really represent because like you said, multiple representation is one of the biggest issues.

You will have people who are not high enough up in the company to actually be speaking for the company all of the time. And our position is going to be, "hey, no. This is the guy who works in the trash room or whatever, and he happened to have found the incriminating documents. So, we want him in the grand jury." Of course anybody who's representing the whole corporation has some interest in saying, "no, I represent that guy too," and trying to have some control over what information we are getting. So, that usually is, and you will probably agree, one of the first

104. Nils R. Kessler is an Assistant U.S. Attorney for the Western District of Michigan.

interactions that we are going have a lot of times in the cases I've had recently. I would be happy to answer questions about any of these kind of things.

I have been lately doing a lot of Ponzi scheme type of cases that could be prosecuted as either a securities fraud or plain old wire and mail fraud type of case. And very often it may look like a corporation from the outside, but it doesn't really have a corporate structure. It is a couple of guys, or sometimes one guy and a couple of friends who are working for him, who present the image of being a corporation. But they are really just a con artist and some friends. So we don't have all those same issues.

David DuMouchel: And we will. In addition to the, and Nils's point is a good one, in addition to the Securities Act and the Exchange Act and the criminal statutes that follow, you have the plain kind of ordinary mail fraud, wire fraud, conspiracy, money laundering general Title 18 statutes that fit with any kind of a fraud scheme. Unfortunately, in many of our cases it also turns into a few more offenses: perjury, obstruction, false statements to agents. That's where you make a bad situation worse. And people do.

I overuse this phrase with people in the office, but it is true: it's not the crime; it's the cover-up. It is hardly ever a situation in a case like this where something is not done to try and cover it up. And as soon as that happens, the whole thing comes undone. People don't try to cover up something that was okay. And so, you start at the other end. You start to look at missing documents. Anybody can figure that out. The investigations start now and go way beyond with the subpoenas for emails. It's a treasure trove. It is the greatest thing that has ever happened for government investigations is those damn emails. And they don't go away, and you're not careful in what you write, and they stay there forever. And they sound a hell of a lot worse later on than they did when you were very clever and wrote them. (Laughter) Some smart-ass comment you made in that email does not come off so good later on, and things like and "this gets too close, I guess, but better if this doesn't see the light of day," you know, minor things like this. (Laughter.)

Nils Kessler: How about, "Don't talk to the FBI?"

David DuMouchel: Don't talk to the FBI. (Laughter.) I got tell you it is just not worth it. We have another investigation where it involves some foreign companies, and the emails are not in English, which ordinarily would be a good thing. In fact, I would prefer most of them not be. (Laughter.) But this one is bad. And we hired these translators, and that is not cheap at all. You talk about where you're going to get hurt with an investigation. Try to get one involving some foreign companies where you've got to preserve the emails, go back ten years and get them, and then have them translated before you turn them over to the government. You are talking about a hell of a lot. Even Richard's fees pale in comparison. (Laughter) They don't go away; they just pale

Rich. Zuckerman: We have to do better.

David DuMouchel: So you give the translator some words to look for like you always do in e-mails. You cannot go after every one, so you work out some terms and stuff. And they do; and they do a nice job. Because we're looking for particular things, and one of our other people is looking and says, "well, why didn't they flag this one? Where it says 'don't show this to the FBI?" FBI was not one of the words that we put in here. It just did not enter our mind that that might be one we might want to pull out. That is not good.

So you end up as part of the internal investigation, or the government does, grabbing the email. And that's where they start. It is where the internal investigations start. It is where the government subpoenas go is emails, documents, records. I mean my office is probably as bad as any. Nothing has one copy. Even when we used to use paper there is 27 copies of everything. Getting rid of 26 of them does not work. But people think it does, and so they start that, and then, they talk. And now there's an issue in the

Southern District over whether or not wiretap results can even be used in securities cases - which is really an interesting issue, where the Justice Department gets an order for a wiretap. Maybe this was mentioned this morning. It is really an intriguing issue. Judge Rakoff said they could get it. The second circuit told him maybe you ought to think about it a little more. And he will. But all of the investigative tools that are available to the government, to the U.S. Attorney's office, to the Justice Department in any other criminal case is available to them in these securities cases.

They're expanding; this is no news to you. You are not the favorite going into these trials or cases if you are representing corporate executives charged with securities fraud. You are not going in on the right side of this and the government knows that. And when they bring these cases and bring their resources to bear, your own internal investigation may have may have helped the government, may have helped yourself, but you're fighting an uphill battle with these cases.

Rich. Zuckerman: So let's say now you are a lawyer. You are a lawyer for the company, right? And so, you [must] kind of mentally structure what you are going to do, and you kind of have a mental checklist of all the things that you have to do and the order in which you do them. And what Dave is talking about is [that] if you are the lawyer for the entity, the first thing you have to do right away, especially if there's been a subpoena served, is you got to freeze the status quo when it comes to documents.

And by documents I mean paper, electronic, and everything else. Because if you don't, you are susceptible of having the government start threatening obstruction. There are form letters that recommend you put litigation holds on documents to advise people that they can't eliminate stuff from their own hard drives if their hard drives are not linked to the servers. What that means is you better find out if the company has an IT department. You better find out how qualified they are. And then, if they are not qualified, or they don't have a good IT department, you have to bring in a consultant in order to assist you both in freezing documents and then in retrieving them. And it becomes a very, very, very costly process.

Now, the last couple of ones that I've been involved in which are still active got kicked off by searches. That is a little different process where the government comes in and then just kind of puts you up against the wall and takes what it wants, and then serves you with subpoenas at the same time, just in case they missed something. There's a whole bunch of junk— excuse me. This is a law school. (Laughter.) There is a whole bunch of things you have to do if in fact a search is being conducted. And try to get out and get inside and talk to the employees. If they won't let you, try to tell whosever in charge, assuming they can call out, that they advise the employees they do not have to talk to the government.

Telling them what their rights are is a lot different than instructing them not to talk to the government because then the nice government will start thinking that you're obstructing their investigation as well. But document preservation and then trying to comply with subpoenas is very, very, very costly, time consuming, and difficult. What we like to do is see if we can get the government to agree to initially allow us to search computers through the use of search terms like David talked about. That shortens the process [and] makes it more efficient. Otherwise, you can have, and you will in any company of any size, terabytes of data that theoretically have to be reviewed to see if anything complies with the subpoena. And cost is not a defense to production. And so, the way I like to do it is I make up a list of stuff. I send it to the government, and I say, "This is what we're going to search for." And then, the good news is that the government usually takes six or eight months to get back to you because they are overworked, too, notwithstanding that everybody thinks the government has unlimited time and resources. And then you kind of negotiate with them the search terms and you try to conduct a search that way. This is how the stuff gets kicks off; this is how they start to require information. You may want to meet with key employees to give them what rights they have, if in fact, the nice government shows up at their home at six o'clock at night to interview them to ensure that they are properly counseled—not properly obstructed. There is a difference, usually.

Nils Kessler: I just want to follow up on the point that these gentlemen are making about the emails and documents, ET cetra. And it really is, in many cases, the cover-up. Our saying in the office is, "give me one good lie, and I'll get a conviction," because generally they're not going to lie about something. What I used to do primarily was violent crime and narcotics work. And you know, anytime somebody said it was an accident, but they cut up the victim into garbage bags and threw them into the river you knew something was wrong about what they are telling you. And it is essentially the same thing on the document level. So one of the things we are always going to be looking for is if people have been trying to delete documents electronically. Not only can we find them in a lot of different places. Every time you send an e-mail and someone forwards it to someone else, you don't know who else got it. We can find that original document in a lot of different places, some of them not within the defendant's control, particularly if it is not really an old document. We'll just send the subpoena directly to whoever the internet service provider is, whether that be Yahoo or AOL or whatever. And we will get e-mails straight from them. So, even if you think you can eliminate it from every server within your corporation, you can't get rid of it from the point of view of the server. And there is a case that me and Mr. DuMouchel were involved in, and without giving you and any details about the case, although it is over, it [has] just become habit nowadays where you have people who are literally ten feet away from each other in the same office. And they will sit there and tap away and talk to each other, you know, by text or by instant messaging or email all day long because they're too lazy to actually get up and walk down the hall. (Laughter.)

We have a lot of communications like that. And the thing that people will forget is, they may think, "I've deleted it from my computer, and I've deleted it from his computer," but it didn't go from your computer five feet down the hall. It went to northern Virginia, or it went to the Northern District of California and then came back. And we will get it from where it went in between. So if we get a document that we see on AOL's server, but it has been deleted from your local computer, that in itself is good evidence of consciousness of guilt.

Audience Member: So, if you have a whistleblower that comes to your office and the whistleblower spills his or her guts, you could go to the cloud or go to the source of those emails?

Nils Kessler: Correct.

Audience Member: Without giving notice to the company?

Nils Kessler: Right, we could, and we do have to have a search warrant. There are different ways to do it. I don't know if anybody here is really familiar with the Electronic Communications Privacy Act.[105] We call it ECPA. [It depends] on where you are. If you're in California they are a lot more strict about this. We have a way that is short of a search warrant called a 2703D Warrant[106] where we can get content from one of those internet service providers. In California, because they're in the Ninth Circuit, they have interpreted that a little more strictly. So we actually have to get a search warrant and that does tend to cover a lot of your internet service providers that are located in California. So, a lot of times, what we will do is just go ahead and put it in the affidavit, for example, that that whistleblower came in; they were willing to be identified to us; sat down and told us that

105. Electronic Communications Privacy Act of 1986, 18 U.S.C. § 2703 (2010).
106. *See id.* at § 2703(d).

this or that, you know, bad thing is going on at the company. That's our probable cause and it goes into the affidavit. We get a judge to sign off on it, and all that e-mail content will be turned over to it.

Rich. Zuckerman: What he is talking about I think is the is 2701 et seq, which is the Stark Communications Act.

And that is something that AOL I think got the Congress to legislate. It has a civil aspect and a criminal aspect. The civil aspect prevents the normal civil litigant from subpoenaing every ISP for anything they have on their opponent's civil litigation. And I think he is talking about the quand phase, but I'm not sure in the Ninth Circuit about the extent to which the Stark Communications Act blocks the retrieval of information for a civil case. On the criminal side, the Stark Communications Acts allows these guys to do virtually anything they could do with a with a grand jury subpoena. But if you are doing litigation, and you're, this is I guess a civil issue. If you are doing litigation, and your opponent decides to subpoena your client's e-mails, take a look at 2701. You're probably can quash the subpoena.

Nils Kessler: Maybe. (Laughter)

Rich. Zuckerman: Maybe. You have a better chance at doing that than you do if it is a criminal case because you won't even know about it.

Audience Member: Would you advise a person who is a whistleblower to go the SEC so they can collect their bounty? (Laughter.)

Nils Kessler: I wouldn't advise . . . (inaudible) (Laughter.) And honestly, you know, the cases that I get, I'm usually hearing about it from a federal agent and the agencies that bring these types of cases . . . to us the most often [are] obviously the FBI. You guys are all aware of [that the] IRS does a lot of this type of investigation as well because they have great accounting firepower. And the Postal Service, the U.S. Postal Inspection Service, I don't know how many people are really familiar with them, but I think there's two things going on. They traditionally were the people who did the mail fraud cases, and there . . . is less and less mail, and so they are branching out into other things and they have become very good at doing computer-type investigations. So I usually am not going to be dealing directly with a whistleblower.

They may have gone to either the SEC first and we will get a referral because they will look at it and say, "Now, we think there's really criminal intent here." Or they may go straight to the FBI. Or in a lot of instances . . . somebody gets ripped off for example, [and] they will go to their local sheriff's department or . . . the police station down the street, and they will look at this and go, "Securities fraud? You know, it's not a home burglary so we're going to call the FBI." And that is how we get it.

Rich. Zuckerman: Why don't you talk about how you protect a client? What would you negotiate on behalf of the client? What type of arrangement, if in fact you represented him individually, and you thought, "Well, maybe they ought to say something to the government?"

David DuMouchel: Well, again, it is not really different than other kinds of investigations in cases. If you represented an individual who had some role and either just knew about something or maybe even participated, and you try to work out an arrangement with the U.S. Attorney where your client wants to cooperate, if he or she does. You try to negotiate some type of either a plea to a reduced offense or ideally immunity or a non-prosecution agreement, we would . . . in fact . . . go to an Assistant U.S. Attorney and try to do that. Others who may not know, you can go to a - if you end up at the FBI, or Postal Service, or whomever. Where that gets to be a little clearer for those of us who are doing internal investigations, is especially – it is easy with a public company. Take that as an example, because you are not going to find out if you are a law firm and you are hired by a public company to do an internal investigation and you find out about fraud, you are not going to just forget about it. You are going to go and disclose that because you have to go and disclose it.

It is a very uncomfortable position to be in because the board of directors and the audit committee, primarily the audit committee, will hire a law firm to do the internal investigation. They get a complaint; they get a suspicion. Sometimes it is easy; 27 agents show up in yellow jackets and tear the house apart [and] the building apart. You figure out there is an investigation. (Laughter.) Even I can figure that out. Sometimes it's not quite so easy. Some employee will just say, "I think so and so is falsifying the revenue recognition." You will find out, and they will report that up maybe to the comptroller. What is she going to do about it? Forget about it? Not in a public company [and] probably not in a private company, anymore. And so . . . the board of directors and the audit committee will hire a law firm to do an internal investigation.

It is almost instinctive to do that, and with really no understanding at the front end of how bad that it is going to get. And it gets bad. It gets expensive. If you are on the audit committee, you have got very mixed emotions about it, "I've got to do it. I've got to hire somebody to find out what went on here. And I hope to hell they do not find anything; I hope there isn't anything. It is not that I hope they do not find anything. I hope there isn't anything because the CEO [and] the CFO are people that I hired. They are friends of mine. I don't want Richard Zuckerman to go find out the guy has been cooking the books. There is nothing good that is going to come from that." But then you are kind of in a tough spot because when the investigation starts going; it starts going downhill like a snowball and you cannot stop it. You start looking at one thing, Richard and I had a case very much like that, where you start looking at something and you can almost fence it in. You can kind of get a rough idea how long it is going to take, how much it's going to cost, what it's going to be about, and then it just breaks outside the fence.

Rich. Zuckerman: It went on for years. It was wonderful. (Laughter.)

David DuMouchel: Richard destroyed the fence. In fact, he said there was no fence. But, in the audit committee you cannot say to Richard, when he makes his report to the audit committee and says, "Well, I have now found out about this." [The audit committee cannot say], "Well, you know, Richard, that wasn't part of the contract. Don't go look at that." That isn't going to work. So this thing keeps going and you find it.

Now, assume you find something wrong. You are bringing people in to talk to you. And we do not do it any different than Nils does. You . . . start at the bottom. You start with documents, and you work your way up, and you talk to people. Now you're up at a level that you really would rather not be at. You know you have got to call the CFO in. You already know what he did. I mean, you've talked to 15 people that told you what he did. I will tell you what I did. I am not sure I should have done it, but Richard can represent me. I do not really want this person to come in and confess to this fraud. Number one I am going to have to go tell the FBI, which I do not really want to do. Number two that really is not going to help the company a hell of a lot when I disclose that my CFO committed securities fraud. That's not going to be real good under the corporate responsibility doctrine. That is not going to help. I kind of rather he just would not come in, because then we can fire him for non-cooperation, which, by the way, I kind of suggested to his lawyer.

And I said, you know, if he comes in, number one, he has got to come in. I hope he doesn't. (Laughter.) Number two, when he comes in, if he tells us the truth we are going to go to the FBI. If he lies to us we're going to go to the FBI. He is not in a good place here and we have got everything down. Well, he came in anyway, which I guess seemed like a pretty good idea at the time. You know he gets fired; he gets prosecuted; and on you go. But when Richard asked what you do if you represent an individual, an individual in that case is the one who finally disclosed to us what was going on, and it was out of a bad movie.

The guy comes in twice and lies to us. You knew that because his lips were moving, so you knew he was lying. He is the one that cooked the books. He did it himself. And the third time he comes in he had been drinking all day, which I did not put him up to. It just happened that way. He comes in [and] we talk to him.

Hey says: "Well yeah. I suppose you think I did this."

We say: "Yeah."

[He says:] "Well I did."

[We say:] "Okay."

[He says:] "I suppose you think I cooked it up. Well I didn't and I got the tapes."

[We say:] "You got the tapes?"

[He says:] "Yeah, but I'm not going to give them to you."

[We say:] "Ok, where are they?"

[He says:] "They're in my car."

Fifteen minutes later you have got the tapes and he tells you everything. (Laughter.) Get him to a lawyer – a good lawyer. Get a call from the Assistant U.S. Attorney who says, "We are now investigating this case," after we gave him half the information, and he said "we'd kind of like your opinion," which they never ask for my opinion about it. So I felt very good. (Laughter.) "If there is anybody you think we should give a break to in this case who would it be?" I said "I think you ought to give it to the guy who came in and finally told us the truth." But you know he's about fifth level down and he can bury everybody, and he is not too high, he is not too low, and he is here.

So, three weeks later [an] FBI agent calls and says, "Can I talk to you?"

And I said: "Sure you can talk to me. Why?"

[He said:] "Well I'd like to know what this guy told you."

I said: "Well I told you what he told me."

He said: "Yeah, I know, but he came in and met with us, and he told us the exact opposite."

I said: "He did what!?"

All teed up to get immunity; all he has got to do is go in and tell the truth and he couldn't do it. So he goes in [and] lies to them. He's got a 1001 issue for lying to an agent, just blown the whole chance of getting out of the case. He goes in and lies to them. I haven't any idea why. But you talk about what you do when you represent an individual. They did the right the thing. The lawyers did the right thing, [but the] client didn't do the right thing.

Nils Kessler: To give my perspective on what you would do, I mean there are a lot of different approaches I've seen from our side, how the attorney who is representing that person comes to us. I think a couple things you might think about first is where this person is in the scheme. If you are representing somebody like you say, who is in the middle somewhere or a little lower down, they are well placed enough to know some information but they are not the most culpable guy in the whole thing, then there is a lot to be said for bringing that person in and trying to cooperate with us. And some of you may be really familiar with exactly how it works, but essentially our sentencing guidelines, and also a federal statute if it is after sentencing, gives us the authority to make a motion to the court to reduce somebody's sentence for what we call substantial assistance. And that usually means putting somebody else away. If somebody can come in [and] be our cooperating witness, we can file one of those motions and they can result in some pretty sizable reductions in the person's sentence. So, if the person really has a lot of inside knowledge and is willing to cooperate, there is a lot to be said for getting in early.

It is kind of race to the courthouse with that. I mean, the earlier you get in as a cooperator the less your sentence is going to be and the more you are going to be kind of our star witness who got things rolling. If you come in really late after we know everything already you are of less use to us and you are less likely to get time off for cooperation. If you are representing that guy who is at the very top, there are also a couple of different approaches to that. It is not going to work in every case, but I've had a few. One of them was from around here recently, a guy by the name of Mark Hamlin. It was already in the paper so I am not telling anything nonpublic. But it was a very small Ponzi scheme – you know, [in] the scope of these things, about a million and a half dollars. He was doing day trading and had people investing money with him and he basically was losing their money because he did not know what he was doing. [He] was sending out fake, basically, bank statements saying, "You're making a lot of money," and so people stayed in or didn't take their money out when they otherwise would have. And the approach that his attorney took, who was a very experienced attorney in our district, who knows a lot of us and has some trust built up, is he actually came to us with this client before we even had an investigation open and just said, "Look, my client wants to come in here and he wants to talk to you." He did not just throw him on our mercy. What he did basically is what is called a proffer.

Has anybody been involved in a regular proffer agreement, like what we normally do? I know these gentlemen sure have. What we do is we send a letter to the defense attorney and depending on where you are, I used to be in the New Orleans office. We used to call it [a] "queen for a day letter." I don't know why. (Laughter.) [It is] also called a Kastigar letter. And what it will say basically is, "You have limited use immunity for anything you tell us, so we want to hear the full truth from you, you know, what you have done. Admit everything you can, but we won't use any of that against you in our case-in-chief. You are protected so that if you decide, 'I do not want to try and work out a deal with you; I have decided I want to go to trial for some reason,' we cannot just call those agents who sat in on that proffer and say, 'What did he admit to you on October 15th?'"

There are always two caveats to that basically. One of the caveats is if you lied to us, the deal is off and we can use whatever you said to prosecute you for perjury. And the other one is if you decide to go to trial, we can use what you told us to impeach you. So you could still go to trial and sit silently and not testify and we would not be able to use anything you said. But the one thing we always put in the agreement because we just can't abide, basically, by somebody coming in, admitting to us that they were the mastermind behind the whole scheme, going to trial, taking the stand, and saying, "I was in France that year. I don't know what happened." You know, if that happens then we will use what you said to impeach you. So there is a little bit of risk from your perspective if you are representing that person. Coming in and trying to get ahead of the game does foreclose your client's ability to lie at trial. To the extent you were not going to put him on the stand to lie at trial anyway, you know, we kind of consider it a win-win for both sides. We find out what is going on, and frankly, we are going to be just a lot happier with your client. I can just tell you personally because there are people involved in this. I would be a lot more happy with a guy who comes in before we even know he has committed a crime and says, "I did a bad thing, I want to get it behind me, and I want to come clean about it," than somebody that we spend three years and hundreds of thousands of dollars investigating.

Rich. Zuckerman: What this leads to is, if you represent an individual in a matter where he is in the hierarchy, the notion is how do you get him the best deal with the least amount of exposure to the government? So you kind have a variety of things you do that have been talked about that you inch along. The first thing you can do is, if the government is interested in this person, see if the Assistant will allow you to come in and say what it is the client knows – an attorney proffer. Nothing in writing, verbal, sit down, talk to somebody you know, hopefully you know, and get a reaction. Then you go back and talk to the client, you know, "There is no guarantee, there are no promises, but it sounds like that if you tell them what you told me and if they can't disprove what you say then it looks like we can work out A, B, C, D, or E." Sometimes the government won't do that for whatever reason. They want to talk to the client. If they want to talk to the client then you want to get some form of protection around what he says. That is a letter agreement, sometimes called a Kastigar agreement, and that basically says that whatever the client says cannot be used directly, but it can be used derivatively.

And there is also a little sneaky thing here that the Sixth Circuit just created which is this. You have a Kastigar letter. It says nothing that you say can be used against you. So you negotiate something. You decide the client is going to plea. The client pleads. He has a Rule 11 plea agreement. Then something is said at sentencing that the client wants to object to, and he does, either through the lawyer or through himself when he speaks on his own behalf at sentencing. And then what the government says is, "Well that is contrary to what you said when I interviewed you." And then the lawyer says, "Well you can't use that stuff against him because I have an agreement." Well the Sixth Circuit has a recent case that says a plea agreement supersedes anything that comes before it, including Kastigar letters. So if you're negotiating a Kastigar letter with the government to protect your client from an interview, if your client then decides to enter into a plea agreement much later for whatever reason, you have got to either incorporate that Kastigar letter into the plea agreement so it still has vitality, or you've got to make certain that the plea agreement somehow independently recognizes that what he said won't be used against him at sentencing. So, if you can't get an attorney proffer, you get a Kastigar letter.

It is a kind of de facto contract with the government. And then if your client is really needed by the government and the government really does not have enough to indict the client independently, then you can sit back and say, "No Kastigar letter because there are too many exceptions to it." The exceptions that the U.S. Attorneys often spill into a Kastigar letter swallows up almost the entire protection. Say "I'm not going to." You immunize them. And then they will try to be nice to you because it takes months to get an immunity. Immunities are very difficult to circumvent once they are entered. They are judicially entered pursuant to statute. So ultimately, if you have a client that has really got something to sell and the government cannot otherwise charge the client, the best way to get the government off your back is to say immunity or nothing. If they give you immunity you win and if they go away because it is too difficult you win. So there is kind of like this scale of things you can do. The other thing to keep in mind is that promises by agents are not binding. So if the FBI agent or the IRS agent or whoever says, "don't worry, here's the deal," they cannot bind the government. Whenever I talk to an agent I want to know who the AUSA is.

Nils Kessler: We always tell the agents, at least I do, "If you are talking to the defendant you tell them 'no promises,' but you will talk to me." And then we have to work it out attorney-to-attorney.

Rich. Zuckerman: They bury it somewhere so it is not real clear what they were talking about. So you keep that in mind too, that agents cannot bind the government. If you know who the AUSA is because they are on the bottom of the subpoena or they are on the search warrant call them. If you're not really sure who it is, ask the agent and they will tell you.

Nils Kessler: And just by the way, you can write this down for anybody who is not real familiar with the U.S. Sentencing Guidelines. What he was talking about, about putting something in the plea agreement that kind of continues that agreement you had in the Kastigar letter. It's section 1B1.8 of the U.S. Sentencing Guidelines.[107] And we have kind of a stock

107. U.S. SENTENCING GUIDELINES MANUAL §1B1.8 (2010).

clause that will say you have . . . the title of it is "Protection for Proffered Statements," and it will basically continue the agreement that you had in the Kastigar letter saying, "Anything you said in any proffers prior to this will continue to be protected the same way."

David DuMouchel: This isn't the place to get into a lot of the nuances, but proffer agreements are used all the time. Proffers are used all the time. Every day, you are going in and you are bringing a witness in, and they are talking to the government, and you are trying to get the most protection you can get. It works almost all the time, but like everything that works almost all the time, the bad news is when it doesn't. So, you have got a proffer agreement, Kastigar letter, won't use anything you say against you, directly. There is a Seventh Circuit case that . . . [is] just ugly. I understand that I cannot have my client go in and meet with the government and tell them that he committed securities fraud and so did his boss, then when he does not get the deal he wants and goes to trial he cannot get on the stand and say, "I didn't commit securities fraud and I don't have a boss, and by the way, I don't have a dog." (Laughter.) None of that - even I can figure that out.

Where the problem is, in the Seventh Circuit case, is that a defendant does not testify – does not say anything – but his lawyer has the temerity to cross examine a witness and try to impeach the witness's credibility. Well, there goes the Kastigar letter. The court says your lawyer is kind of saying something that is inconsistent with what his client said during the proffer session, so in comes the proffered statement. That was a bad day for whoever thought that Kastigar protection covered.

So there are issues. But I will tell you that, and Richard's case he mentions, which is a pretty stunning opinion, those kinds of things do not happen very often. If you have got a client that goes in and is aware of fraud, aware of what is going on, cooperates, and is truthful, which is, you know, they keep sticking that in there, and is truthful, chances are it is going to be very beneficial.

My experience, maybe my clients and nobody else's, but the truthful part does not come easy and it is a process. It does not get said in the first meeting. There is truth said in that first meeting, and there may not be many lies said in the first meeting, but it is not the whole truth in the first. The second one gets more. The third gets a little more. As you keep going it keeps getting better. You have got to have somebody you can work with, some Assistant who has got some patience, who is not going to say at the end of the first meeting, you know, "that wasn't completely truthful," because you need to know when you go in there – and I know we are not talking to people who are going to do that much, but there are times when you are going to take the first person in [and] the government does not know anything about it. That's not very often. You have got to assume the government knows more about this case than you do. They have probably got five people in there before you got there, and it helps when you tell your client, because you know, you are really not going to fool people a lot when you go in there. And it is a process you have to go through.

If you want to help your clients M.O., either don't not go in at all, which is fine, and don't cooperate at all, and that is fine too, and [then] nobody gets mad at him. Nils Kessler is not going to get mad at a target of an investigation for not going in and talking to them; [he is] not going to get mad at him at all. That is their right. It is what they do and it is fine. And they understand that very well. What they do get real mad about, is when I call them up and say, "I'm going to bring my client in, cooperate and be truthful," and he sets up a meeting and he has three agents come in there and they spend a half a day and the guy goes in and lies to them. That tends to annoy people, and –

Nils Kessler: Let me piggy back on that, because it is not just that we get upset. Let me explain the mechanics of the problem that gets created . . . . We see this all the time.

The cooperating witness comes in first, and it does not matter if it's a CEO or if it is the corner crack dealer, they want to tell you a little bit at first and minimize, and . . . part of it is sometimes people do not want to admit they did everything that they did, and some of it is they deliberately want to hold things back thinking, "I'll trade this nugget of information for X number of months or years off of my sentence, and I've got more but I'm not going to tell them yet. I'm going to try to extract more for this information."

The problem becomes that when we have one proffer and they tell us part of the story, and then we find out more or we knew more, and they come back, when confronted with, "no, we actually know you did X, Y, and Z as well." Then they go, "okay, yeah I did," then you have a second statement that is different than the first. And then when we come back and go "you also did P, Q, and R," and they go, "yeah, I did that too," now I have got three statements. Is anybody familiar with the case of U.S. versus - we just call it Giglio – U.S. versus Giglio or Giglio versus somebody.[108] But, it's a case about impeachment evidence, and we are required to turn over in discovery to the defense counsel for whoever is going on trial any information that could be used to impeach our government witnesses. So if we have got a cooperator that you guys are representing and he has told us three different stories, I have got to turn that over. I have to actually tell defense counsel, "he only told us this, and then he expanded a little and he told us more, and then he told us more again," and it leads to a devastating cross examination.

When I put that witness on, a good defense attorney is going to say, "isn't it true you only said this, and then only later when you were actually caught did you expand it to that?" And, "you lied to them the first time?" Now I have got a witness who really has not helped, and he may have even hurt my case. And I have had a few of these cases where, honestly, it is not

108. Giglio v. United States, 405 U.S. 150 (1972).

even just that me personally, I'm angry with them. My supervisor may just say, "that guy almost tanked your trial," or "he did tank your trial," and now despite the fact that he has been convicted and has a cooperation agreement in his plea agreement, we will not file a 5(k) motion to give him any time off his sentence, so he will be worse off than if he had just gone to trial.

David DuMouchel: The other part of that, just because I just can't, to sit in those meetings, you sit in those meetings; this only happened once that I am aware of. Richard will know who did it, but we are sitting in the meeting, and it was an obvious case. It was not a securities fraud case; it was not a white collar. It was actually a mob case, years ago. My client would rather not have been talking, and he was in there, and he is talking, and he is denying everything. Why the hell he went in there [was] somebody else's decision, because he wanted to. And the agent, he isn't writing anything down. Tell me what that means. I said "Mark, you didn't seem to be writing anything down?" He said, "I will write it down the next time when he tells me the truth." (Laughter). That isn't how it's supposed to be. (Laughter.) You are supposed to write this down and they are calling eating their pencils, they didn't get the –

Rich. Zuckerman: (interrupting) There are a couple things, I'll work backwards. If you have an agreement with the government, a departure agreement, pre-sentence 5-K1 for cooperation and your client is perceived to have tanked the government and the government does not file that motion, that is pure prosecutorial discretion and courts cannot order the government to file a motion. So if you annoy the government too much and they decide to hell with your client, you cannot run to court with some motion and have the court weigh the cooperation versus how badly he might have or maybe did tank the case. So you got to make sure the clients understand that if they go in and tell multiple stories, that's Giglio material, but if they go in and tell one story that says someone else did it, and then he did it, and then you get *Brady*[109] material and it even compounds the problem if they are providing the government with a series of statements that exculpate somebody the government is going after. And, it is terrible. The other thing to keep in mind if you are negotiating a plea agreement is that some of these U.S. Attorney's Offices, no matter how good your information is, have policies where the best you can get is half off the guidelines. You better know this going in because the client thinks he is giving the government, you know, who killed Jimmy Hoffa, and the government says, "yeah, you know, you got 10 years, we'll give you 7, isn't that great?" And the client looks at you like, "what kind of deal is that?" So understand whether or not the particular U.S. Attorney's office has a policy and how far and what kind of a reduction they will give you, even if your client lives up to everything to do with the plea.

The other thing, there are a couple of judges in the Eastern District of Michigan, and I was in a case recently where, notwithstanding the government agreeing that the sentence would be reduced to a much lower range, that does not bind the court. The court in this case, there were twelve defendants, there were six the court considered to be key people, everyone of them but one got above the range that the government agreed to. That creates a problem for you because you are telling a client, well, it used to be 36 to 42 months and now it is reduced to 18 to 24 and the court goes in and gives the client 30. Well, the client's looking at you, saying "what happened," and you are trying to tell the client, "well I told you the court could do what it wanted," but the clients do not remember that. It also creates a problem for the government because if the government cannot deliver on its promise you have to weigh whether or not the risk to the client to fight the government . . . that is something else on the scale of whether you fight the government because the government cannot deliver. The only way the

109. *See* Brady v. Maryland, 373 U.S. 83 (1963).

government can deliver, there are three sentence, there are three under rule of and there is A, B, and C, and I don't remember which is which, one of them is sentence specific, but the courts have this –

Nils Kessler: You want to say –

Rich. Zuckerman: Yeah. The courts have this notion that they are not going allow pleas that bind the court to give a particular sentence. You know I have always suggested that that is a separation of powers problem, but no one wants to litigate that.

Audience Member: Is it better to go to the SEC first or the Department of Justice first, or at the same time if you are going to cooperate?

Nils Kessler: Are we back to these guys? I never see the SEC side of it.

David DuMouchel: Right, and when we had an internal investigation some time ago, where we found out the securities fraud had been committed, I actually arranged for a conference call with the SEC and we went over to the U.S. Attorney's Office and setup a meeting with the AUSA's and had the SEC on the phone on a conference call and told them both at the same time. I don't know why, except it seemed like a good idea at the time, and it actually was. And the SEC fellas. The cold fact is that the Justice Department investigation is going to trump the SEC investigation. Nobody wants to get sued by the SEC and nobody wants to get 102-E bars and nobody wants to get any of those things, but they really do not want to go to jail. (Laughter.) So when you got a decision to make, you really got to have that investigation trump the others, or the results of that investigation trump the others. And related, [as] Richard had mentioned, and I know they talked about it a little bit this morning, but just two aspects of guidelines, and they bore everybody - mostly me.

Nils Kessler: Except the defendants.

David DuMouchel: Well, except the defendants. The whole criminal justice system in the federal court is all run exactly backwards. It is all run backwards. It starts with sentencing guidelines. Of course I have not been charged yet, but you know, we start at the other end. Everything is run by the guidelines. And how serious this case is and what the sanctions are going to be at the end, what you look at, and the AUSA's look at it, defense attorneys look at it. What are these guidelines [are] going to be, how long is this person going to face, and it is a grid. Twenty years ago someone thought they were going to make sentencing be objective, they didn't, but they said they were going to, and so they put it on a grid, which must mean its objective. (Laughter.)

And then [in] a securities fraud case, or any fraud case, there [are] two categories. One has to do with the individual. So you have prior records, prior convictions, all this stuff, and that comes off or whatever it is. And then the other axis is fraud loss. What is the loss, and obviously the higher the loss, the higher the guidelines, the longer the potential sentence range. I mean, I just don't have time and nobody wants to hear it. The whole thing is a sham. We talk about mail fraud. (Laughter.) What it did was turn the sentencing system over to the Justice Department as opposed to the court, but that is a whole other story because they decide what to charge you with. We could charge you with a violation of the migratory bird act or we could charge you with fraud, and I would rather charge you with fraud, unless you are cooperating and then the migratory bird act would fit. The whole thing is supposed to be objective and it isn't. But, the fraud loss numbers in securities fraud cases, there is not enough zeros on the end of some of these things. And, and this is not just a defense attorney talking. It also happens to be true, which are not always the same thing.

A lot of that is serendipitous. It is like mortgage fraud and the fraud loss. If the market goes up, the loss is lower. If the market goes down, the loss is higher. That fraudster did not have a damn thing to do with that market going up or down. A lot of it is bad luck; some of it occasionally is good luck. You have got the same thing with securities fraud.

The dollar figures on loss figures and securities fraud cases are astronomical. That is why some of these sentences are as high as they are. Is a person any more venal because he caused a loss of 300 million dollars instead of 100 million dollars because the market went down? I guess God can figure that out, I am not quite as good at it. The numbers get astronomical when you get in early, and maybe you can impact some of that: the charging that is going to be done - what charge is going to be brought.

Another thing that people do not talk about much [is] charge bargaining. What charge is this person who is cooperating - what is he going to be charged with? What year, maybe the loss got higher in another year and we just charge him with this one. There are a lot of things you can do for your clients in those cases.

Another thing, compliance programs, I assume that was talked about this morning. Under the sentencing guidelines it is a huge deal if a company has a real compliance program. Writing down on the back of the page the Ten Commandments and sticking it on the shelf ain't going to make it. It has got to be a real compliance program and it has got to be followed. The good and the bad news of having a compliance program is that if it is not followed you are worse off; got to have one people pay attention to. And you will hear from prosecutors, I heard this from a state prosecutor who happens to be here to today, God Bless him (laughter), but the tone at the top of a company matters. It matters to prosecutors if this is a company where the tone at the top is to follow the law or whether it is not. No matter how good it is you can have bad apples or good eggs, whatever the hell we are going to use, but what is the tone. Does that company have a real compliance program where that kind of conduct is not going to be tolerated or [are] people just going to look the other way at it? That is a big break on sentencing guidelines. You know you go and talk to

Richard's clients or mine and corporate clients, you talk about sentencing guidelines and compliance programs they look at you like, "what the hell are you talking about? We're honest people. We are not going to commit [crimes.] What do we care about sentencing guidelines?" Well, some real good companies thought the same thing and it makes a big difference if you have an effective compliance program and one that is followed.

Nils Kessler: Not just guidelines wise, but just to give you a concrete example of that. It wasn't exactly a securities fraud case, but I had an investigation not that long ago where the allegation was that the company was internally wire tapping its employees. That is illegal in case anyone didn't know it. I mean, we can do it with court authorization, but it is a pretty cumbersome process. One private party cannot do it to another. That was the allegation, and by the time we had even, just a few weeks later, we got to talking to the attorneys for the company, they came in with a package like this (holds up folder) of all the things they had done to fix the problem. They had disciplined the supervisor who had been listening in on people's conversations, admitted everything that was going on, showed us the training program that they had, videotaped the training program they had been giving all their employees, and it made a difference. I mean, just as a person, I sat there and watched this and said alright they care enough that maybe this is something that should be civil as opposed to criminal.

Audience Member: Richard, I have seen some sentences of 50 year; 85 years. Just two minutes on guidelines?

Rich. Zuckerman: Well, the guidelines simply score your bad deeds: the higher the score, the higher your sentence. Basically, the easiest thing for the government to do in a complicated securities case is charge mail fraud. Because it is easy to prove, it is well established that you do not get into the nuances of fraud in the sale of securities and is just starts, straight out lies. If you look at the guidelines, they are break points. The average major fraud today is has got to be at least $20 million. If you start at $20 million of loss or intended loss, meaning, for example, you've got people who invest $20 million dollars and you are going to steal their money. [It] doesn't matter that their money wasn't lost because the intended fraud was $20 million. If you are at $20 million, you add the numbers for the $20 million, you add the base offense, and then some other things like: the number of people involved; the number of victims; whether they are vulnerable victims; whether there is an abuse of skeleton trust which would apply to say a stockbroker, lawyer, or an accountant. You are at 20 years. If you go to $50 million, you could be at 30 years easy, maybe life, depending on all of the add-ons to the amount of the loss. I am sorry, at $50 million you get 24 points plus the original. I will go on the lower, six, you get 30 points. 50 victims, add four more, is 34 points. If you made misrepresentations to a financial institution, you would add two, which is 36. Sophisticated means, you could add another two, which is 38.

Nils Kessler: You always have sophisticated means

Rich. Zuckerman: Naturally, of course, and you always have vulnerable victim. Life is terrible. (Laughter.) You know, if you have a violation of the securities laws which is a constituent of the mail fraud, you can add four for that; four for [an] aggravating role if there is obstruction of justice. Of course, as long as you are stealing money you might as well lie to the government. I mean what the hell, you've got nothing to lose. (Laughter). Two for abuse of position of skill and trust [and] that is a very broad category. I think I am probably at around 47 and the guidelines only go to 43; 43 is life. Now what you are limited to is the statutory maximum, so even if your guidelines calculate you know, 3,000 years, the statutory maximum limits what the government can do, except if there is multiple counts. If there are multiple counts, then there is another, you go through another short calculation and all of the sudden you now have, say three or four 20 year offenses that are stacked. They run consecutive.

Nils Kessler: Even if they do not run consecutive, one of the things you have to be aware of –

Rich. Zuckerman: Stack them.

Nils Kessler: Yeah, if the guideline, say is 30 years, and mail fraud comes with a 20 year statute. If you have one count of mail fraud, 20 years is going to be your maximum sentence. If you have two, the court can go up to 40 years, and actually the guidelines will tell them to stack –

Rich. Zuckerman: Right –

Nils Kessler: those maximums to give them enough, what we call cap room to impose the guidelines sentence.

Rich. Zuckerman: Mail fraud used to be five years. It was almost was worth it . . . I think. (Laughter.) You talk to some clients and you say to them, if it is a five year max, you do two and a half and they are going to steal $50 million. I don't know any of my former clients that wouldn't jump on that. (Laughter.) You would too.

Nils Kessler: Let me throw one thing in there. Both of these gentleman have mentioned it, talking about what they call charge bargaining. We are required, under normal circumstances, to charge somebody with the most serious readily provable offense. But there are exceptions to that. For example, if somebody is cooperating. If that is our big cooperator and that is the only way we are going to get them to testify, we can get an exception to that. And, if you are one of those first people who is coming through the gate and you are valuable to us, you could for example, this is one thing I actually really like, is have that first person plead guilty to a conspiracy under 18 U.S.C.S § 371 to . . . conspiring with his client . . .. Now I have my witness locked into a plea where he says, "I admit that I am guilty of conspiring with all of these guys." I have got my case against these guys and your client has a five year maximum under 18 U.S.C.S § 371.

Rich. Zuckerman: By the way, I have been in cases where the one client pled and the other three have been acquitted.

Nils Kessler: Yeah, that looks really bad if that is your client

Rich. Zuckerman: That does look bad. (Laughter.)

Nils Kessler: I throw out one other thing about the guidelines - are we out of time?

Elliot Spoon: Well, we have got two minutes.

Nils Kessler: The last thing about the guidelines is that they are not binding anymore. If anyone wants to look up these cases, it is Booker v. Washington, or U.S. v. Booker and Blakely v. Washington, or the other way around. Booker and Blakely[110] is what we call them. And, basically the SC said that it is unconstitutional for the judge to find . . . the person gets a higher sentence without going in front of a jury to find those facts. So essentially, they fixed this by making the guidelines advisory. So tone matters a lot. You may have very high guidelines, but I know at least one of our judges, Judge Bell for example, will look at that amount of money and go, "wait a second; it's just more money because you didn't catch it or the government gave away this money for 10 years as opposed to two." And if the person is really contrite it is going to make a lot of difference, and it is going to be your job to go in there and explain why a lesser sentence is more justified and the court is not going to be stuck with the guidelines.

Elliot Spoon: Let's thank the panel for a very entertaining afternoon. (Applause.)

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110. *See* Blakely v. Washington, 542 U.S. 296 (2004); *see also* United States v. Booker, 543 U.S. 220 (2005).

111. Editor's Note: The 2010 *Midwest Securities Law Institute* concluded with attendees dividing into nine teams and participating in a mock FINRA arbitration. It was not recorded for transcription.