PROCEEDINGS OF THE 2011 MIDWEST SECURITIES LAW INSTITUTE SYMPOSIUM*

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WELCOME FROM ASSISTANT DEAN ELLIOT A. SPOON, INTRODUCTION, AND SUMMARY OF EVENTS

Elliot Spoon: Good Morning. I am Elliot Spoon, the Assistant Dean and a professor here at the MSU College of Law.[1] I want to welcome you to our annual Midwest Securities Law Institute. Dean Howarth, who would normally officially welcome you, is on law college business in Washington D.C. today, but she sends her welcome as well. We have a very interesting program for you today covering a variety of important developments in securities law, with special reference in most of the topics to the Dodd-Frank Act.[2]

Before we move on to the substantive part of the day, I want to mention to the folks in the room that it takes a lot to put on this program and a lot of the work is done by our students. We have two won-

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* **Editor's Note:** The staff of the *Journal of Business & Securities Law* would like to thank the speakers at the institute for an informative and entertaining afternoon.

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.c

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

derful organizations. Well, actually we have many wonderful organizations at the Law College, but two in particular play a vital role in the production of this program.

The first is the Business Law Society. They put on a variety of programs during the year. They bring in speakers to talk about various aspects of business law. They also just went to visit a law firm and met their lawyers who talked to the students about the kind of law practice they have. So, if you are interested in a group of students visiting you, we would certainly be interested in talking to you.

The second organization is the *Journal of Business & Securities Law*. It is a relatively new journal. I think it is in its fifth or six year, but in the last couple years it has become an official journal. It has risen dramatically in the rankings for specialty journals that are devoted to a specific area of law. One of the things that it does is publish the transcript of the proceedings of this institute, and it has from day one. But, it also publishes articles about various aspects of business and securities law, not only from academics but from practitioners as well. So, if you are interested in getting a subscription to the *Journal of Business & Securities Law*, there are subscription forms on the table, and we would urge you to do that.[3] There are also some past copies available for a minor fee on the table outside.

What I would also like to do at this time is recognize our student leaders who have been so instrumental in these organizations and in this program today: Ellen Durkee, who is the Editor-in-Chief for the *Journal of Business & Securities Law*; Kate McClymont, who is a representative of the Business Law Society; Brett Wallace, who is actually a representative of both organizations; and Alissa Graffius, who is the President of the Business Law Society. So, if you would please join me in congratulating these student leaders. [Applause].

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3. Information on subscribing or submitting articles for publication to the *Journal of Business & Securities Law* is available at https://www.msu.edu/~jbsl/.

In addition, you will see throughout the room are our law students. They are very important to us, at the law college. As I mentioned last year, and the year before – and things have not changed very much – the job market is not that good for entry-level lawyers and maybe for others as well. But, at our law school, we have emphasized to our law students the importance of making connections, networking, and developing relationships. So, I would ask of our practicing lawyers who are here today to welcome those students because we have told them to seek you out and talk to you about your job, the market in which you practice, and related areas, particularly during lunch time where there will be time to do that. Thank you in advance for your cooperation.

It is now my great pleasure to introduce my co-chair of this event, Joe Spiegel.[4]

Joseph Spiegel: Thank you Professor Spoon. It does take a lot to put this on, and the students are just phenomenal. As you know, this is our twenty-fourth year of putting on this program. And, as many of you know, we like to start off this program with something interesting. This year's program is themed the Dodd-Frank Act.[5] It is rare that we actually have an opportunity to talk to, or see rather, the act … the actual bill, the actual law. So, this year, I felt it was important that we look at an interview of the law. This takes about five minutes. It is "PG-R," so anyone under sixteen without a parent must leave the room. I am going to leave it at that, and start the interview. Thank you.

[playing *The Daily Show with John Stewart: Dodd-Frank Update*][6]

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4. Joseph H. Spiegel of Joseph H. Spiegel P.C. has extensive experience in securities, corporate, partnership, and commercial litigation and is the Co-Chairman of the Midwest Securities Law Institute. He earned his J.D. from John Marshall Law School and B.A. from Cornell College.

5. Dodd-Frank Wall Street Reform Act § 1502.

6. *The Daily Show* (Comedy Central television broadcast July 28, 2011), *available at* http://www.thedailyshow.com/watch/thu-july-28-2011/dodd-frank-update.

With that, I suggest that we listen carefully to our speakers and take good notes because we have another year to go. There are still only thirty-eight rules that have passed, so we have quite a few to go.

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

Elliot Spoon: Thank you very much, Joe. That certainly represents one perspective. We would like to welcome our first panel, which is Developments in Broker-Dealer and in Investment-Advisor Regulations with emphasis on some of the changes mandated by Dodd-Frank. I would like to welcome back Hugh Makens of Warner Norcross & Judd.[7] I would like to welcome for the first time Donald Wierenga[8] of Centennial Securities Company and, for the first time, Kris Easter,[9] who is the Assistant Director of the Office of Chief Counsel in the Office of Compliance Investigations and Examinations with the SEC [Securities Exchange Commission]. So, we are very pleased to have this panel and to welcome two new members this year. Are we ready to start?

Hugh Makens: Yes, we are ready to start, thank you. Welcome everybody. The biographies are in the materials. Don Wierenga has been kind enough to step up at the last minute as Bill Alsover, our regular panelist for this group, is now lying in bed with his leg up in

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7. 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 United States Securities & Exchange Commission (1966-1972). For over 25 years he has represented broker-dealers, 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 18, 2012).

8. Don Wierenga is an attorney at Centennial Securities Company in Grand Rapids, Michigan.

9. Kris Easter is an assistant director with the SEC's Office of Compliance Inspections and Examinations.

the air in a cast.[10] So, we are grateful for Don stepping forward. We are going to be focusing on what is happening in the world of inspections and examinations. Much of Dodd-Frank is based upon markets and the reality that Kris and her counterparts at the SEC face is that when the rules are made by all of the other sections, guess whose lap [the duty] to see if the rules are really working falls in? With that note, when I get to the financial crisis we can examine some of the other material. Could you start off Kris?

Kris Easter: All right. I wanted to give a brief overview on some of the Dodd-Frank provisions and subsequent rulemaking that most impact our examination program. I am pleased to say that the examination program did have a seat at the table in working on all of the rulemaking because as Hugh said, we are on the frontline out there trying to see if people are complying with them. If there are not some clear bright line ways for us to assess compliance, then that can be difficult. So, we had a seat at that table to say this is not going to be measureable, and this is how we can make it more measureable. So, it has been a good process. We do have a ways to go, as you saw.

I wanted to first give the standard disclaimer that I of course work for the government, and the views that I express today are mine, and not the views of the Commission, the Commissioners, or my colleagues on the Commission staff.

Hugh Makens: Both Don and I would also like to make the observation that the views that we express here today are [neither] the views of our firms, nor necessarily the views of our spouses. [Laughter]

Kris Easter: I think I can say my spouse would agree with me. [Laughter]

Hugh Makens: I think my wife would say the same thing. [Laughter]

Kris Easter: So, one of the things we have been working on heavily the last year, and I know my colleague,

10. Bill Alsover was Chairman at Centennial Securities in Grand Rapids, Michigan. He has also served as a consultant with FINRA.

John Walsh, spoke to it when he was here last year, is our continued coordination with the state regulators on how the transition is going to work, and the mid-size investments advisors that will be deregistering from the SEC and registering with the states.[11] We have been coordinating very closely with the state regulators on how can we make sure that the states have the information that they need from the SEC on what we saw the last time we were at one of these entities that was transitioning, what the bigger deficiencies [] were, and any tips and complaints that we have received in the last year with respect to these entities. So, we worked out mechanisms to share that, to have perhaps joint examinations, as necessary, and to make sure that the transition is as smooth as possible with respect to these entities. And of course, this sharing will be ongoing, I am sure, after the transitions, given that so many entities are interrelated these days.

So, one of the bigger things that the Dodd-Frank Act did to Title IV with respect to private funds is to take away the exemption §203(b)(3) for private fund advisors.[12] We will talk about that a little more later, but that was one of the bigger impacts to us. As we assess who is moving out, we have had to try and assess who is moving in, how many exam resources will we need to cover, and the population. [] It has kind of been a moving target because one of the things we assess is what will be the assets under management of the entities left in the SEC's registered population. Because of market-fluctuations and because we cannot really tell who may leave or stay, it is a much more difficult thing to assess at this point in time with the continued moving target.

I would like to emphasize that the GAO[13] came in and did a study on the feasibility of having an escrow for private-fund advisors. So, this has come

11. John Walsh is Chief Counsel for the SEC's Office of Compliance Inspections and Examinations.

12. 17 C.F.R. § 275.203(b)(3)-1 (2011).

13. The Government Accountability Office performs audits and investigations on behalf of Congress.

up a lot and it is actually noted in their public report that the SEC had many registered advisors there who manage private funds, and the staff and program already have significant experience going out there and examining the advisors to these private funds. Many of the issues that we would look at with respect to an advisor that does not necessarily manage private funds would be the same issues that we would expect to look at if they did manage private funds. So, we expect on the midsize advisor transition to lose approximately 3200 investment advisors. And, if you read the release, you have seen, I think, forty-eight of the states have said that we do require registration of these advisors and we do have an examination program.[14] One of the conditions of them registering with the state is that the state has laws that require them to do so, and the state does have an examination program for investment advisors. Wyoming does not, and New York has actually told the staff that they do not. New York is of course a large investment advisor population, so those are some of the one's that will not be leaving the SEC's jurisdiction.

Kris Easter: One of the bigger impacts to our program has also been the large number of new categories of registrants that we will be covering in the near future. And of course the private fund advisors will be one, although as I have said we have experience with those. Municipal advisors are a new one. They have already started registering. We have already begun developing a program to review these new entities and persons. And then of course Title VII of Dodd-Frank, which relates to derivatives, brought on several new categories of registrants. And that rulemaking, for the most part, is still in the proposal stage, and we are working closely with the Division of Trading and Markets.[15] But the exam program is

14. Securities And Exchange Commission, Release No. IA-3221, Rules Implementing Amendments to the Investment Advisers Act of 1940 (2011), *available at* http://www.sec.gov/rules/final/2011/ia-3221.pdf.

15. Dodd-Frank Wall Street Reform Act (codified in scattered sections of 7 U.S.C.A.); 11 U.S.C.A. § 761 (2010); 12 U.S.C.A. §§ 4421-22, 5461 (2010); 15 U.S.C.A. §§ 77-78, 8301-08, 8321-25, 8341-44 (2010).

gearing up which regions would be most impacted by this and developing programs to look at major security-based swap dealers, swap participants, the execution facilities, and the data repositories. So these are some of the categories of registrants in the derivatives space that we will be looking at. I think as Commissioner Walter[16] noted in one of her statements, we are expecting thousands of new registrants in this space.[17] So it is going to be a challenge for the exam program.

As you know we already had limited resources and we did not get any new resources in the budget. And so we have been trying to find ways to improve our upfront decision-making on where the risks and the businesses of these entities who we should look at first, better prioritize our exams, and better focus them so we can use the resources that we have more effectively. We have some new legal mandates, so in addition to not getting new resources and having new categories of registrants, we also have new mandatory examinations that we have to do.

I am sure everyone has watched all of the new laws and rules related to Nationally Recognized Statistical Rating Organizations, or as we call them NRSROs. The Senate's PSI investigation came out with a large report on the financial crisis.[18] I think it was 600 pages. And of course more rules, more provisions in Dodd-Frank related to their oversight, and more authority and mandates to the SEC in their oversight. And one of the [most] impactful provisions to us has been that you have got to go in and examine every single registered NRSRO, every single year, and you do not just have to go in, but

16. Elisse B. Walter was appointed by President George W. Bush to the United States Securities and Exchange Commission and was sworn in on July 9, 2008.

17. Commissioner Elisse B. Walter, Opening Remarks Regarding the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants (Oct. 12, 2011) (transcript available at http://www.sec.gov/news/speech/2011/spch101211ebw-sbs.htm).

18. Sen. Carl Levin & Sen. Tom Coburn, S. Permanent Subcomm. on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse (2001), *available at* http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2.

you have to look at these ten categories of issues every time you are in there. And then you have to issue a public report on the key findings from those examinations. So if any of you are interested in the NRSRO space, our first public report came out two weeks ago. Thankfully, that team did a great job and they made it on time. We were, of course, all the staff worry about meeting deadlines with the limited resources that we have. And the NRSRO program is one that we have dedicated staff from other parts of our program to move that program forward, given that was a priority and had specific deadlines and so the staff worked together from our New York offices, Chicago, and our D.C. home office to get those examinations done. And they even went to Japan. We had two Japanese credit rating agencies register with the SEC. So that has been an interesting process. That public reports available on our website if anyone wants to take a look at it.[19] And next year, I imagine, there will be more meat to that report because next year we will also be in there looking at those NRSROs to see, "Did you take corrective action in the areas that we found you were not necessarily up to snuff?" In this year's examinations, so keep an eye on that progress.

We also have an annual mandate with respect to clearing entities if they become designated as systemically important by the Financial Stability Oversight Council. And that will be an annual examination requirement for those. Of course, Title VIII, which related to clearing entities in financial market utilities, also requires us to coordinate heavily with the Fed and with the CFTC[20] to develop a framework for assessing the risk of these types of entities, and to work closely together and supervise oversight of them. That process has been ongoing.

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19. Securities and Exchange Commission, 2011 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization (2011) *available at* http://www.sec.gov/news/studies/2011/2011_nrsro_section15e_examinations_summary_report.pdf.

20. Commodity Futures Trading Commission is a government agency that regulates the options and futures markets.

It has been a great process. There is a joint report to Congress that is available if you want to read about what the SEC, the Fed, and the CFTC are doing in this phase.[21] And one of the great provisions that came out of Dodd-Frank for the examination program is Section 929(Q).[22] This is a provision that helps us follow the money, so to speak.

After Madoff, you heard our Chairman and our Director and my former supervisor, John Walsh, who was Acting Director at that time, testify about the need to go to third parties to verify what we see, to make sure that assets are there, and that they are there in the amount the clients or customers think that they should be there. So Section 929(Q) of Dodd-Frank gives us legal authority to get records from unregistered entities that have the custody or use of these assets. And it does so with respect to investment advisor client assets and with respect to registered investment company assets. So that has been a great new tool that we have already used heavily. It has helped us follow the money and we expect to continue to use that going forward. On a similar note, Section 929(Q), as I mentioned, helps us on the 40X side with investment advisor client assets and registered investment company assets. It does not relate to broker-dealers' customers. So there is a proposed rule out right now that you can review – rule 17A-5, amendments to rule 17A-5 – and the specific purpose of this rule was to implement parts of Dodd-Frank that gave the PCOAB additional authority over auditors of broker-dealers.[23] And parts of the amendments to rule 17A-5 would implement the Dodd-Frank provisions but would also enhance our ability to review custody for broker-dealer customers, which would be great if it is adopted as proposed.

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21. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, SECURITIES AND EXCHANGE COMMISSION, AND COMMODITY FUTURES TRADING COMMISSION, RISK MANAGEMENT SUPERVISION OF DESIGNATED CLEARING ENTITIES (2011). *Available at* http://www.sec.gov/news/studies/2011/813study.pdf.

22. 15 U.S.C.A. §§ 80a-30, 80b-4 (West 2010).

23. 17 C.F.R. § 249.617 (2011).

In particular, there is a set of amendments known as the Form Custody Amendments.[24] It would require a new form to be filed by broker-dealers that would disclose if they [had] custody assets, the amount, and disclose some other information that would help our examination staff assess different firms without necessarily going to get records from all the broker-dealers that they want to look at custody with respect to. So, this would be a much more efficient use of our resources and help us protect investor assets in a more expeditious fashion. In addition, the Form Custody Amendments as proposed would require broker-dealers that have custody, that carry assets, to file with the Commission a compliance report that asserts compliance with certain specified rules and with internal controls. And if they are not a carrying broker-dealer, they would still have to file something, which would say they are exempt and not a carrying broker-dealer. So this would also be additional information in the hands of our program that would help us assess where we should go and how we can better protect investor assets.

And finally, this particular rule would give SEC staff the ability to leverage the work of auditors of broker-dealers. And because of all of these new custody issues that would be disclosed in the form, that the custody aspects of it would be part of an auditor's work so we could better leverage the auditor's work and that would help also save our staff resources. And save, frankly, a firm's time in having to produce records to staff in that area. And then the final thing I wanted to talk about today that has had an impact on our program, is Section 929(U), which is a statutory deadline for completing examinations.[25] And the statute provides that "not later than 180 days after the date on which Commission staff completes the onsite portion of its compliance examination or inspection, or receives all records requested from the entity being

24. 17 C.F.R. §§ 240, 249 (2011).
25. 15 U.S.C.A. § 78d-5 (2010).

examined or inspected, whichever is later, Commission staff shall provide the entity being examined or inspected with written notification indicating either the exam has concluded, concluded without findings, or directing them to take certain corrective actions."[26] It does have a provision within that statute that says we can have an extension, a one-time additional 180-day extension of time, with the approval of our director and notification to our Chairman, if we find the examination is sufficiently complex that we just cannot reach a conclusion or determine any corrective action within that initial 180-day time frame.[27] And so Hugh, I will turn it back over to you.

Hugh Makens: Yeah, but you will not escape for long. [Laughter]. Well, our format that we use for this program – that we have used for years – has been to raise a series of questions and toss them back to Kris to field, and that is the technique. And Don and I will comment a bit as we go. The good news, by the way, on Dodd-Frank is that at least now we have a structure in place. We never again have to worry about any kind of collapse. [Laughter]. The European financial organization[28] that works on the Basel Accords has developed a series of stress tests to test whether any of the European banks can fail. There is a Belgian bank by the name of Dexia that, about ninety days ago, passed the stress test with flying colors. And then about a week ago, they collapsed.[29] [Laughter]. The reality is that there are no perfect systems and goodness knows Dodd-Frank, or as I like to call it "dud flunk," ended up far from perfect.

A couple of bits of observation: one of the problems that we are facing, and I think we will face for a long period of time, is that of trust. Organizations do not trust each other. They do not trust each other

26. Id.
27. Id.
28. The Basel Committee on Banking Supervision was established in 1975.
29. *See* Stanley Pignal, *Dexia Agrees to Belgian Bail-Out*, FINANCIAL TIMES, Oct. 10, 2011, http://www.ft.com/intl/cms/s/0/af0f7f4e-f307-11e0-8383-00144feab49a.html#axzz1ltIzyr1u.

financially. They do not trust each other on products. They do not trust each other on securities. And what used to be a very high level of confidence that if you said something, that is the way it would be in the securities business, does not exist today. And it will take some time for that bridge to be repaired.

I am also sure that you are not worried about the exposure because people have become more conservative and the chances of something going wrong simply because of that conservatism will help. I would point out, however, that Morgan Stanley has as of a couple weeks ago, a face value in derivatives of fifty-six billion dollars outstanding. And I was a little worried about that until I found out that JP Morgan had seventy-nine… I am sorry, not billion, trillion – trillion! And that JP Morgan has seventy-nine trillion dollars in derivatives outstanding. When we talk about the level of risks in the market, they are still almost beyond comprehension in size when you put all of the major players together, and then add to that the hedge funds. I am sure that no bank today would be so reckless as to accept poor collateral. Today I am sure they would want AAA mortgages – no, I suppose not. [Laughter]. . . . U.S. Treasuries? Well, there are some people who want to shut down the U.S. government. We have a problem, but we will get into how we are going to deal with those things in a little while. Let me start tossing questions, and Don, jump in freely as we go, please. How are you doing, how is the SEC doing in terms of rule adoption? I think Don might want to give his statistics before we go.

Donald Wierenga: These are statistics from our trade association, the Securities Industry Financial Markets Association. We call them SIFMA. They hate that term because the first speaker that ever talked about them said that he knew a guy who had that disease at one time. [Laughter]. Their report that they sent out yesterday said so far there have been 235 rulemakings already generated, 41 reports, 71 studies authored by 11 different federal agencies.[30] Now they are saying we are up to 51 new rules, so the 38 [number] might be a little behind. But there are also, just during the third quarter, there were 122 rulemaking deadlines to be met. And there are many, many, rules that are late. There were 190 missed deadlines. So we are seeing a lot of the rule requirements that have not been met yet.

Last year, I attended the National Society of Compliance Professionals meeting. A representative of the SEC was there talking about that within five years, because of Dodd-Frank, their budget would double and the number of people would double. The next night was the election. So I guess one question I would have is, since you do not really have any more money, but you have all of these rules to comply with, where did you pull the money from? Are there areas that you had to back off on, from the normal SEC responsibilities?

Kris Easter: I think that is probably a better question for our rulemaking groups. In the exam program, I can say we have definitely have had to reshuffle resources and think about, can we use people, as I mentioned, from our broker-dealer program to help look at the NRSROs because we had initially said publicly we think we need twenty-five to thirty-five people to adequately look at all of these entities. These are not simple entities and not simple issues. We had a dedicated staff of six, I think, going into the process, and so we borrowed people from our advisor program, and our broker-dealer program, to do those examinations and we are using people from those same programs to look at the municipal advisor issues that are coming up. And thankfully, the derivatives issues fit neatly into some of our existing programs, as do the private fund advisors, but it still is the same number of resources as you mentioned. And so you do have to find better uses of technology and other things that can help you leverage what you need to do. On the rulemaking side,

30. Dodd-Frank Rulemaking Resource Center, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, http://www.sifma.org/issues/regulatory-reform/dodd-frank-rulemaking/overview/ (last visited Feb. 10, 2012).

it is a really good question and I think that some of the other rulemaking that had been of interest to the Commission, you have to triage. What do we have to do to meet deadlines versus what did we just plan to do that can wait, so that we can try to get the deadline rule-making done in a timely fashion?

Donald Wierenga: I know that a lot of the industry trade associations have followed the theory of delay, delay, delay. Water down, water down, water down. So that is a constant goal of the trade associations. They knew they were not going to stop Dodd-Frank, but now, when they have a chance, they are working very hard to get the best rules, from their standpoint, that are possible. And that is obviously going to affect the rulemaking process.

Hugh Makens: The major impact I think has been in the Division of Market Regulation. And there we have observed over the last few years that there has been at times almost paralysis on more routine things because they have had to throw so much staff at the rule-making process. Accordingly, the ordinary business is suffering as a consequence of the failure to staff up the Commission to deal with Dodd-Frank.

Kris Easter: If I could just add one point, there does take a considerable amount of time to coordinate with other regulators and Dodd-Frank, of course, and many aspects of it d require coordination between CFTC, the SEC, and the Board of Governors at the Federal Board Reserve. For example, the Volcker Rule, that is one where a lot of coordination went into play, so it is also not just SEC staff time that you are talking about. They have to coordinate with other regulators and they want to do what they can to make the rules consistent so that there are not inconsistent regimes out there. So that is another thing I wanted to add.

Hugh Makens: Incidentally on the Volcker Rule . . . the Volcker Rules proposal came out from the SEC Wednesday, and Thursday morning, Davis Polk [Davis Polk & Wardwell] had put out on their website a wonderful summary of the proposed rules.[31] They must have had twenty people staying up all night long. But it is on the Davis Polk website. I would recommend that if anybody is interested in the Volcker Rules, which are the rules that regulate . . . they are the "too big to fail" rules. So I would encourage you, if you are interested, to pull up that material. The rules are 298 pages long. So it is no small effort that has been involved. Some of that goes to economic analysis, and Kris, the SEC has been troubled lately by having a crystal ball that is somewhat cloudy in dealing with the issue of economic analysis. We saw in the proxy rules, that the rules were tossed back to the Commission to say the economic analysis was inadequate. What problems have been experienced that have affected OCIE in that process?

Kris Easter: OCIE is not typically involved in looking at economic analysis and the impact. And I will say, under our chairman Mary Shapiro,[32] she has created a new division that does help with this, and it is the Division of Risk, Strategy, and Financial Innovation. We just call it Risk Fin for short. It is much easier. And they have some great economists in that group that can bring external experience to bear, and then doctors in economics, Henry Hu[33] was one. We have a new director of that division. And I know that we have seen a lot of instances where the Court of Appeals is questioning the SEC's economic analysis. I believe the analysis staff is doing a great job of trying to get economic analysis done, and we will have to see how it plays out.

Hugh Makens: From the first phase of adoption of Basel III,[34] the industry had projected tremendous costs in imple-

31. Dodd-Frank Resource Center, DAVIS POLK, http://www.davispolk.com/dodd-frank/ (last visited Feb. 10, 2012).

32. Chairman Mary Shapiro was appointed as Chairman by President Barack Obama in 2009.

33. On September 16, 2009 Henry Hu, a law professor at University of Texas School of Law, was named Director of the SEC's new Division of Risk, Strategy, and Financial Innovation.

34. Basel III is a global regulatory standard on bank capital adequacy, stress testing, and market liquidity risk agreed upon by members of the Basel Committee on Banking Supervision in 2010-11.

mentation. When they actually checked on implementation, the costs were less than one-tenth of the estimate that came from the industry. It is a horribly challenging problem to be able to look into the future and say, "How much is it going to cost to implement something?" Because until you actually start working on the project, it is very difficult to know where you can be effective and use computer aided and artificial intelligence to establish things, and what is going to take a whole lot of very expensive, time consuming resources. It is a challenge. Where do we go?

Hugh Makens: In the movie Other People's Money,[35] Danny DeVito says, "They can pass all the laws they want. All they can do is change the rules. They can never stop the game. I do not go away. I adapt." Are we expecting too much of Dodd-Frank?

Kris Easter: Well, I will say that that is always demonstrated. That statement demonstrates really clearly the need for a very strong examination program at the SEC and us being out there looking at the culture of compliance at the firms that we go examine. I will throw it back to you, Don.

Donald Wierenga: Alright. One of the things that really bothers small firms, I guess small and midsize firms, is the basic one size fits all regulation. Small firms did not get involved in derivatives. Small firms did not need bail-outs, but they are being bludgeoned by the rules. Has the SEC looked at addressing that type of situation?

Kris Easter: I cannot speak for the rule-making groups, but in the exam program it is a challenge that we always face. We face it on a daily basis because we look [at] a branch office of a broker dealer that may have two registered reps and then we will go to an investment advisor that is part of a large bank holding company and, as you said, one size does not fit all. You have to make sure that you are flexible in your examination approach, and maybe the same types of issues can exist at different types of entities, but the approach to it may be different and

35. OTHER PEOPLE'S MONEY (Warner Bros 1991).

what you want to look at may be different. So we have to make sure that we tailor our examination approach accordingly. The one thing I will say is, certain issues we would always expect a firm of any size to have controls over, and those are fraud, misappropriation, and those types of issues.

Donald Wierenga: Now, how often do you actually examine a firm? Is that by size, risk level – how is that determined?

Kris Easter: All of the above. We have a complicated risk analysis process right now. I am not a risk person, so I cannot speak to it, but we did, under our new director create a centralized office of risk assessment within the exam program who really dedicate themselves to looking at news and looking at trends in examinations and emerging products and other issues to try to help us prioritize what new products we want to look at and who is selling them, what is the impact, and where should we go next. So we are trying to better focus our examinations in that respect.

Hugh Makens: Thank you. Commissioner, Kathleen Casey,[36] commented a few months ago, that "Overly prescriptive, static, one-size-fits-all rules in a dynamic system run the risk of design failure, and in promoting homogeneity, they can lead to a great systemic risk." The Commission has struggled for as long as I can recall with the difference between Main Street and Wall Street, and has come down largely over the last fifteen or twenty years on the side of Wall Street, rather than Main Street. I was at the NASAA meeting, North American Securities Administrators Association, a couple of weeks ago, and Commissioner Elisse Walter raised the issue whether the SEC is focusing too much on the perceived needs of Wall Street and large institutional investors, and too little on how retail investors are being treated. That is the first time I have heard those words expressed out of Washington in twenty years. I certainly commend Commissioner Walter for that approach. Do you see any changes? Do you

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36. Kathleen L. Casey was appointed by President George W. Bush to the United States Securities and Exchange Commission and sworn in on July 17, 2006.

see any impact of the thinking that we have got to look beyond just the large firms, making it easier to trade and faster to trade?

Kris Easter: Yes. I will say that I have a great job in that I get to talk to 900 examiners across our entire national program and see all the interesting things that they may be working on. And often it differs from region to region depending on the types of entities that are in their region that they go examine. I think, speaking from the exam program, we have people that definitely have the investor in mind on a regular basis. A lot of what we have done is public. I, of course, I cannot tell you all of the interesting things I hear that are nonpublic, but we did a sale to the military review. I believe that was coordinated with FINRA.[37] We have a public report on that where we are looking at inappropriate, unsuitable sales to military personnel and as a military brat myself, that one was near and dear to my heart. We look at unregistered offerings. Some of our regions deal with more of the retail approach on a regular basis, and I think you are exactly right, Hugh. We cannot lose sight of that, at the end of the day, this is also about the small retail investors that we are here to protect.

Hugh Makens: One way that you protect the retail investor is spotting the bad guys and referring them over to enforcement. With what frequency does that happen? How is that functioning?

Kris Easter: I think the frequency fluctuates from year-to-year depending on what types of work we are engaged in throughout the year. For example, there may be a year where we do certain specialized exams to help inform policy, inform the Commission on how certain rules are working or if we want to change certain rules. Or we may have a lot of tips or complaints that year that have a high priority and so we may do more cause exams. We may have more enforcement referrals in that particular year. Since our fiscal year just ended this past year, I do not have

37. The Financial Industry Regulatory Authority (FINRA) is a private corporation that acts as a self-regulatory organization.

any statistics that I can talk to you about, but I can say we have had a couple of very interesting public collaborations with enforcement. And we do have working groups now in the exam program that align in some ways with the specialized units in enforcement. Some of our working groups include trading, munis, and we had a group looking at microcap fraud. One of the cases that I thought might interest you is recently enforcement and the exam program collaborated and suspended trading in seventeen microcap stocks, and you can see this on our public website.[38] It was a great coordinated effort, and the SEC's microcap fraud working group has staff from across the agency that worked on this. And they found in the order that there were many questions raised with respect to these companies regarding the accuracy of their public disseminated information, including the companies' assets, the companies' business operations, the companies' current financial condition and issuances of shares in the companies' stock. So they just halted trading in all seventeen. And that was a great collaborative effort that you can read about on our website.

Then another collaborative effort we had related to advisors and funds, and taking a look at aberrant performance returns. Are they higher or lower than generally seen? Are they staying static and above what we would expect to see in this market? That was a joint effort that resulted in a lot of enforcement actions. Just to name one, the Nadal[39] case, N-A-D-A-L, if you would like to go take a look at it. That is a case in which they found the advisor and its principals fraudulently induced clients to invest in a program in which clients would buy and sell preferred utility securities in the open market, hold them for a short period of time to generate dividend income or capital appreciation, and the clients paid trading commissions and management fees. Instead

38. *SEC Suspends Trading in 17 Companies in Proactive Effort to Combat Microcap Stock Fraud*, SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/news/press/2011/2011-120.htm (last visited Feb. 18, 2012).

39. Complaint, SEC v. Nadel, No. CV-11-0215 (E.D.N.Y. Jan. 13, 2011), *available at* http://sec.gov/litigation/complaints/2011/comp21812.pdf.

of trading in the open market in these particular investments, the principal was trading between client accounts, and creating false impressions of liquidity, and shuffling securities back and forth. So the assets were not really what the clients thought they were. And that is a case you can read about online.

Hugh Makens: One of the results of the crash has been that it smoked out more Ponzi schemes. Almost every month in the SEC Digest you get a report of more and more Ponzi schemes, many of them coming from registered investment advisors. So Madoff, of course, teed it up, and Stanford, the two major Ponzi scheme cases recently, have teed up the issue of "good heavens, how can we not catch the Ponzi schemes?" Well now I have to believe that the level of awareness on catching Ponzi schemes is pretty high. How is the approach to looking for Ponzi schemes changing in the inspection program?

Kris Easter: As some of you may have read about in the news and heard our chairman testify to, and John Walsh testify to, we had a certified fraud examiner incentive where we encouraged people to study for, pass, and get the certification for certified fraud examinations. We have had training. We also, as I said, have tried to focus our examinations and have a more upfront, due diligence approach where we know about the entity and the activities before we even get there so that we can ask the right questions when we are there. I would add, I think, that in tough economic times Ponzi schemes tend to suffer and come to light more than they would when everybody is getting their money and everybody is happy. So that is another thing, in tough economic times, those schemes tend to crash more too, which is probably why we are reading about it more in the news.

Hugh Makens: How does your inspection process differ today than what it was, say three years ago? And when all the rules of Dodd-Frank are finally done, how would you expect it to change in that time frame? Obviously there are going to be different priorities.

Kris Easter: Right. I think the main change is, and I am sure everyone has probably read about, we have a new Director of OCIE, Carlo di Florio,[40] who was hired to come in and assess, "How can we streamline what we are doing? How can we restructure?" So, we have restructured, and we are still in the process, but a lot's been done. We have created the new working groups, as I mentioned, to facilitate the sharing of information across the agency with respect to structured products, munis, different trading issues. Algorithmic trading is an emerging issue, and high frequency trading. How can we better detect this and look for patterns? What are we seeing? So the sharing of information, breaking down silos, that has been one huge initiative. We have also, as I mentioned, focused on due diligence, getting the information we need up front, doing more limited scope examinations up front, perhaps where we ask firms for a few pieces of information to better get to know registrants we have never been to and see where we might need to focus our resources going forward. So it is a new approach, and I think when all the rulemaking is settled we will have to reassess and see if there [are] any new additional tweaks that we need to make to that.

Hugh Makens: Let me give you a question out of left field.

Kris Easter: I love those. [Laughter].

Hugh Makens: FINRA has a policy of going into a new brokerage firm within six months of its operations and taking a look just to see that everything is up and running. That has not been true in the IA area. A new investment advisor may not be visited for many years. Is there a way that you can get a better handle, not you but OCIE, can get a better handle on what is happening at a new advisor, and whether there may be problems before they get into operation and continue for a long time? Has there been any discussion of trying to do at least some kind of drop in on new advisors during the first six months of operation?

40. Carlo di Florio was named Director of the Office of Compliance Inspections and Examinations (OCIE) by Commissioner Mary L. Schapiro on January 4, 2010.

Kris Easter: Well, I do not know necessarily if it is within the first six months of operation, but there has been a focus on which advisors are fairly new, those who we have not been to yet, and how can we get to know them better. We have what we call risk assessment examinations where we do primarily a correspondence exam just to get additional information about the business, try to assess the culture, get more information about the types of clients or customers, and assess if we need to do a broader scope examination of any specific entities or issues.

Donald Wierenga: There has been a large trend in recent years for registered reps to leave brokers firms and set up small independent investment advisory firms and go state registered. The primary reason for it is their view that they are having less regulation. Is that a concern of yours looking at the industry as a whole? Obviously you are not regulating those, but is there a concern that a lot of the regulation is going to be ignored because of this change?

Kris Easter: I think with respect to the states that are getting jurisdiction over the advisors, we have confidence. We have been working with them. They are going to be able to hit the ground running with those entities. To the extent that the entity may have registration in different areas with different regulators, there has been some work on collaborating to make sure there is no regulatory arbitrage in their different spaces. So, for example, if they have an insurance business or an advisory business that is registered with the state, and a broker-dealer business registered with FINRA, and then a piece registered with the SEC, we would try to get the various regulators together and look at their pieces and then talk and discuss, "What does this single legal entity look like as a whole, and how can we make sure that they have an effective compliance culture there without missing a piece of it?" So that has one approach we have been taking.

Hugh Makens: That is a dramatic improvement.

Audience Member: Kris, let me ask you a quick question. Going back to 17A5[41] and following the money, let us assume you are a counsel for a small, either registered investment advisor or a small broker-dealer. And you get a, is it going to be an inquiry, it is going to be a subpoena, to try and follow the money. What do you do with that as their counsel? I mean, are you going to be issuing third-party subpoenas? How does that work? You said, "Follow the money."

Kris Easter: Right.

Audience Member: What mechanism would counsel say to his or her client? What do we do with this?

Kris Easter: On the exam side, we would not be issuing a subpoena. That has a difficult question for me to answer because we have been working with counsel for the entities that we go to that have custody over assets, and our response now is, "If you have custody or use of an advisor's client's assets or registered investment company assets, this is not negotiable. The law now requires you to give it to us. We have independent examination authority over your records to the extent they relate to custody." That is the answer on the examination side. In fact, we have an exemption with respect to unregistered banks now with respect to the Right to Financial Privacy Act[42] because we are doing a legal examination. As I have said, this has been a huge tool and benefit to the examination program because you do not have the same level of having to negotiate or get the consent of the advisor to go get these records. We can now go straight to the custodian and get it. Th[is] has been interesting in some cases, and one in particular that I thought you might be interested in, that I can publicly talk about because the litigation release mentions examinations where exam staff were involved. We had to go down to a car dealership to verify assets, and that is where the

41. 17 C.F.R. § 249.617 (2011).

42. Right to Financial Privacy Act, 12 U.S.C.A. § 3401 (West 2011). This Act gives the customers of financial institutions the right to some level of privacy from government searches. Before the Act was passed, the United States government did not have to tell customers that it was accessing their records, and customers did not have the right to prevent such actions.

clients were invested in subprime auto loans reportedly. So, we went down to the dealership to verify assets. That case ultimately got referred to enforcement and enforcement has filed a complaint on the matter. So we have had some interesting uses of 929(Q),[43] and it is been a great tool that we received from Congress.

Audience Member: What did this car dealership do when you walked in the office? [Laughter].

Kris Easter: I was not part of that team. I would have loved to be part of some of these teams that go in there. We have had to go to a medical supply company. So, it is interesting.

Audience Member: So are you saying that the SEC now has authority to go to a car dealership, knock on the door, and say, "Do you have twenty-five loans on X number of cars?" They have to give you the information?

Kris Easter: To the extent that it is records related to custody of assets of an investment advisor's clients or a registered investment company's assets, yes. We can follow the money. If those records are available at the advisor level, we would look at them, of course, at the advisor level.

Audience Member: I am going to take it one step further. You are counsel for the auto shop, and you make a misstatement to that investigator. Is that a felony? Because every misstatement to now an SEC examiner, it is the Martha Stewart problem.

Kris Easter: Well, I am not a criminal defense lawyer or prosecutor. On the exam side, we would always hope that we could go in and have a candid conversation and that if you are a company that wants private equity investments, we would hope that you would have an interest in making sure the money that you think is coming to you is really coming to you.

Hugh Makens: I have had a rule that I have followed most of my time in practice and that is "try to avoid taking a stick and jabbing it into a wasp's nest." And one of the rules I have had in dealing with the Commission has been if there is any way I can give them the information, I am going to figure out how to do

43. 15 U.S.C.A. § 80a-30 (West 2010).

it because if I do not, I know what she is going to do. Not you, Kris, but somebody in your office, is going to pick up the phone and call enforcement and say there is something funny going on here because they are not cooperating and that is going to get enforcement involved and that is the first time you will see a subpoena because that is the only [] Division that has the authority to issue the subpoenas. But it, in fact, may come down, and you can turn a very minor matter into something that is a much more difficult matter, and end up a year trying to extract yourself, even if you have done nothing wrong. As to your point about potential criminal liability, yes, there is. Certainly, if you intentionally mislead the SEC with information that you provide, you are now running the risk of – you are not running a risk of perjury because you are not under oath when you provide that information – but you are under the possibility of obstruction of justice, which, gee whiz, is also a ten year penalty just like perjury, and that is what Martha Stewart ran into was the obstruction of justice.

Audience Member: You need more practice putting people in jail.

Hugh Makens: Yeah, I am done.

Donald Wierenga: One of the specific areas that our firm obviously always wonders about is has there been a change in how your office works with FINRA as a result of Dodd-Frank?

Kris Easter: Well, we have always tried to coordinate with FINRA well, with respect to broker dealer oversight. The one thing I think that Dodd-Frank did change is Section 964[44] of Dodd-Frank requires the GAO to come in, I believe, it is every three years to access the SEC's oversight of FINRA in several specified categories, including: FINRA's governance; its funding of its activities; and its cooperation with the states. So, that could be viewed as kind of a legal mandate of areas that Congress wanted the SEC to focus on. Of course, we have done that over the years, but not all at one time, in every single inspection. So, that is something new

44. 15 U.S.C.A. § 78-d-9 (West 2010).

for us. I think in this particular instance we want to go in, in a single instance, look at all of those areas, and then going forward we would again spread it out over different inspections. But that will be an interesting interaction now with FINRA and the GAO that takes place following Dodd-Frank.

Donald Wierenga: One of the things we always heard was when the SEC comes in to do an audit, after FINRA's been there, it [has] been more for the purpose of determining whether FINRA did a proper job of completing their audit. Are there other things you look for beyond what FINRA was looking at?

Kris Easter: Well, I think anytime we are in an entity that we also regulate, we would have our eyes open for things that would concern us as well and that we would point out those deficiencies or weaknesses. Then, in an instance where we are overseeing FINRA, we would send a letter to FINRA pointing out things that we believe they should have paid particular attention to.

Audience Member: Does Dodd-Frank address joint SEC state and FINRA inspections?

Kris Easter: I would say that 964[45] does look at the level of collaboration. And, so, what you read from that could be that Congress was looking for a certain level of cooperation, but that I cannot speak to.

Hugh Makens: No mandates, no rules, or anything have come out that would compel them to more effectively work together other than the general admonition that they are supposed to be working together.

Kris Easter: I think from where I sit, I hear a lot about how relationships play out across the nation because, of course, FINRA has district offices across the nation, and then all the states are scattered everywhere, and we have regions across the country. It all comes down to personal relationships and you forming them with the regulators in your regions, and working together. I have heard incredible success stories in certain areas where, as I said, they do go in and make sure they coordinate on various pieces of one single legal entity to make sure that

45. Id.

they have a holistic view of the entity. I think that the collaboration is moving in the right direction.

Audience Member: Kris, I have a quick question for you. When you were speaking a few moments ago about coordinating between the regulators or the business entity that has different pieces, can you speak a little bit about, practically, how that happens. Does one person reach out to the other regulators, or is there an oversight format already in place to deal with these situations?

Hugh Makens: Let me restate that briefly for the record here.

Kris Easter: Yeah, go ahead.

Hugh Makens: The inquiry is, in shortened form, how do you coordinate with other agencies when you have dual responsibility for rules, and where does the initiative come from to make that process work?

Kris Easter: You know, in some instances we do have formal agreements and so we do have confidentiality agreements with the fifty states, which is great. It enables us to then exercise our legal mechanisms to share information more readily than we could if we did not have these agreements in place. But, when it comes to doing coordinated work that we are talking about, it seems to be a more informal approach. And this is what we would like to try this year. They may call my office and say, "we want to make sure we are dotting our 'I's and crossing our 'T's with respect to the law and sharing our nonpublic information, but we still want to make this happen." So, it is more of an informal process, and my office comes into play to make sure that it is done in accordance with how we can share SEC records.

Hugh Makens: Kris, I think we are also asking, what is the process, for instance, if the CFTC and the SEC have a joint responsibility in the area of credit defaults swaps, or other derivative regulation, how is that process being accomplished?

Kris Easter: To answer that more globally, and I think to address what I think you really asked, sorry I did not get to that, and to what Hugh is asking, we would typically see our regions or home office meeting with the other regulators to say, "what are you planning to do this year? These are the entities we believe we may go visit this year, do you have any interests in these areas? How can we work together?" It is more sharing in advance of what is the plan, who are you going to go visit, and then talking about what you can do to collaborate where it seems that would be beneficial. That is why I say it is more of an informal process where they get together and meet and say, "let us see how we can make this happen."

Hugh Makens: There are now periodic meetings between the SEC and CFTC. In fact, one of the historic problems that led to Dodd-Frank was a joint effort by the SEC and CFTC to develop rules relating to derivative products, and Senator Dodd sent a letter to Chairman Cox,[46] and the then chairman of the CFTC saying, "this is my purview, not yours. You will not move independently without going through me." It is rather ironic that the two people who probably contributed more to the crash than any two legislators were both Dodd and Frank. Frank, of course, for his work in trying to protect Fannie Mae and Freddie Mac from any kind of regulation or disclosure. And then to find them out in front of this is extraordinarily humorous. Speaking of politicians, the Tea Party and a number of Republican presidential candidates have proposed repealing Dodd-Frank. Is this all for nothing?

Kris Easter: We would be very interested to see the outcome of that. [Laughter].

Hugh Makens: It certainly does raise some issues. And politically, the Commission itself is a political instrument. Have there been any disagreements among the commissioners on the rules?

Kris Easter: I think some of that disagreement has been in the press, and one more recently in the press that I can speak to is the adoption of the whistleblower rules. That was a highly contentious process both in the commenting process and in the open meeting regarding its adoption. The more contentious point is do we require internal reporting up the chain before

46. Christopher Cox was Chairman of the SEC from August 3, 2005 – January 20, 2009. He was appointed as Chairman by President George W. Bush.

they go to the SEC and are eligible for an award? At the end of the day, that is not a requirement, but incentives were built in to encourage them to do so. Our Commission did pass the rule and that is the current state of play.

Hugh Makens: On the rule proposal for the adoption of the Volker "Too Big to Fail" rules, Commissioner Paredes,[47] I think it was, observed that, "While I am voting to put this out, I am very much concerned that we may be damaging liquidity in the market with the proposal that we have. Therefore, I have reservations about this, but I want to go through the comment process to see what people have to say about that."[48] It is rare to go back to the days when there were five people voting and saying "yes" on anything that was, from a policy standpoint, controversial.

Kris Easter: And, I would add Hugh, and this is not just a political comment on my part, that members of the staff, they take interest in the views of all of the commissioners and the chairmen in these proceedings, and not just the majority. We definitely want to hear the views of the minority and those decisions, and take those into account as we move forward.

Audience Member: A quick follow-up on the whistleblower, when OCIE comes in to do an exam, would they routinely ask for any internal whistleblower kinds of complaints or follow-up?

Kris Easter: That is a good question. I think that would depend because we can envision instances where we are going to get a TCR in our Tips, Complaints, and Referrals system that are from a whistleblower, which we would be following up on. But we can also envision instances, which would be more rare, but could occur, where someone approaches our examiners in the field and says, "You know, hey you are looking at ABC, but you are way off base. You really need to be looking at XYZ." That per-

47. Commissioner Troy A. Paredes was appointed by President George W. Bush to the United States Securities and Exchange Commission and sworn in on August 1, 2008.

48. *See* Jesse Hamilton, *SEC Proposes Volker Rule Curbs on Proprietary Trades*, BLOOMBERG (October 12, 2011 11:57 AM), http://www.bloomberg.com/news/2011-10-12/volcker-rule-proposal-to-limit-banks-trading-set-for-sec-vote-on-comment.html.

son, then, theoretically, could ultimately qualify as a whistleblower if they perfect their claim, and they have original information, and meet all of the other requirements of the rule. Those are two different scenarios in which we could see things playing out in an exam with the whistleblower.

Joseph Spiegel: The question before you leave on examinations, are there any public manuals available on your examination process? Like the enforcement?

Kris Easter: Not at this time.

Joseph Spiegel: Are there any being considered?

Kris Easter: Yes, and I think our director has spoken about all of our work on getting one comprehensive manual in place.

Hugh Makens: Let me put that back in for the record again. Joe asked whether there are any manuals that are currently publicly available. No, but there are apparently some being contemplated.

Kris Easter: Yes, we definitely have a manual, and it is in its final stages. And I know our director has publicly spoken about it, and getting a useful tool out there and making it public. Of course there are processes within the Commission we have to go through to make that kind of document public.

Audience Member: Hugh, thirty seconds on the fiduciary standard debate status.

Hugh Makens: The question that Rocky is asking is, "What is the status of the debates, discussion, and the rulemaking process on applying a fiduciary standard to broker-dealers as well as to investment advisors?" Most of you are aware that there was a report issued by the Commission staff, I am going to say nine months ago roughly, that recommended the adoption of a fiduciary standard.[49] The rule has been out now for comment for some period of time. It appears from the speeches that have been made that there is going to be some form of fiduciary standard applied. It appears from those comments that one of the areas of difficulty relates to are you going to prevent or impair the creation of proprie-

49. SECURITIES AND EXCHANGE COMMISSION, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS (2011) *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

tary products. Can you enlighten us any more on that process?

Kris Easter: No. There is really not much more I can say publicly. I know our Chairman has publicly supported a fiduciary standard, and one of the things Hugh asked me to talk about today was the study that the SEC did pursuant to Section 19(b) of the Dodd-Frank Act,[50] which was how can we get information in a better way to investors? Something interesting that came out of that study is that investors often do not necessarily know which hat the person they are talking to is wearing. Are they an investment advisor? Are they a broker-dealer? It is kind of an interesting concept when you are thinking about fiduciary duty. It does raise some interesting questions if the investor that the person is talking to is not even clearly in their mind one or the other.

Donald Wierenga: You want to touch on [Department of Labor's] recent attempt to muddy the water?

Hugh Makens: Yes, please.

Donald Wierenga: Ok. The Department of Labor also came out with a proposed fiduciary duty, which would apply, among other things, to all IRA accounts. So that has muddied the waters in this whole area. They have withdrawn their proposal at this point, but they have said that they are going to re-file it at the start of 2012.

Hugh Makens: We are going to turn briefly, very briefly, to the couple of the questions on the crash. There was an article that came out quite recently, I think it is the Financial Times, no Bloomberg, where William Hambrecht, Chairmen of W.R. Hambrecht which used to be with Hambrecht & Quist, who did the Google offering, observed of the Wall Street bankers are not going to make the money they wanted. And another hedge fund manager noted, "I do not think it is time to make money, I think it is time to rig for survival."[51] The former chief investigator for the TARP program observed that the systemic ad-

50. 15 U.S.C. § 78s (2010).

51. Max Abelson, *Wall Street Sees 'No Exit' From Financial Woes As Bankers Fret*, BLOOMBERG, (October 12, 2011 12:00 AM), http://mobile.bloomberg.com/news/2011-10-12/wall-street-sees-no-exit-from-financial-woes-as-bankers-fret.

vantage that "Too Big to Fail" enjoyed in the lead up to the financial crisis may be diminished in the near term, but the structure is still essentially the same. It will almost certainly help catapult them to record profits and bonuses when the good times return. But that may be a ways down the line. One of the things that really bothered me about the Dodd-Frank Bill, and the crash itself, was the role that was played by boards of directors and the failure of anybody to respond to the question of, "why did the directors fail so badly?" What is OCIE doing now, in terms of looking at issues with directors, to try and ensure that they are better informed?

Kris Easter: Under our new director, Carlo Di Florio, our senior managers have been engaged in a new initiative to go out and meet with boards of directors and discuss with them how they oversee risk and compliance and other matters, and to get a better sense of the culture. So that [has] been an interesting new development.

Hugh Makens: This is the first reaching out to boards that I have seen at the Commission going back for many, many years. What information is coming into the board, how is it coming in, and what is the responsibility of the board to look at it more deeply? What in the world do you do as a board director when you have got seventy-nine trillion dollars out there, how do you begin to ask questions that would let you know what is our exposure on those derivatives, what is our firm risk, what could take us down? Even if you ask those questions, how can you remotely begin to feel comfortable about the answers that you are getting? I have heard no answers to the question. But if anybody has got them, please see us afterwards. I am entitled to ask one more question, Elliot says, and then we are going to wrap up. The final question is a difficult one. Why does the Big Ten have twelve teams and the Big Twelve have ten teams?

Kris Easter: My former boss gave me the answer to this one. I am not a sports fan, but he said to say, "I do not really care as long as MSU goes to a bowl game."[52]

Elliot Spoon: All right, are there any final questions for the panel? Well, let us thank the panel for a very informative session. [Applause]. Thank you. We are going to be moving right into our next panel so it will just take a minute to set up.

SESSION 2: SEC "TRANSACTIONAL" HOT TOPICS ARISING OUT OF DODD-FRANK

Elliot Spoon: For our second panel, we are going to be addressing what we call SEC transactional "hot topics" that have arisen out of Dodd-Frank. They will range from executive comp[ensation], proxy access, and other corporate governance type matters. One of the trends that has occurred that I point out to our students is that corporate governance, which historically has been the province of state law, is slowly and inexorably moving towards more direct federal oversight. Our panelists today that we welcome back are Martin Dunn,[53] of O'Melveny & Myers and Mark Metz,[54] of Dykema. And we wel-

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52. Michigan State went to the 2012 Outback Bowl and overcame a 16-0 halftime deficit to defeat the University of Georgia Bulldogs 33-30 in triple overtime.

53. 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 United States 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/.

54. 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 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

come a new panel member this year, Jennifer Powell,[55] from Butzel Long. I think Martin will be starting first.

Martin Dunn: Good morning, everybody. I got a kick out of the fact that this is called a transactional panel. Since there are no transactions, there is nothing to talk about. Thus, we are going to talk about governance and other things. As I was standing outside listening to Hugh talk at the end of the last panel, it struck me when he asked the question, "What is the SEC going to do about boards and risk?" I was at the SEC a long time and I love Hugh, but the question kind of bugged me because the SEC should not be doing anything about teaching boards what to do about risks. I remember when we all grew up doing this. The SEC is about disclosure and the states are about governance. I do not particularly know what level of expertise the SEC has on teaching boards about risk. I certainly know that when I was there that was not what I had trained my whole life to do; what I had trained my whole life to do was to figure out how securities law worked and how disclosure worked. So, it troubles me the way they are going, but, unfortunately, it is the way it is going. So, we all have figure out how to deal with it.

With that, I am going to start on a topic that is near and dear to my heart, which is proxy access, and which is going to be near and dear to a few of your hearts come this proxy season, whether you like it or not. So, we are going to dive in, and I am going to give you a little bit of the history first, just so that we are all on the same page. Everyone always talks about access and uses the phrase "the right of shareholders to nominate directors." Well, that is wrong. The state law defines when a shareholder can nominate a director. State law says when you

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guidance to privately-owned businesses. DYKEMA GOSSETT P.L.L.C., http://www.dykema.com/bio/display.asp?empID=155.

55. Jennifer Powell is a shareholder in Butzel Long's Business Law Department. She focuses her practice on mergers and acquisitions, venture capital and private equity financing, corporate governance, securities law compliance, securities offerings, and general corporate matters. She is based in the firm's Bloomfield Hills office.

can nominate somebody to be a director. The SEC's question has always been "when does it go into the company proxy statement?" Or, "do you have to run a contest in order to run your own nominee?" This has always been a question because the proxy rules are supposed to equal attendance in person – your right to do through the proxy is what you can do in person. And yet, virtually under every state law, if you jump through a few hoops, shareholders can show up at a meeting and nominate somebody to be director. Now, of course, because you do not have the proxies, you are not going to get any votes. So, it is really kind of a useless ability; so, the SEC has always been trying to figure out "when do shareholder nominees have to go in company materials and make it an open election?" It truly is "these are the three shareholder nominees, these are the eight board nominees, vote for your top eight." Not a new issue.

The SEC first considered this in 1942 and was very close to proposing a proxy access rule in 1942 and decided against it. I think they decided against it because they thought it would be too unwieldy. It comes up every fifteen or twenty years – you see this trend going towards it and I got to spend ten years of my life doing it from 1997 to 2007. And, when it first came up in 1997 I was doing shareholder proposals. The union pension funds of the time really wanted to be able to put in proposals that say "change your bylaws so any shareholder holding 'X' shares for a year can nominate 'X' number of directors." There has always been an exclusion in the shareholder proposal rule that says you do not have to include a proposal if it relates to, and this is the old wording, "an election of directors."

Our view of it was that you could not do indirectly what you could not do directly. So, "an election" included "a process" for elections. Not only could you not say, "Vote for Marty," but you could not say, "Create a process where next year I get to say, 'Vote for Marty'" because we thought that was form over substance. And so we always denied the unions when they would come in and say, "Make them put in our proposal." The staff would say, "No, you do not have to." That all changed in 2007 in a case called AFSCME v. AIG[56] in which we actually debated what the word "an" meant for a good while. And in one of my proudest moments, I was handily defeated by the Court of Appeals of the District of Columbia. They just humiliated me, which you get used to when you work for the government because it happens a lot – especially with the D.C. Circuit. The Commission had to figure out what to do.

We proposed two different rules: one was "stick to the status quo," and two was "allow proxy access." It went nowhere and got caught up in election politics and died. In 2010, the Commission finally adopted a proxy access rule.[57] They actually did two things: first, they created a federal proxy access right, which said "if a 3% holder has held shares for three years, it can nominate up to three directors – pretty simple to remember. It is kind of like Herman Cain's approach by a third.[58] And, so it was there. And, they also adopted another rule that said: "And not only that. So not only is there this federal right, but we are changing that 14a-8[59] rule that Marty spent so many years on and we are going to say 'now those process proposals get included.'" And the next slide we will look at, two slides from now, gives more detail on that. So, they adopted both of those. Immediately the Business Round Table and the Chamber of Commerce sued in district court, so we all knew where that was going to go, and said that they had been arbitrary and capricious and it violated the Administrative Procedures Act in adopting the rule. It got argued in April and was decided in I believe the last week of July of this year – yes, July 22. It is on the slide, how about

56. AFSCME v. AIG, 462 F.3d 121 (2d Cir. 2006).

57. 17 C.F.R. § 240.14a-8 (2008).

58. Herman Cain was a 2011 candidate in the Republican presidential primary. Cain proposed a tax plan which was known as his 9-9-9 plan. Under the plan, there would be a flat 9% tax for corporate and individual income taxes, and for the national sales tax.

59. 17 C.F.R. § 240.14a-8 (2008).

that? I should really read my notes before I talk. [Laughter]. The Court said, in fact, that the SEC in their view had been arbitrary and capricious.

You have to remember that the SEC has a special standard under the 1934 Act[60] that says they also have to consider competitiveness, efficiency, and markets when they adopt their rule. They said they did not do that. So, they vacated Rule 14a-11,[61] the Proxy Access Rule. Now, while this litigation had been pending, the SEC had stayed all the other rules because they said they all kind of fit together and we need to know where we go. So, the shareholder proposal rule changed and had not been in effect.

What does the SEC do after the district court slaps them down? It was really, if you read it, very unkind. They referred to one thing as "mind-numbingly" and were not pleasant. The SEC decides what to do and I think they really did not have a choice. They chose not to appeal. The reason I say they did not have a choice is: (1) they were not going to win, and (2) what the court did in smacking them down and saying they had not done enough in this rulemaking was actually create a rulemaking standard for what they have to do and how they have to consider comments. What they have to do that I have to tell you, if I was writing a lot of these rules today, I do not know how you meet. It is really an incredibly high standard. You can be deregulatory it appears, but coming up with new rules is going to be very, very hard. I say that as someone who wrote rules for a very long time because so often you can come up with costs of doing new disclosure, and the SEC is supposed to be about disclosure after all, right? You can come up with costs of creating new disclosures even if it is as simple as one more line on a D&O[62] question – you can put a cost to that. But, you can never really come up to the benefit of "it is material and it gives

60. The Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*

61. 17 C.F.R. § 240.14a-11 (2010).

62. Directors and Officers Questionnaires are given to directors and officers to complete during preparation of proxy statements or other filings.

people more faith in the company." There is nothing tangible to weigh the costs against the benefits, so it is really difficult to do. I think the SEC is going to have a real challenge in going forward. And I always thought that the last thing they wanted was to have an appeals court say, "Absolutely, we agree with this and here is an even stricter rulemaking standard." So, they did not appeal.

Once you do not appeal, the question becomes what do we do with this shareholder proposal rule that we adopted, 14a-8(i)(8)?[63] Try saying that five times fast. What do we do? So what they did about a month ago was they lifted the stay and they said going forward, those rule changes that we had are now going to be in effect, and they are going to be in effect for this proxy season. So what does that mean we have for this season? It means that we do not have a federally mandated right of proxy access. So, if a shareholder says, "I want to nominate somebody and I have had 5% for five years," there is nothing in the federal rules that says a company has to put that in the proxy. What they do have for this year though is what the shareholders wanted all along and what a lot of people argued was the better alternative, which is in D.C. called "private ordering," which means that at each company anybody is eligible to write in a shareholder proposal under the SEC shareholder proposal rule so long as you have held two-thousand dollars worth of stock for a year.

Mark Metz: Very low standard.

Martin Dunn: Pretty low standard, and pretty tough not to meet that one – although it is getting easier in a lot of companies. [Laughter] If that gets written in, that proposal then has to go to a vote of shareholders. And, up here [referencing PowerPoint], is now the only thing you can exclude. And you will see those sub-bullets there [referencing PowerPoint]. And you will see that this was always the staff's interpretive position as to what it is for this year. So, "an" is now read to mean "this election." I cannot

63. 17 C.F.R. § 240.14a-8(i)(8) (2008).

say, "Vote for Mark, vote for Jen." But, I can say, "Put a process in place where going forward we can." You are going to see shareholder proposals in company proxies going to a vote that are written in by incredibly sophisticated investors, or some of the cut-and-paste things you see, or it can be shareholder proposal advocates, which are all over the map as far as sophistication.

You will see these shareholder proposals coming in and companies are going to have to deal with them. Everybody is now saying, "Oh my God, oh my God, oh my God, what do I do when I get one of these?" I have been on a lot of panels with a lot of investor activists and they seem very uncertain as to what is going to happen. You will talk to some and they say there are going to be hundreds of these and everybody is going to get hit with them. You will talk to others and they will be like, "We do not think there are going to be that many because we want to come up with a good approach to this and we would rather have a federally mandated standard, and if you start seeing proposals that are a little out there and do not get any vote you are going to have people saying 'shareholder[s] do not want this. This is just a small activist community.'" Thus, they seem a little divided as to how many you are going to see.

It is a crystal ball thing; most people tell me it is going to be somewhere between fifty and two hundred of these that you will see. I do not know if it will be two hundred, but at the same time if you get one shareholder like the famous shareholder activist named John Chevedden who just sends proposal after proposal after proposal and he has a team of people who own two-thousand dollars in every public company. And, I have actually met John a few times and he is a nice enough guy. But, if John gets this stuck in his crawl that this is going to be his issue this year, you will see three-hundred of them just from John. So there is no way to really predict. But, the big activists have so far said that they are not just going to flood people with these things and that they are really going to try to be thoughtful about it because they want to get big votes. They want it to be successful.

So, companies have been asking, "What do we do about shareholder proposals and what do we do about proxy access shareholder proposals now that we are in a private ordering world?" I have told everybody do not jump out and do anything; you have to wait until this comes to you. It is an enemy you can see down the road and it may never get to you, right? Companies should by now have good advanced notice bylaw provisions. If anyone has been counseled well, they have better advanced bylaw provisions. There have been some Delaware cases in the last few years that really caused people to take another look at that. So, you are seeing better-advanced notice bylaw provisions. If you have not updated it in the last five years, you should, because you are not getting the right information and you are not having the best-advanced notice you can. That is simple; everybody has that. I say do not do anything about shareholder proposals on proxy access until you get one and you find out that it probably has to go in. Now, when I say do nothing, I mean formal. You need to say, "If I get one, what am I going to do?" The advice I would give is that you have three approaches once you get one. You can say, "This is a crackpot proposal; look at the wording of it, it is terrible; nobody is going to vote for this." Or, "At our company this is not the type of shareholders we have; they are not going to vote for this." You can put it in the proxy and hope it gets no vote. You can probably have a good feel for that as you go along. That is one way.

The other two approaches involve an actual response. And, this is the dynamics of "shareholder proposal land" at the SEC. Because what you want to do is if you are afraid it is going to get the vote, you want to have your proposal, not theirs. You have two choices to do that if that is the approach you want to take. One is to adopt a bylaw, go [to] the SEC, and say, "we have already substantially implemented this proposal, and therefore, it does not have to go in our proxy." The other is to say, "We are going to put our own proxy access proposal in the proxy," and then go to the SEC and say, "We do not have to include theirs because it conflicts with ours." Those are the alternative approaches.

The approach I would take one hundred times out of one hundred would be to put in a proposal and say it conflicts. Here is why: the standard for implementation is "substantially implemented," and the SEC has almost read out "substantially." You have to have not only done the topic, but also the way they want it, in order to get implemented; whereas, "conflicts" is very broad. The example is John Chevedden puts in a shareholder proposal at one hundred companies every year that says, "let shareholders act with 10% shareholders being able to call a special meeting." If you write into the SEC and say, "We have substantially implemented this because we have a standard that says 15% can do this;" they will say, "No, you have not substantially implemented this because he wanted 10%." But, if you write to the SEC and say, "This conflicts with our proposal because we think it should be 25%; it is a conflicting proposal because they cannot vote for both." They will say, "You are right." Since "substantially implemented has gone away and "conflicts" is easy, my approach to this is think about how you would want to respond and how you would want to do access at your company. And, then know how you would phrase that.

If you get a proposal to decide whether to include it or not, and if you think you will get enough of a vote that you think you need to be worried about it, put your proposal up for a vote and see what shareholders say. That way you get to control the game, but you do not have to do something out of fear of getting something. It allows you to run the show. The last slide here is interesting because it says "that if this does happen, if private ordering occurs and you have shareholder access at your company (so shareholder nominees have to be included), shareholders still have a disclosure requirement which is the Schedule 14N,"[64] which is kind of useful to have because it is a little background about them. It is not a contest, but it is additional information about who is behind this and who is running it. So, that will be in effect; but again, that is for once you get this into play in another year – if you do. For this season, it is going to be, "What do I get as far as shareholder proposals and how do I respond?" Any questions?

Mark Metz: For the obsessive compulsive among us, have you heard whether the SEC is going to go in and cleanup some of the rules? For example, there is a reference in 14a-8[65] to the rule that has now been vacated. Do you know anything about that?

Martin Dunn: Right. I have not heard that they are going to. They are about seventy-six rulemakings behind on Dodd-Frank anyhow. I would not want that job in a million years these days. It would be easy it seems, but at the same time, they have so much else going on. If I was the SEC, I would be so worried about the conflict minerals provision in Dodd-Frank that I would be panicked.

Mark Metz: It seems to me that the conflict minerals provision is going to suffer from much the same problem as the proxy access in terms of the cost-benefit analysis. It is going to be a tough bar to cross.

Martin Dunn: "Conflict minerals," real quickly, is in Dodd-Frank. See, this is giving you time to change over. It is like we planned it. In Dodd-Frank there is a great section, the 1500 Rule,[66] called "miscellaneous provisions," which just got tossed in. The three that are in there are requiring the disclosure of mine safety notices. You must file an 8K every time you get a mine safety administration notice. My favorite is that there were goats by the porta-potties or something and you had to file an 8K for that. There are two, which are (1) extractive enterprises – what you pay in foreign countries for projects – and, (2) the other is conflict minerals, which are certain types of minerals that you are going to have to go

64. 17 C.F.R. § 240.14a-11 (2010).
65. 17 C.F.R. § 240.14a-8 (2011).
66. Dodd-Frank Wall Street Reform Act § 1502.

back and audit where they came from. If they came from the Democratic Republic of the Congo or adjacent areas, you are going to have to disclose that and say how you got them. It is really securities law based, right? So, the SEC has to adopt this and it could possibly be incredibly expensive to audit all the way back.

We also have 404, right? Twenty-five thousand dollars, right? They proposed the rules, then the decision comes out on proxy access and there is no way the cost can justify the benefit to shareholders. I mean, maybe there is a societal benefit, but it does not fit what they are supposed to do. And, I am not getting into the societal issue because that is obviously not anything that I know anything about. If I was them, I would be like "Oh my God I do not know how to write this." So, they have done what you do when you are at the government – they are having a round table. Next week they are going to have a roundtable on conflict minerals. It should be interesting. It is going to be on the website[67] if anyone gets a chance. I think it is the 18th. It would be worth checking out.

Mark Metz: The interesting part of that is that automotive suppliers and the OEMs[68] already have to deal with this even though we do not have final rules because if they go into effect next year, they are going to need to be already getting that information ahead of time. It is a real nightmare. I am going to take a few minutes to talk about one of the interesting things out of Dodd-Frank, I think at least, for public companies, which was "say on pay," that all public companies, other than the smallest reporting companies, had to deal with last year. And to give you some results from that first year, some lessons learned and just some thoughts that I had as I kind of looked at what happened last year.

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67. *See Roundtable on Conflict Minerals*, SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/news/otherwebcasts/2011/conflictmineralsroundtable101811.shtml (last visited Feb. 10, 2012).

68. Original Equipment Manufacturers.

So, this first slide is just a summary of what the actual requirement was under 951[69] and the Rules that came out of the SEC as a result of that section. In a nutshell, what we have is a requirement that all companies hold an advisory vote on the executives' compensation, which we call "say on pay." That has to happen at least every three years under Dodd-Frank. And, then, the company also has to hold an advisory vote on the frequency of the "say on pay" vote because as I said, it is *at least* every three years. The advisory vote is whether that will happen every year, every two years, or every three years. So, what happened last year on the "say on pay"? As you can see, more than 98% of companies "say on pay" proposals were passed or approved, and as you can see in the second bullet point, by a pretty high margin, I think; an average vote of about 90%. At least 70% had over 90%. All of that indicates, to me at least, that is pretty strong support from shareholders of executive compensation policies as they stand. At least based on where people were in the first part of 2011.

Martin Dunn: And I have actually heard the average director votes went up this year. There were fewer "vote no" campaigns because people were taking it out on this rather than the compensation committee. So in a way, it kind of worked out.

Mark Metz: Yes, very interesting results. It is worth noting that Institutional Shareholder Services, which, for those of you who do not know, is probably the largest proxy advisory firm or at least it makes recommendations to the most companies and for the most institutional investors, tells them how to vote on these various proposals. A few of the results from that are enlightening. As you can see, about 12% of the Russell 3000 companies that ISS advised on received a negative recommendation[], and all of the failed "say on pay" votes received a negative vote recommendation from ISS. I thought that was kind of an interesting fact. The remainder who got a negative vote recommendation from ISS but still

69. 15 U.S.C.A. § 78n-1 (West 2010).

their vote passed, saw a big drop in the vote on the "say on pay" proposal from about 90% on average to about 70% on average. The main reason why ISS was recommending a vote against was a pay for performance disconnect, which led to a lot, or at least more than usual, [of] companies filing supplemental proxy materials and talking to shareholders to respond to the negative vote recommendations from proxy advisors, including ISS and Glass Lewis, which is probably the next largest.

Most of these companies were contesting the advisor's assessment that the company failed the pay for performance test, and they did this by disputing a lot of the underlying analysis. For example, saying that ISS's use of a single measure total shareholder return for one and three years, ignores things that companies use to measure performance, such as earnings per share, EBITDA, revenue growth, or other internal metrics that companies have. Companies were also attacking the fact that the ISS analysis seems to focus more on short term performance, whereas companies were trying to look at a longer term focus. Some pretty good arguments there. By and large those companies were successful in getting a positive vote – not all of them, but most of them got a positive "say on pay" vote.

A few companies, unfortunately, at least from where I sit, who received a negative "say on pay" vote, got sued as a direct result of that negative "say on pay" vote. The basis for the suit, interestingly enough, was basically compensation as measured by the summary compensation table in the proxy statement that went up and the stock price fell as of 2010, and as a result we think that the board breached its fiduciary duties in granting the compensation to executive officers that it granted. We think you made misrepresentations in the proxy statement because you said that, in your CD&A[70] mainly, that you have a pay for performance policy, yet performance, at least stock performance, went down and compensation went up. There is a dis-

70. Compensation Discussion and Analysis, as required by S-K Item 402(b).

connect there. Therefore, you should have told us you did not follow the policy, and that was a misrepresentation. There are claims of corporate waste in these suits, and there are about eight to ten of them out there. They also claim unjust enrichment against the executive officers who got paid last year to run the company. Finally, there are claims against the compensation consultant, breach of contract, you did not give us good enough advice, and aided and abetted the breaching of the fiduciary duty.

Some interesting claims, I think. For the most part, people are saying they appear frivolous; and I have read most if not all of the complaints and they seem frivolous to me. But at least one, in the Cincinnati Bell situation, has survived a motion to dismiss.[71] That sent shivers down the spines of many corporate lawyers, like me, wondering what is going to happen here, and probably just raised the cost of getting that case settled.

A few observations in addition to the idea of them being frivolous, is that these complaints make an interesting argument. And that is that a negative "say on pay vote" should rebut the business judgment rule and shift the burden to the defendants. Just to backtrack, in case you do not know what the business judgment rule is, it is a legal presumption that when a claim is brought against a board of directors, that the board has acted in good faith and in the company's best interests. This presumption is fairly difficult to overturn for plaintiffs, and it is generally only in situations of bad faith, corporate waste, fraud, self-dealing, and those types of things, that plaintiff has to prove to get past the business judgment rule. What these complaints are arguing is that the negative "say on pay" vote by the shareholders rebuts the presumption that the actions by the directors were in the company's best interest because the shareholders have said that this was not in our best interest to pay the executives in this

71. NECA-IBEW Pension Fund, Derivatively on Behalf of Cincinnati Bell, Inc. v. Cox, No. 1:11-cv-451, 2011 WL 4383368 (S. D. Ohio Sept. 20, 2011).

way. That goes right against the statutory language in § 951(c) of Dodd-Frank, which says the vote on compensation may not be construed as overruling a decision by the board, or to create or imply any change to, or additional fiduciary duties on the board.[72] It just seems to be in direct conflict with that language, in my viewpoint.

One other thing before we move on here, I think that these cases are likely to increase the cost of hiring a compensation consultant. Most everyone does hire a consultant, at least one and sometimes more than one. So, we are likely to see higher costs overall as a result of these, and stronger indemnification provisions because compensation consultants do not want to ultimately have any money come out of their pocket.

As we turn to "say on pay" frequency, this is the second part of the Dodd-Frank summary that I mentioned a minute ago, shareholders were overwhelmingly in support of an annual "say on pay" vote. Where triennial votes were actually recommended by shareholders, they tended to be at smaller companies. So, if you were at a large company you almost uniformly ended up with an annual "say on pay" vote. Boards as a whole were recommending a triennial, every three-year, vote early in the proxy season, and, interestingly, that shifted as they began to see the handwriting on the wall. In view of that, and in view of the ISS's sort of uniform recommendation that the vote be annual instead of triennial, boards began to recommend later in the proxy season that shareholders vote for an annual "say on pay" vote. At the end of the day, a little over half of boards overall during the proxy season did recommend an annual vote, and about 42% for triennial.

One other point to make on the "say on pay" frequency, and that is that these are advisory votes on how often the company should hold the "say on pay" vote. Almost uniformly the companies are taking that shareholder advice and saying that is in

72. 15 U.S.C.A. § 78n-1(c) (West 2010).

fact what we are going to do, even if we recommended something else. But, there have been at least a couple companies I know of at least, that have said they are going to implement a triennial "say on pay" vote despite the advisory vote from the shareholders – a company called America Reprographics, and another one called Annaly Capital Management. So, it will be interesting to see what happens at those companies. If ISS has its way, they will probably recommend a vote against the directors, although Annaly does not even have institutional investors, at least none that hold at least 5% in the proxy statement.

So, some lessons learned from the first year of "say on pay". The first thing we saw was that institutional shareholders were largely following proxy advisory advice. That deference, along with the change in broker non-vote rules that we talked about, I believe, last year at this seminar, is giving proxy advisors more influence in how the votes turn out. As a result, I think boards would be well advised to at least understand the ISS governance model, how they evaluate compensation, and how they make a decision to recommend votes. Not that they have to sync right in with an ISS guideline, but at least know whether there is going to be some risk out there, or not, if they make certain decisions. Remember that no company that received a positive ISS recommendation had a negative vote outcome. Past performance does not guarantee future results, but it probably makes sense to try and get yourself in line there, especially if you have a lot of institutional shareholders at your company.

The second point that we learned is that companies need to attempt to understand the basis for that proxy advisor analysis generally, and to be ready to respond to a negative recommendation because if you get a negative recommendation it comes just a short time before your shareholder meeting. If you want to have any chance at all in changing the vote or stopping a downward trend in the vote, you need to make sure that you are able to respond to that very quickly.

The third lesson is that many companies found that it worked very well to engage with their larger shareholders prior to the proxy season. As soon as they knew "say on pay" was coming down the pike, they started talking to their largest institutional shareholders explaining their story, why they were doing compensation the way they were doing it, and getting those shareholders on board. That is a good thing, I think, just in general to have the shareholders on board with what management and the board is doing with compensation. Getting that buy-in ahead of time also helps in the situation where institutional shareholders are just too busy during proxy season to talk to you, as I think some companies found out.

Another thing that companies did with some success to get a positive vote this year was to improve their CD&A, the Compensation Discussion and Analysis, section in their proxy statement. I have listed here four different suggestions that I had based on my research of things people were doing, or said that they were doing, in order to improve their analysis and to improve the responses they were getting from shareholders. One was to show the link better between pay and performance. Use graphs; use pictures; document why the compensation was reasonable going beyond just the basic requirements. A lot of companies have viewed CD&A as an exercise in compliance. We have to make sure we cover all the things the SEC rule, the SEC release[73] says we have to follow or comply with and disclose to our shareholders. The companies who were more successful this year are going a little beyond that and just getting right down to the nut of it telling their story: why does their pay work with performance, how is it connected to performance, and explaining why they use the performance measures they use.

73. *Staff Observations in the Review of Executive Compensation Disclosure*, SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm (last visited Mar. 31, 2012).

Another really important one that I have seen and was recommending to my public companies, was to include an executive summary at the front of the CD&A, just a page or two, that makes the point as clearly and concisely as possible about how the pay is linked to performance, and just generally how the compensation was paid during the course of the year. I think the fact of the matter is that most shareholders, if any, are not going to read a fifteen page CD&A, which you see in a lot of proxy statements. They are more likely, if they are going to read the proxy statement at all, to read a short and concise summary. And I know that is true, just anecdotally, at institutions who get hundreds of proxy statements related to the various investments they hold; they are not going to read the whole CD&A, but they might read that executive summary. So, if you can make your pitch there you have a good shot at convincing them.

Then fourth, going back to the point I mentioned earlier, you have a potential litigation risk. So, when you draft your CD&A now, even more than in the past, you want to try to draft it with litigation in mind. Realizing that a plaintiff's lawyer can cherry pick language from your CD&A and put it right into that complaint, trying to make their case with your own language. So, be very careful in how you describe the link between pay for performance, do not necessarily describe it as a policy; perhaps describe it as a philosophy is one practical idea to come out of that. And, note that it is one thing out of several that the compensation committee looks at as it determines the compensation for executives.

Fifth, given the increased litigation risks companies need to be sensitive to the due care and process issues that they have in making these determinations, realizing that the compensation committee minutes may end up being delivered to a plaintiff's lawyer in discovery. So, create a good set of minutes. If someone at the company, maybe a just a clerical person, usually drafts minutes and there is not a lot of care given to what those look like, I recommend that somebody in the legal department, or maybe outside counsel, looks at those minutes and makes sure that they are well drafted and they properly document all of the steps that the compensation committee took to make its decision, so that the duty of due care can be demonstrated as a defense in the lawsuit. Make sure you get a full set of good information out to the directors. Make sure that, if possible, you use a compensation consultant or expert, which will oftentimes bolster a duty of care argument.

Sixth, companies with negative votes obviously need to look at their compensation to try to avoid getting another negative vote on "say on pay" in 2012; but also companies who were positive, but not overwhelmingly positive and the borderline seems to be around 70% as the cut off. If you got less than 70% at your company, you probably should be thinking about what we should have done to get shareholders more on our side. Should we change a policy? Can we be communicating better? Make sure that you have thought that through before you get too much further down the road because the 2012 proxy season will be upon us before we know it.

And then finally, based on my research, shareholders were much more likely to vote against a "say on pay" proposal where there was a negative shareholder return. Now, that should not shock anybody, but the fact of the matter is with the market down considerably, at least my portfolio is down this year, I think 2012 has potential to have quite a few more negative "say on pay" votes, unfortunately.

So, the final question, since we are at college, let us ask the academic question: did "say on pay" have a positive effect, did it do what Congress was after? The answer to that is that it depends on who you ask. There are commentators on both sides, as you might imagine; some who say it was a wild success and some who say it is a total abject failure. My observations are based on over 98% of the companies getting a positive "say on pay" vote in 2011. I do not think there is any way one could argue that corporate America got a message or was sent a message by shareholders about compensation policies. In fact, I think the message, if any, that was sent was generally "We approve of your compensation." I do not see any way to sugar coat that, but I think that there were some positive things that came out of the "say on pay" exercise.

It has encouraged companies to improve their disclosure, which is a good thing. It has encouraged companies to improve their dialogue with their shareholders, as I mentioned earlier: getting out there and talking with shareholders, developing a relationship, telling their story, explaining why they're using the metrics they are using, all those are good things. Eliminating some of the compensation practices that would drive some of the union pension funds and ISS crazy like high perks, club memberships, financial planning perks, tax gross ups. They hate tax gross ups. Multipliers of three times or more on compensation in connection with changing control parachute arrangements. A lot of those have been eliminated by companies as they looked at, for example, ISS guidelines, and said, "Hmm, we might get a negative vote if we do not get rid of some of these things," and as a result those are gone and compensation practices perhaps have improved. I think companies have made even more of an effort to link pay to performance by using additional incentive arrangements. So, what does the future hold? Well, as Marty said, "The crystal ball is a little cloudy." I think there will probably be more negative votes because the market is down and because people are likely to be more disenchanted with companies. And of course, we have Wall Street protests in the news every day. We have an election year coming up where there is likely to be some rhetoric back and forth about Wall Street. So, I think this is going to be an issue that will stay in the public eye and it may increase the negative "say on pay" votes. So, if you are at a company in-house or you are advising companies you are best served to bear that in mind and take whatever action you can to forestall that. Any questions on that before we go on? Ok.

Jennifer Powell: Ok. Well as the newbie on the panel I was tasked with providing the regulatory and compliance update. It is really the miscellaneous section, and I had hoped, without much optimism, that the SEC might adopt some additional rules and I could tell you just how exciting the 2012 proxy season was going to be. That has not been the case and so that leads up to my apology that this is the driest portion of this panel. I did prepare a power point; I am not really going to follow it for a variety of reasons and, perhaps this is hazing, I am not sure, but I recently took on the executive comp portion of the regulatory update, so I am going to focus on that and some of what I am going to talk about is not in the power point. Also, you can all read, and most of these items are going to be discussed in a little bit more today. These are issues where we do not even have proposed rules yet. Most of them we expect in the next quarter, and adopted rules not until the first half of next year. So you can –

Mark Metz: Jen, is it safe to say that most of, if not all of, the things for which we do not have proposed rules, will not be in place by the 2012 proxy season? Is that what you are seeing?

Jennifer Powell: I think that is safe to say.

Mark Metz: So the only thing that we have proposed rules on, that there is an outside chance that we will have a final rule on that will be in effect for next year, is the executive comp that you are going to talk about?

Jennifer Powell: That is right. And it is really only one prong of what I am going to speak about, which is the proxy disclosure rules. So, I will turn to that. This is § 952 of Dodd-Frank, which added § 10(c) to the Exchange Act.[74] That section requires the SEC to adopt rules directing the national security exchanges and the national securities associations to prohibit the listing of any equity security of an issuer with the exceptions that is not in compliance with 10(c)'s compensation committee and compensation advisor requirements.[75] It also requires the SEC to adopt proxy disclosure rules concerning the use of compensation consultants and conflicts of in-

74. 15 U.S.C.A. § 78j-3 (West 2010).
75. Id.

terest that might arise. As I mentioned, the SEC has proposed rules issued on March 30th of this year, proposing new exchange act rule 10(c)1 that implements the comp committee listing requirements, and also rule amendments to Regulation S-K Item 407e to implement the proxy disclosure requirements.[76]

I guess his first question is: what do the listing standards apply to? I will note that § 952 states that, "it applies to all national securities exchanges and all national securities associations." It does not apply to over-the-counter bulletin boards since they are not exchanges. I will also note that in terms of associations there is only one registered; that is FINRA and there [are] no securities listed. So, in practice it is not going to apply to associations, but may in the future to the extent that additional are registered, or they list additional securities. In terms of what securities are affected, there is some question in the language of 10(c) whether the listing standards should apply to equity securities only, or all securities of an issuer. The SEC and the proposed rules have determined that they should only apply to equity securities. This they think promotes the intent of the Act and is consistent with current practices; current practices being that issuers of debt securities only are exempt from various listing requirements, for example, NYSE's[77] compensation committee requirements, SEC proxy rules, etc. In addition, they note that the majority of issuers of debt securities are privately owned. One additional category of securities that the SEC is proposing to exempt is securities futures products. This is because technically the issuer is a clearing agency and they do not think it is meaningful for investors to get information about the clearing agency as opposed to the actual securities.

That leads to other exemptions under 10(c)[78]: 10(c) itself under the Dodd-Frank Act did exempt five classes of issuers from the listing standards. Those

76. 17 C.F.R. § 229.407 (2008).
77. New York Stock Exchange.
78. 15 U.S.C.A. § 78j-3.

are: controlled companies, limited partnerships, companies in bankruptcy proceedings, registered open-end management companies, and foreign private issue owners.[79] In addition the SEC, as you know, has broad authority to exempt any other person, security, or transaction, and this authority was extended to the exchanges in the Dodd-Frank Act. In its proposed rules the SEC has noted that it would leave to the discretion of the exchanges whether to propose additional exemptions. Now that we know whom and what the SEC proposes listing standards apply to: what are they, and what are they supposed to look like? The listing standards would require that all members of the compensation committees to be members of the issuer's board. It would require that all members of the compensation committees be independent as defined by the exchanges. [It] grants to the compensation committees the authority to consult with compensation consultants, independent legal counsel, and other compensation advisors. Compensation committees will be required to have direct responsibility for the engagement, compensation, and oversight of compensation advisors. Listed issuers must provide appropriate funding to compensate the advisors as determined by the compensation committees. In selecting compensation advisors, the compensation committees will have to consider the independence of those advisors by references to factors to be identified by the SEC.

There [are] a lot of moving pieces here. Finally, the exchanges must provide issuers with a reasonable opportunity to cure and defect before they delist, or prohibit a listing of securities. So, a couple things to note on this: one, current law does not require an issuer to have a compensation committee, but current listing standards generally do require that issuers either have a compensation committee composed solely of independent directors, or they have a majority of independent directors actually rec-

79. Id.

ommended and oversee executive compensation matters. The proposed rules would not change this framework; they require exchanges to adopt listing standards applicable to any committee of the board that oversees executive compensation, whether it is called a compensation committee or something else, and whether or not that committee performs other functions. They do not require the listing standards to apply to independent directors who oversee executive compensation in lieu of a board committee and this is for a couple reasons. It is in keeping with the current framework, 10(c) only refers to compensation committees; and also under state corporations law, such action is deemed an action of the full board with only the independent members acting, not as a committee action. With respect to independence of the committee members, again, currently most of the exchanges require that board of directors of listed issuers be composed of a majority of independent directors, or the directors overseeing the executive compensation must be independent.

The one issue is that the definition of independence would vary among the exchanges. Under the proposed rules, the exchanges would continue to have some discretion about defining independence. They can craft their own definitions. They are however required to consider, not to adopt, but to consider, the factors set forth in 10(c) including: the source of compensation of a director; consulting or advisory fees paid by the issuer to the director; whether the director is affiliated with the issuer or a subsidiary. Unlike what we saw with Sarbanes-Oxley for audit committees' members, the exchanges are not required to adopt these as minimum standards. They are just required to consider them. As the SEC suggests, they may be more flexible than they were with audit committee members. For example, you might have a significant investor with a seat on the compensation committee, or somehow affiliated with a member of the compensation committee. This might very well be in line with motivations of other shareholders to oversee executive compensation. So it is a bit different of a context.

With regard to the compensation committee's authority to engage compensation advisors, the SEC notes a couple things in its proposed rules. The committees are permitted, but not required, to engage a consultant. Although, as Mark mentioned, most now do. They also do not have to implement the advice or recommendations of their advisors. They are not required to engage independent legal counsel. They are not precluded from retaining non-independent counsel, or from relying on in-house counsel or outside counsel that might have been engaged by the issuer or management. There have been some comments on this section requesting that the final rules clarify this position because there is some concern that compensation committees would not be able to consult with their own in-house counsel, or current outside counsel.

Again, compensation advisors do not actually have to be independent, but they are required when they select an advisor to consider various factors of independence. There are five of them that Dodd-Frank enumerated: the provision of services to the issuer by the advisor or the entity that employs the advisor; the amount of fees that are received by the advisor or its employer as a percentage of its total revenue; policies and procedures that the advisor or employer has in place for conflicts of interest, any business or personal relationships between the advisor and a member of the compensation committee; and, whether the advisor owns any stock of the issuer. Under the proposed rules, the theme throughout this matter is that the exchanges have broad discretion to add or determine their own factors and how their rules will look. Finally, on this item, the listing standards are required to promulgate certain opportunities for issuers to cure any defects. The SEC has punted a bit to the exchanges, but perhaps rightfully so because the exchanges tend to already have robust procedures in place for delisting or prohibiting a listing of a security. Again, the SEC did suggest that the exchanges may consider adding a corollary to the audit committee listing standards and cures, such that, if a compensation committee member ceases to be independent for reasons outside his or her reasonable control, they may remain a compensation committee member until the earlier to occur of the next annual meeting, or one year from the chartering event. So, that is something that the SEC has adjusted in the text of its proposed rule but is not in the rule itself.

So that is my quick summary, I know we are coming up on time here, of the listing standards matter. The second prong of § 952[80] is the proxy disclosure rules. Again, § 10(c) requires that in any proxy or consent solicitation materials for an annual meeting each issuer must disclose in accordance with SEC regulations, whether the compensation committee has retained or consulted with a compensation advisor, and if so, whether any conflicts of interest have arisen, and then, if so, how are those conflicts being addressed.[81] Because regulation SK item 407[82] already currently requires certain proxy disclosure for certain annual meetings, at least at which directors are re-elected, the SEC has proposed just to layer these requirements into the current rules. This will integrate the Dodd-Frank mandates. They think that the disclosure is most relevant in annual meetings where directors will be elected, so they are going to limit the rules to that context, not just any meeting. They are also going to extend the requirements to all Exchange Act registrants, whether or not they are listed, just for simplicity's sake. Finally, in terms of transition and timing, in terms of listing standards, the Dodd-Frank mandate was that the SEC rules issue by July 16, 2011.

Mark Metz: Oops. [Laughter].

Jennifer Powell: Yeah, but it gave no specific deadline for the effectiveness of the listing standards. So, the SEC is standing on that a bit and expects to have final rules adopted by the end of this year. They would have requested that the exchanges propose listing standards within ninety days after publication of the final rules in the federal register, and then SEC ap-

80. Id.
81. Id.
82. 17 C.F.R. § 229.407 (2008).

proval would be expected within one year of publication. So, we have some time on these. With respect to the disclosure rules, the SEC was required to adopt rules for meetings occurring on or after July 21, 2011.[83] So, again, a bit of an oops; but the SEC notes that Dodd-Frank also required that such disclosure be in accordance with its regulations. Since it does not have regulations on this yet, the disclosure rule delay is not such a big deal. They do expect final rules by the end of the year and it is unclear what the final rules will say in terms of when they go effective. But because they are being layered into the current disclosure requirements, and because there is an interplay with "say on pay" and some of these other executive compensation issues, I would not be surprised to see it for 2012. In terms of the other items for Dodd-Frank, you can, if you are interested, you can peruse the rest of the power point.

Elliot Spoon: Are there questions for this panel? If not lets thank them for a great presentation. [Applause]. We are now going to have a short break. There are drinks and snacks in the back corner, and then we are going to reconvene with our SEC Enforcement Issues Panel.

SESSION 3: SEC ENFORCEMENT ISSUES ARISING OUT OF THE FINANCIAL CRISIS

Elliot Spoon: Our next panel is going to deal with SEC enforcement issues and we are pleased to welcome back to our conference Brad Schram,[84] from Hertz Schram, and Joseph Papelian,[85] who is Deputy General Counsel for litigation for Delphi Corporation, and we would also like to welcome, from the SEC,

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83. *Id*.

84. Bradley J. Schram established the law firm of Hertz Schram, P.C. in 1979. He has served as its President since it incorporated in 1981. He serves as general counsel to clients including local developers to international Fortune 100 companies.

85. Joseph E. Papelian is the Deputy General Counsel for Litigation for Delphi Corporation. Prior to joining Delphi, Mr. Papelian was an assistant 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.

David Van Havermaat.[86] I am most appreciative of David's presence here, as he has traveled from Southern California where he is at the LA regional office, to join us at this conference. Why anyone would want to come from Southern California to Michigan, I do not know [Laughter], but we appreciate it. Without further adieu, I will turn it over to the panel.

Joseph Spiegel: We should add a footnote that David's a Michigan graduate, so he is here for another reason. [Laughter].

Elliot Spoon: You were not supposed to say that. [Laughter].

David Van Havermaat: I was going to end my comments with a "GO BLUE." [Laughter].

Bradley Schram: David, do you want to give your disclaimer?

David Van Havermaat: I shall. My comments, as with all the other SEC personnel here today, are mine alone, do not represent the views of the Commission, the Commissioners, or any of the staff.

Joseph Papelian: And I give a similar kind of disclaimer as it relates to my views and not necessarily those of Delphi.

Bradley Schram: All right, to start off, Dodd-Frank[87], as most of you know, required the promulgation by the SEC and implementation of whistleblower rules. Those rules were finalized in May of this year and became effective on August 12th. So, what we are going to be discussing today really is in its nascent stages and we are hoping to raise many issues and address some of the concerns that all of you, as practitioners, will have.

The premise of a whistleblower action is probably familiar to all of you. Specifically, it requires the voluntary provision of information to the SEC by an informant with original information that ultimately leads to a successful enforcement action by the SEC that results in the recovery of damages in excess of a million dollars arising out of the core set of facts that was the basis of the original com-

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86. David Van Havermaat is Senior Trial Counsel for the Securities and Exchange Commission.

87. Dodd-Frank Wall Street Reform Act.

plaint. The participant, the whistleblower-relator will be eligible, depending upon circumstances, to an award ranging from 10% to 30% and we are going to talk about what circumstances may impact that decision. Many of you may have similar or analogous experience in the *qui tam*[88] area, where, as you know, an evidentiary disclosure is made by counsel for a relator, that evidentiary disclosure is attached to a complaint that is typically filed in federal court under a federal statute, or could be under a state statute as well. And, at that point, the government is required to investigate, in the *qui tam* context, the complaint that has been filed. So, my first question to the SEC is: is there an analogy here? Is the SEC required to investigate and are there resources sufficient to do that at this point?

David Van Havermaat: There is no analogous *qui tam* provision in the whistleblower provisions that were recently promulgated. The requirement to investigate is essentially a self-driven requirement that the Commission obviously has been under fire recently for matters that were not adequately investigated. The staff is obviously fully aware of the various issues that have presented themselves in that regard and it takes very seriously any TCRs[89] that come. In fact, very recently, the Commission has implemented revised procedures for reviewing all TCNRs that come through. It would be in the not too distant past that a tip might come in and there were not great mechanisms for determining whether similar tips had come into other offices, whether similar tips had come in on [the] same but related matters. Those are all being consolidated now. There [is] much greater agreement between offices. There is much greater correlation between what is coming into one office and another, so that if someone gets a tip from a whistleblower, it is much easier for the staff to determine whether that is something that is

88. A writ of *qui tam* is a writ whereby a private individual who assists in a prosecution can receive all or part of any penalty imposed.

89. SEC. AND EXCH. COMM'N, FORM 2850 (2011), *available at* http://www.sec.gov/about/forms/formtcr.pdf.

an isolated instance or whether there have been multiple tips that need to be investigated much more fully.

Bradley Schram: One significant difference though, between a *qui tam* action, which is under the False Claims Act,[90] and the kind of whistleblower provisions of the SEC, is, I do not believe there is any provision under the SEC like there is for a relator, to continue the action if the government decided not to intervene.

David Van Havermaat: That is correct. There is no analogous provision. In terms of the differences, the *qui tam*, for example the False Claims Act.[91] [pause] Again, I cannot speak for the Commission, but I think the general sense is that there is the perception that that could be subject to abuse and it was taken upon the Commission's staff to investigate and to be the ultimate arbiter of whether and how far an investigation needed to go. I realize I did not answer your other question about the resources the Commission has. There is an Office of the Whistleblower in D.C. that I think has a staff, at this point, of, I want to say, a few dozen people. But this falls upon all members of the SEC staff. This is not something that goes through the Office of the Whistleblower and that is it. This is something that, if a tip comes in to the Los Angeles Office, there is a lot of interaction with the whistleblower office now. But this is something every SEC staffer is responsible for.

Bradley Schram: Joseph, one of the issues that this legislation or these rules creates for all in-house counsel is the tension created by the implementation of these rules and the impact on the compliance function. How do you, as an in-house lawyer, deal with the issue of, on the one hand, the statute provides, the rules provide, that a whistleblower can come in and earn perhaps an enormous pay day, yet on the other hand, have that individual perhaps come to you as

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90. False Claims Act, 31 U.S.C. §§ 3729–3733 (2006).
91. Id.

in-house counsel, you could have solved the problem, investigated the problem, on your own.

Joseph Papelian: And minimize the damages. That is a terrific question. There is a lot of tension between compliance programs that most companies have in place and the whistleblower provisions. And during the debate, as it relates to the regulations, a lot of the business community was urging the SEC to require that a whistleblower first make the disclosure to the company, and then, if the company fails to act within a certain period of time, then the whistleblower would be allowed to go forward and make the complaint. From many companies' standpoints, that regulation did not go forward. Instead I think the SEC adopted kind of the middle ground, where the whistleblower is not required first to make a report to the company, but can make a report to the SEC directly. But the SEC kind of rewards the whistleblower if he or she first makes a report to the company and the company does not do anything. I think it is 120 days now. And then it later results in over a million-dollar type of penalty. Then, the whistleblower can benefit greater for having first made the disclosure within the company. But there is a lot of tension, particularly within a company as it relates to the obligations of employees to come forward, to report conduct. For example, many companies have in place an annual conflict of interest survey. Or when an employee leaves employment, there is an exit interview where the employee then is asked a series of questions about his or her knowledge of the kind of financial accounting irregularities, Foreign Corrupt Practices Act[92] issues, a variety of issues that the employee often would report. So, if you are placed in a situation where the employee has completed the conflict of interest and indicated that he or she is not aware of any information that should be reported, or during an exit interview, and then turns

92. Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd–1-3 (2006).

around and makes a report to the SEC, how would the SEC view that information?

David Van Havermaat: That is a good question. To address a couple of the issues that you brought up: first, with respect to the lack of a requirement that a whistleblower first go through the internal processes, that is something obviously that the commission received a lot of comment on, there was a lot of analysis done on that, and a great number of factors obviously entered into the decision to have the provision as it is. I think one of the primary factors is that, although a lot of this, and certainly here today, is in the context of corporate wrongdoing, really the bread and butter of what the SEC does is things like offering frauds, Ponzi schemes, [and] things of that nature. And in those contexts, it does not make a whole lot of sense, most of the time, to have a requirement that a whistleblower – again this is the calculus that the Commission I think went through – have to go through where the entire situation is a essentially a fraud. The Commission did, I think, try to strike a balance by incentivizing through various methods an employee going through the internal processes, but at the same time not making that required. With respect to the issue of the exit interview situation, hard to say. That is something that really depends on the facts of the case. That is something that the staff would have to determine what was the basis for this being withheld from the exit interview. Obviously, there are a number of factors that go into determining whether and in what amount an award is appropriate. Frustration of internal processes is one the negative factors that can reduce an award or potentially eliminate an award.

Joseph Papelian: Let me add to that scenario a little bit. Often times in an exit interview, it may be accompanied by a severance agreement; and in that severance agreement, it requires that the employee fully disclose any wrongdoing. Sometimes in a severance agreement, there is a claw back provision. So what happens, then? You are a practitioner, Brad, representing the whistleblower. He has got the severance provision in the exit interview. He or she has now made a report to the SEC, looking to kind of double dip, if you will. So, if you handle the whistleblower on that, do you run the risk of a lawsuit from the company?

Bradley Schram: Sure, you could. A lot of the issues, back to David's point and the *qui tam* context, is trying to determine, and it is always difficult, the credibility, in a whistleblower case, of the relator. And many attorneys will not even consider taking a case unless there is sufficient documentation, which raises other issues about whether confidential or proprietary information has been taken by that employee to provide a nexus to the claim.

Joseph Papelian: Let me kind of reverse the situation, Brad. You are now representing the company ,and you are now aware that an employee has left the company with a severance package, signed the agreement that he or she is not aware of any negative aspects of the company and now, representing the company. You realize that the whistleblower has taken proprietary information of the company, has received a severance. Would you advise a company to actually sue the whistleblower? And then are you concerned with what kind of a retaliation provision the SEC would look at?

Bradley Schram: Well, my primary goal would be, as counsel to the company, to make sure that the investigation is concluded and that I can help convince the SEC that no action is appropriate. So, my first goal, of course, is to quash the effort. [My] secondary goal would be to deal with the individual involved, and I would look at it both in terms of the principled action, that is, how it impacts the company and others that may be similarly thinking about doing something like that, and then, of course, the cost-effectiveness of doing it.

Joseph Papelian: David, I used to handle *qui tam* matters and I remember one that I handled in Los Angeles, in fact, where the court actually unsealed the complaint before the Justice Department decided to intervene. And the company had the opportunity to make a presentation to Justice [Department] and try to convince [the] Justice [Department] not to intervene or take over the case. And I remember arguing to [the]

Justice [Department] that they should intervene and take over the case and dismiss it because it was frivolous. Of course, that did not happen, but they did not intervene. What do you do, David, when you find a company is arguing for you to actually dismiss the case and you have a whistleblower perhaps represented by a very able counsel like Brad who is arguing just the opposite?

David Van Havermaat: Well, a lot of times, that is not something that can be determined at the outset, obviously. The Commission and the staff [are] very aware of the need to not let another Madoff[93] slip through the cracks. It is something where obviously if the corporation has [pause]; you look at the weight of the evidence, first of all. You see what the Commissioner is able to provide. If it clearly refutes what the whistleblower is alleging, that certainly goes into the analysis. But if, as in most situations, it is an area that is a shade of grey, again, not speaking for the staff, but I think in pretty much any instance, there is going to have to be some investigation done for the staff to become comfortable with the company's position if in fact that is where it ends up.

Audience Member: Is there a difference between a whistleblower situation with a broker-dealer and a registered investment advisor versus Joseph's company, which is just merely a registrant, in the staff side?

David Van Havermaat: The staff does view any sort of gatekeeper certainly as, I do not want to say a much different entity, but as someone that is generally, again, I do not want to say accorded more weight, but it is taken very seriously. If there is someone that is a gatekeeper, whether it is someone that is registered or an in-house lawyer, that is something that is not taken lightly. Again, not to say that any whistleblower complaint is taken lightly, but that, I think, is something that would be given great scrutiny.

93. In 2009, Bernie Madoff was sentenced to 150 years in federal prison for the operation of a Ponzi scheme estimated to have cost investors over $18 billion.

Joseph Spiegel: Joseph, one of the areas that I would worry about if I were an in-house counsel at a major firm, is the investigation itself and the use of either outside counsel or your own staff with regard to the investigation where the allegations are that key executives are involved and that this is not just an outlier situation. How do you offer advice in that area? Do you try to obtain separate counsel? Do you bring the question to the board?

Joseph Papelian: Well, those are very good questions. One thing I think is important to keep in mind is if you are a lawyer on behalf of a company, your client is the company. It is not the CEO, and sometimes people can blur that understanding. If it is a significant matter, formal investigation by the SEC and top officials are involved, certainly you want to look hard about getting outside counsel. But I think an important issue up front is whose the one that is controlling the legal review and often times it is the audit committee because they are made up of outside directors and, you know, presumably they were not involved in the issue. Putting in place the prophylactic measures to start the matter can later help you quite a bit when you are looking at the collateral consequences of disclosure of confidential information. For example, many times an audit committee will take over the handling of an internal review and the lawyers, inside and outside, are actually reporting to the audit committee. And that can be a little dicey if you are in-house and certainly the people you ordinarily report to are those who are being looked at. It can put you in an awkward situation.

Joseph Spiegel: Similarly, David, how would you deal with the situation where you have counsel, presumably outside counsel, that comes to the SEC in the context of a whistleblower situation and there is multiple representation, and it is the SEC's goal, presumably, to resolve it, and, given the tools available to the SEC, the SEC may be in a position to evaluate and prioritize and try to target one or more of those individuals for cooperation, perhaps entering into agreements that do not have collateral effects. How does the SEC approach a lawyer in that potentially conflicted situation?

David Van Havermaat: That is a situation where the Commission and staff ha[ve] historically not wanted to tread heavily at all on the propriety of any attorney client relationship. That being said, there is a recent wave, for a lack of a better word, of situations where an apparent conflict does arise. And again, the staff does not have a whole lot of weapons because it does not want to tread too much on the relationship; but it will point it out to the parties and make sure everyone involved has full consent and full disclosure to the situation. I think that the situation that you described, has been in place before the whistle blower provisions. The whistle blower provisions make that even more acute because previously you did not have something where there was a great likelihood that one represented party could come in earlier and therefore receive a greater award than another represented party. That conflict, in itself, the commission and the staff would want to make sure is identified by all parties. But again, it is an area the Commission is very wary of any allegation or accusation that an attorney-client relationship has been tampered with.

Joseph Spiegel: Joseph, have you faced a situation, perhaps not in this specific regard, but where you are investigating on behalf of the corporation, and you are interviewing employees of the company and you fear that that information that you obtain may not be subject to the attorney client privilege.

Joseph Papelian: Well, I think at the start of any kind of review you certainly want to understand what the issues are and get in place the proper memos to kind of protect yourself that it really is a legally privileged review. But there are Miranda rights when a defendant is arrested by the police and, similarly, there are corporate Miranda rights when you conduct interviews. It is absolutely critical to, one, never do the interview alone; you want a second person there. [Two], it is absolutely important to tell the interviewee that you are counsel for the company, not them, that the conversation you are about to have is protected by the attorney-client privilege. The privilege is the company's not the employee's, which means that if the company later decides it wants to waive the privilege and disclose what the witness has told us, it can do so without coming back to the employee. In other words, you do not want to create an attorney-client relationship between you and the witness. And another thing you got to add in that corporate Miranda warning is that if the witness provides you intentionally with false information and you take that information and you disclose it to the government that witness subjects himself to causing a false statement, 18 USC § 1001,[94] to be made. I think there have been criminal prosecutions for interviews conducted by company counsel and the counsel turns that information over to the government. So, having said all that, you would not be surprised that the employee, sometimes, is not really eager to talk to you. But I think it is really important to provide that information before the start of the interview.

Audience Member: Joseph, do you think it should be written?

Joseph Papelian: I do not provide it in writing. That is why I think it is important to have that second person there. I think, providing it in writing puts even more pressure on the interview. It is an awkward situation and you really need, when you are doing a review, you need the information from the employee and sometimes the employee will say, "I want to talk to a lawyer before I decide to do the interview." You have to make a judgment call whether you are going to allow that employee to do that or you tell that employee, "Look you have consequences for not providing the information up to the point of employment being terminated." Or, you may decide you really need to have that information and counsel representing the employee coming in is not going to impede that matter and you postpone the interview. It is a difficult call. One thing we were talking about on whistle blower, which I think is very important: what happens if the whistle blower

94. 18 U.S.C. § 1001 (2006).

is privy to privileged communication, attorney-client privileged material, and turns it over to the SEC, and becomes clear to the SEC that it is privileged material? How do you un-ring the bell so to speak?

David Van Havermaat: That is a very difficult situation. I think the provisions try and minimize the likelihood of that happening by providing, for example, that any information being obtained illegally is not something that would be amenable to a whistle blower award. That is an area, again it depends on the facts of the case, generally what happens is if the information gets to a point where a staffer suspects something has been taken improperly, a lot of times the interview will be stopped for a determination of what the source of the information was, whether it was in fact improperly obtained. The un-ringing of the bell, that is the problem, it is impossible to do. There is no fruit of the poisonous tree doctrine analogy that would prevent follow up from being taken.

Audience Member: David, is there a privilege if the whistle blower comes to you? A privilege between you and that whistle blower? If some guy walks in and says, "I know my company is doing X, Y, and Z." Do you say to them, "Anything you tell me is privileged."

David Van Havermaat: There is no privilege, but there are confidentiality provisions where the Commission, where the identity, assuming that the whistle blower wants to be kept anonymous, his identity will not be revealed. But even that has exceptions too: if it is necessary through a litigated proceeding or administrative proceeding, or pursuant to an access request with another entity, and, I think, even foreign security entities as well. So, there is not a whole lot of assurance the Commission staff can give to a whistle blower that his identity will never be revealed.

Bradley Schram: I think it is the SEC's position regarding confidentiality agreements between employees and the company, if I am not mistaken, that those agreements are void if they prohibit the employee from sharing information with the government.

David Van Havermaat: I think that is generally correct, yes.

Joseph Papelian: One thing, we are talking about the SEC and all, at least in my mind that looms kind of big is the eight hundred pound gorilla in the background that is the Justice Department. I know the SEC has taken a lot of the cards that the Justice Department has often used like non-prosecution agreements, and deferred prosecution agreements. And, one big difference, and maybe you can comment on this David, my understanding is on non-prosecution agreements with the SEC, there is no requirement of admission on behalf of the defendant. And as that relates to the Justice Department, often times, there is a requirement of admission for a deferred prosecution agreement.

Bradley Schram: David, just before you get there, to add to that the dilemma that practitioners face in dealing with FINRA. For example, in FINRA enforcement, and in trying to enter into a settlement, an AWC, an acceptance, waiver and consent, or in dealing with the SEC to enter into a settlement with a consent. That information, as long as the individual does not try to deny it later and there is a subsequent action, typically that information, from my perspective, is not admissible against the individual or the company. In this context, with the continuation, I think, of the SEC's philosophy following the C board line, that they want cooperation, it seems to me the deferred prosecution agreement really puts counsel in a quandary as how to resolve the issue of the day without making it a problem later on down the road with regard to collateral impact.

David Van Havermaat: The bottom line is that almost all settlements with the Commission do not require any admission and are generally done without admitting or denying liability for obvious reasons: it makes it much easier to settle matters. I think the objective of the Commission is, first and foremost, to put a halt to any ongoing fraudulent activity or to stop any activity that is imminent. And anything that facilitates that, whether a situation where a defendant does not need to admit liability, I think that is viewed as facilitating the ability of defendants or potential defendants to communicate with the Commission. The thought that down the line they are not subject to Commission action, but will not have an admission of liability hanging over their head that the rest of the universe can come after them on. There is, as I think was touched upon, the issue that you cannot thereafter stand on the court steps and proclaim your innocence. Without admitting or denying does include a provision that you will not directly or indirectly take any action that is perceived as denying the Commission's allegations.[95] It is a two way street, you get your judgment and pay your disgorgement and you get your injunction, but you do not get the benefit of being able to deny engaging in the activity that constituted the violation.

Joseph Spiegel: Joseph, it seems to me this would be a critical issue to you and to all in-house counsel in the context of collateral impact of a deferred prosecution agreement may put your company at risk. For example, companies that want to contract with the government or do RFP's for government work, may be at risk of needing to disclose or potentially down the road if there is an alleged violation hanging over the company's head that could impact all the issues involving value to the company.

Joseph Papelian: It is true, I think universally, in an application, for example, a Department of Energy grant, it asks for any SEC actions the company has been involved with for, I think, the last ten years. So those disclosures would have to be made, and I think it would cause some concern for the grant. Another really big concern is, for lawyers who end up representing a company and, let us say, you are reporting to an audit committee. Audit committees are very focused on making sure that the company is cooperating fully with the investigation. They are singularly focused on that, to make sure they can get whatever

95. On January 6th, 2012, the SEC announced that it would no longer allow defendants facing civil fraud or insider trading charges to say they neither admit nor deny the allegations when reaching a settlement. *See* Edward Wyatt, *S.E.C. Changes Policy on Firms' Admission of Guilt,* N.Y. TIMES, Jan. 7, 2012, at B1, *available at* http://www.nytimes.com/2012/01/07/business/sec-to-change-policy-on-companies-admission-of-guilt.html.

benefit they can and root out whatever problems there are within the company. Often times, when you are doing a legal review, the audit committee will direct you to disclose the results of the legal review. Additionally, I think it is important that you let the audit committee know that while disclosing the result of the legal review may well benefit the company, in the sense of on a *Seaboard*[96] analysis how cooperative they are in taking immediate action to correct the problem, taking action to make sure it does not happen again, getting rid of the individuals who may have been responsible for the problem. All that is very good, and will be looked at favorable by the SEC. [However], giving the results of an internal review, again, will help you very much with the SEC, and maybe even with [the] Justice [Department]; but, boy, it really hurts you down the road with class action law suits that will inevitably come from these types of issues. You will not be able to claim later on that you did not waive the privilege, particularly under the Sixth Circuit rule, where it says that we have rejected selected waiver and any of its various forms.[97] Proposed Rule of Evidence 502[98] looked at carving out an ability for a company to provide privileged information to a government entity without having it later viewed as a waiver to third parties, but that was not adopted. Trying to be a little bit pregnant is often difficult.

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96. SECURITIES AND EXCHANGE COMMISSION, RELEASE NO. 44969, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 AND COMMISSION STATEMENT ON THE RELATIONSHIP OF COOPERATION TO AGENCY ENFORCEMENT DECISIONS (2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm (setting forth what the agency "will consider in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation – from the extraordinary step of taking no enforcement action to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents we use to announce and resolve enforcement actions.").

97. *See In re* Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289 (6th Cir. 2002) (discussing the Sixth Circuit's rejection of a government investigation exception to the third-party waiver rule as applied to attorney-client privilege).

98. *See* FED. R. EVID. 502 (discussing the proposed language of the rule "selective waiver" in the advisory committee notes).

Joseph Spiegel: As you go down the line, Joseph, as you know, there is third party litigation frequently. And there are different individuals whether there are arbitrators or administrative judges that may take a different view of the impact and may decide for purposes of discovery or admissibility for purposes of trial or arbitration that they are perfectly willing to have you give that up.

Joseph Papelian: Absolutely. And that to me, aside from trying to get the SEC issue resolved, the biggest issue practitioners are going to face down the road are the collateral lawsuits that are going to happen after.

Joseph Spiegel: We had talked a little bit in our pre-meeting about the impact or potential impact on other individuals, for example, the board of directors, other key executives, in terms of potential claw backs as may have been discussed for a moment in the prior session. Have either of you had any experience with that or had issues raised at your offices?

Joseph Papelian: The only claw back provision that I am aware of, has to do with a severance agreement and later on if the employee who was severed was determined to be involved in, let us say, a securities violation, often times there is a demand for repayment of the money. The analogous situation that you often times find yourself in is the innocent director that is named in a class action law suit and expects the directors and officers insurance (D&O) to easily cover the activity. I remember speaking about D&O insurance, and I align it to an umbrella salesmen. They sell you the umbrella when it is sunny outside and as soon as it starts to rain they take it away. It is important, and I think I mentioned this last year, that you look carefully at the D&O coverage in your policy. Some of the coverages require just a finding of fraud to void it; I think the better policies require a final adjudication of fraud. For example, if you have a securities fraud case, and there is a finding against the CEO, some policies for innocent directors will say that if there is fraud finding as to a CEO, general counsel, CFO, that it may void the policy for the innocent director that had nothing to do with it. So, be very careful, not all D&O policies are the same. You do not want to be the umbrella salesmen out there.

Joseph Spiegel: We have talked about resources a little bit before. In this technologically savvy environment with companies, especially hedge funds, being so adapt at this, how does the SEC keep up?

David Van Havermaat: It is difficult. I think I have seen various iterations of some statement that the Commission's entire budget is equal to the IT budget of some major brokerage houses. It is getting better, with more funding it will become even better down the road. I guess there are several aspects to that. I started at the Commission twelve years ago. I have noticed over the period that I have been there that the quality of people coming in is incredible high. I think that a lot of people view the SEC and government work in general as some place you go if you do not want to work hard; but I can tell you nothing is further from the truth. There are a lot of very qualified people coming in from top rated firms and it is not because they failed out of the firm, but because they want to come somewhere where they can do what they perceive as good work for the people that they serve. Again, that being said, there are few of us against many of them. It is generally an uphill battle. I think the whistle blower provisions obviously provide us with an advantage. If you hang a dollar bill in front of somebody there is a much better likelihood that they are going to disclose to you something they would not otherwise disclose. We rely on tips from all and every source imaginable, and our duty is to follow those up to the end to determine whether it is worthy of a recommendation or not. Our duty is to follow those up to the end to determine whether it is worthy of a recommendation or not. It is again it is always an uphill battle but we are holding our own at this point.

Bradley Schram: Does the SEC utilize outside services, outside vendors to help it?

David Van Havermaat: Sometimes. Where appropriate. A lot is done through [Washington] D.C. – a lot of the forensic work and things like that. But yeah, when appropriate, we can certainly use outside resources if that is something that would assist the investigation.

Bradley Schram: Dave, You mentioned earlier about your personal reluctance, and perhaps policy as well, to intrude on the attorney-client relationship especially when it appears that there [are] multiple representations going on even though you may not think it is a good idea, and you may want to target one or more of those individuals and the issues surrounding that that we have discussed. What about the SEC's approach to going after lawyers who they believe have violated either the Securities Act, or in this context, the Dodd-Frank Act? For example, in participating, I know there are several cases ongoing right now where lawyers have been accused of reviewing and then modifying documents to add disclosures and add other items that may have not been there originally and were the cause of some issues.

David Van Havermaat: Sure. The gatekeeper issue – which the Commission views any attorney working in a securities context as a gatekeeper. That is given much greater scrutiny than would otherwise occur. I think gatekeepers and attorneys in particular are held to a higher standard. They are part of the guardians of the process, frankly; and when they fail a lot of times that becomes a huge loophole for other fraudsters to perpetrate their schemes. Part of the problem is, in the attorney context, it is sometimes difficult to separate "is an attorney just giving bad legal advice or is he actively involved in a fraud?" I know there are a number of situations where, again, you look at the totality of the circumstances. If it happens once and it is an isolated instance, it is much more likely that an SEC action will not be taken. But if it is a situation where it is an attorney that is actively out there facilitating a fraud, the Commission has made no bones about the fact that they tend to come down hard in those situations.

Joseph Papelian: Well, what about [pause]; it kind of begs the question – is there a procedure or policy as to when the SEC would call its cousin the DOJ to get involved?

David Van

Havermaat: There is no specific policy. Again, I have said this a few times, it is on a case-by-case basis. In dealing with our local U.S. Attorney's Offices, I think we have a good sense as to what would interest them and what would not interest them. A lot of times we will not bother them with something that we believe is clearly outside their guidelines. But certainly a situation involving an attorney is, I think, something that not only the commission, but the Department of Justice, is highly interested in pursuing any case of that nature.

Joseph Papelian: Do you find that in entering into agreements with individuals or companies, whether it is a non-prosecution or a deferred prosecution agreement, that they are asking you whether [the] Justice [Department] is involved or asking you to get [the] Justice [Department] to buy off on it? I find it, if it is a difficult case or a significant case for the SEC, I think that then begs the question from the practitioner's standpoint, can I enter into an agreement with the SEC without knowing whether [the] Justice [Department] is involved?

David Van Havermaat: Yeah, we get that all the time. Obviously, the deferred prosecution agreements are relatively new so it has not necessarily come up in that context. But every day someone will ask, "What is the criminal interest in this?" And our response is generally, "You need to contact the criminal authorities. We have no ability to: A, we do not have an ability to speak on behalf of them; and B, we generally cannot speak for them. We do not know what their priorities are, what factors go into the determination of what they would be interested in pursuing." We encourage them to contact criminal authorities, but a lot may depend on in what stage the criminal investigation, if there is one, is in. It may be a situation where the criminal authorities do not want to reveal themselves. And so, at that point, the attorney is left hanging and without the information that they need.

Bradley Schram: On a slightly different topic, Joseph, how do you as in-house counsel deal with the question of what you rely upon that is given to you by outside counsel so that when you are answering some inquiries you may be in a position of actually not knowing the answer, but strictly relying on others?

Joseph Papelian: Well, maybe we should have Lauren Stevens[99] come answer that for us. Many of you may be familiar that Lauren Stevens was a former general counsel of a Pharmaceutical company and she was relying upon advice of outside counsel. And the U.S. Attorney's Office took issue with that and she ended up being criminally charged with so-called "obstruction.[100] "And a lot of it was based upon a crime fraud exception that was held by the magistrate. At the conclusion of the government's case the federal judge – I think it was in May – granted the defendant's Rule 29 motion and dismissed the case, holding that the magistrate's decision of finding a crime-fraud exception was wrong and that Lauren Stevens had a good faith basis to rely on advice of outside counsel.[101] So it is a pretty significant case.

Bradley Schram: And what lessons did you learn from that?

Joseph Papelian: Well, make sure you have good outside counsel. [Laughter]. There is a concern certainly, if you are working in-house, that you represent the company; you do not represent any individuals. You want to be careful on that. The interviews you conduct with people make sure you kind of give them the corporate Miranda rights. And now with all the kind of whistleblower provisions, a lot of times the CEO may ask you that you uncover a foreign corrupt practices matter. And so you got the matter under control, you have got rid of the people who are responsible, and it is now tidied up, and the CEO thinks, "Ok, now I am done with it," and then the question he says is "Do I have to report?" Frankly, unless you are doing something to cover it up, there is no legal obligation for the company to have to

99. A former vice president and associate general Counsel of pharmaceutical company GlaxoSmithKline, who was prosecuted by the U.S. Department of Justice for allegedly misleading the Food and Drug Administration (FDA) about her company's promotion of the anti-depression drug Wellbutrin™.

100. United States v. Stevens, 771 F. Supp. 2d 556 (Md. 2011).

101. *Id.* at 569.

report the matter. But you know, the risk is awfully high because now with whistleblowers, if people are out there and they are familiar with it, and if you do not report it, and it does get reported to the SEC or [the] Justice [Department], you know they are going to look very hard at a foreign corrupt practices issue because it is kind of a hot topic right now. And if they initiate an action against you and you have not reported, I think you are going to be in much worse shape than had you taken the information, corrected the problem, self-reported, and addressed the issue that way. I am interested in the SEC's position on that.

David Van Havermaat: Well, I was going to add one other tangent to that – to the multiple representation and not specifically dealing with the conflict – that is something that the head of enforcement has made known over the last few months is an issue, and that is in any situation involving multiple representation a lot of times the witnesses will all have the same story. Coincidentally, they will all have the same recollection of certain key events. Essentially, the head of enforcement has directed the staff to take a much more critical eye to those situations. Again, there is not a whole lot of weapons at our disposal at this point but any [pause]; I think you can certainly bank on the fact that there will be more digging than there ordinarily would be if a number of witnesses represented by the same counsel have the same somewhat incredible story. It is not going to fly as well as it might have in the past.

Joseph Spiegel: Kris Easter talked about the Dodd-Frank 929(Q)[102] third party information obtaining. Is there anything in the Dodd-Frank Act you can comment on that increases your ability to investigate – without subpoena, say?

Bradley Schram: Well, there is a provision in the Dodd-Frank Act that permits the SEC to go beyond just the registered individuals or registered companies. So historically, the limitation on the SROs is that they

102. Dodd-Frank Wall Street Reform Act.

only can regulate their own people, or registered representatives, or investment advisor representatives. Here, Dodd-Frank does specifically provide that the SEC has the authority to go beyond registered individuals.

Joseph Spiegel: So, has that given you another tool in your toolbox?

David Van Havermaat: Y[es], I think all of this has, you know [pause]. Again, there are certainly criticisms as we have identified: the disincentive to having things reported internally, things of that nature. But at the bottom line, the Commission's goal is to enforce the federal securities laws and to prevent these things from happening in the first place. So, a lot of this is – I do not want to characterize it as collateral damage, but if it furthers the SEC's mission, then, ye[s]. I mean these are all various tools we can use to get the tips, to investigate the tips, and to enforce them.

Joseph Papelian: One comment on that. I would assume that [pause] it is a lot easier now to issue a subpoena from the SEC than it used to be. And then second, even without issuing a subpoena, have you contacted a company in the past and said "look we do not have a subpoena, but we would like you to provide this information?"

David Van Havermaat: Oh, all the time, yes.

Joseph Papelian: I bet the company has never said, "No, were not going to provide any information."

Bradley Schram: David, I noticed in the news last night that the SEC had a good day just like our Tigers. I think Raja Rajaratnam received, was it eleven years?[103]

David Van Havermaat: Y[es]

Bradley Schram: Eleven years. What impact if any does the Dodd-Frank Act and the new rules have on the SEC's ability to further pursue hedge funds?

David Van

103. Peter Lattman, *Galleon Chief Sentenced to 11-Year Term in Insider Case,* N.Y. TIMES, Oct. 13, 2011, *available at* http://dealbook.nytimes.com/2011/10/13/rajaratnam-is-sentenced-to-11-years/.

Havermaat: Well, again, all these tools contribute to it. Not being a Dodd-Frank expert, I cannot point to a certain provision, but all of this is geared toward the goal of enabling the staff to get to the bottom of what is going on. A lot of times in the past there would be much more stonewalling; there would be, again, inconceivable stories by witnesses. A lot of what Dodd-Frank attempts to do, I think, is first of all, incentivize people to come in and talk about what is going on. The Ponzi scheme situation, or an insider trading situation dealing with hedge funds, or any insider training situation – you are not necessarily going to have, prior to Dodd-Frank, an incentive for someone to say, "Hey, this is going on. You guys need to do something about it;" particularly in an insider trading situation. But now there is the financial incentive. I think that if anyone is operating or considering operating something like a Galleon[104] situation or a PGR[105] situation, you have got a lot of people spun into that web, and all you need is one of them to decide, "Hey, instead of going forward with this and risking liability, I am just going to report and hopefully get a bounty at the end."

Joseph Papelian: One thing we did not comment on is the anti-retaliation provisions in the Dodd-Frank Act.[106] I do not think the anti-retaliation provision hinges on there being a recovery on behalf of the SEC. Is that correct?

David Van Havermaat: That is right. In fact I have the exact language is something like, the whistleblower needs to reasonably believe that the information he is reporting relates to a possible violation of the federal securities laws. So, the standard for recovery of an award

104. Galleon Group was a hedge fund management firm founded by Raj Rajaratnam that closed in 2009 amid an insider trading scandal.

105. Primary Global Research was involved in an insider trading scandal in 2010. *See* Katya Wachtel, *Everything You Need to Know About Primary Global Research: The Expert Network at the Heart of the Scandal,* BUSINESS INSIDER (Dec. 17, 2010), http://articles.businessinsider.com/2010-12-17/wall_street/30018412_1_pgr-primary-global-research-expert-network.

106. Dodd-Frank Wall Street Reform Act §78u-6.

is different from the standard that must be met to invoke the anti-retaliation provisions.

Bradley Schram: So, if a company has kind of a mediocre performer and the mediocre performer kind of senses he is on his way out and he makes a report to the SEC and now the company is kind of in handcuffs to get rid of the employee in fear of retaliation.

David Van Havermaat: Y[es], I mean, there are some protections in that regard; however, frivolous whistleblower information is not covered. Again, it has to be a reasonable basis of a possible securities law violation. So, I think what the Commission has tried to do there, to the extent possible, is to minimize the risk that someone is going to use this as a weapon against the employer as opposed to an affirmative path to reporting wrongdoing.

Joseph Papelian: As a final comment, and perhaps not directly related, I have noticed over the past couple of years in several cases with FINRA enforcement with the SEC, especially out of Boston or New York, that post-Madoff, post-Stanford,[107] instead of being able to resolve cases easily and without lengthy investigations and OTRs, they ultimately get resolved; but they are charging far more people and spending more time on cases where they freely admit that a couple of years ago we would have sent a letter of caution and we would have been done with this. My concern is that we are at a critical stage given what we see going on in the economy and the schemes that are out there. There is going to be a fine balance between using the resources and looking at cases that really demand investigation, and separating them out from the ones where they are really not systemic type problems.

David Van Havermaat: I think that is right and I think the staff has no lack of tips to sift through. So, I think that naturally the

107. R. Allen Stanford is currently being tried for allegedly defrauding investors in a $7 billion Ponzi scheme. *See* Clifford Krauss, *Trial Set for Financier Accused in Decades-Long Ponzi Scheme,* N.Y. TIMES, Jan. 19, 2012, at B3, *available at* http://www.nytimes.com/2012/01/19/business/trial-set-for-texas-financier.html?pagewanted=all.

priority matters come to the top – or at least that is how it should pan out. I think in enacting the regulations the Commission is obviously acutely aware that it does not want to impose an unnecessary burden on players in the economy. All of this is going to impose some burden, but I think the calculus is that the integrity of the markets is enhanced more than whatever burden is imposed, and that is where a number of these regulations are in gray areas. There are areas of criticism, certainly, but in the long run I think the Commission has decided that this is what is needed to maintain the integrity of the markets.

Bradley Schram: My concern is a qualitative one: that there are limited resources and those resources should really go to the bad guys, taking care of the bad guys.

David Van Havermaat: Do you have any questions?

Elliot Spoon: Any questions? Any questions for the panel?

Audience Member: Joseph, in thinking about the self-reporting issue, which is a sweaty palms decision, if you had a Foreign Corrupt Practices Act[108] situation and it was cleaned up, the people were terminated, and you thought it was just a one-timer, but the activities were on the edge or potentially criminal. As you approach that line would you say one really has to look at self-reporting if the counsel determines it was close to the legality line?

Joseph Papelian: I think the whistleblower provisions now take you over the edge because if you do not report it, I think you have to believe that someone else might. I think that is the tipping point. In the past maybe you would not, but I think that now you probably would.

Elliot Spoon: Other questions for the panel? If not, let us thank them for a very insightful talk. [Applause]. Now I have got four comments to make. One is, as I have mentioned, the Dean is out of town, so I have to have the communications people come take a picture to prove to her there were so many people because my bonus depends on it and academic pay

108. Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd–1-3 (2006).

being what it is. [Laughter]. Second, we are going to have lunch now, and we are going to try and control the flow of traffic. If you go out that door, there is a table and you can go out this side and come back in this door. Number three, folks please encourage the students to come and eat with you and talk with you – some of them are a little shy. And four, about one o'clock we are going to have our luncheon speaker, which I know you are going to enjoy.

LUNCH SESSION: GUEST SPEAKER ZACHARY SCHRAM[109]

Elliot Spoon: I am very pleased to have as our luncheon speaker Zachary Schram. Zack is counsel to U.S. Senate Permanent Subcommittee on Investigations and works for its chairman, Senator Carl Levin. He is a coauthor of the 650 page Subcommittee report, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse,*[110]which he will be talking about. He has also conducted complex bipartisan investigations into the Financial Crisis, money laundering, tax evasion, oil corruption, and more. Mr. Schram is a graduate of the University of Michigan and Northwestern University School of Law. He thinks that Michigan State has a great defense this year, [Laughter], but not great enough to stop Denard Robinson: University of Michigan 28, Michigan State University 24.[111] [Laughter].

Zachary Schram: Thank you Elliot, and thanks also to Joe for including me today. I am happy to be here. This is the

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109. This portion of the transcript incorporates minor clarifying edits.

110. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (2011), *available at* http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2.

111. Denard Robinson was the 2011-12 starting quarterback for the University of Michigan football team. *See Player Bio: Denard Robinson,* UNIV. OF MICH., http://www.mgoblue.com/sports/m-footbl/mtt/robinson_denard00.html (last visited Jan. 29, 2012). The football game between the Michigan State University Spartans and University of Michigan Wolverines took place on October 15, 2011, one day following the MIDWEST SECURITIES LAW INSTITUTE. It was actually the Spartans who scored 24 points, while holding Denard Robinson and the University of Michigan Wolverines to only 14 points. Football Schedule, Mich. State Univ. Athletics, http://www.msuspartans.com/sports/m-footbl/sched/msu-m-footbl-sched.html (last visited Jan. 29, 2012).

first time I have spoken publicly about the Subcommittee's investigation into the Financial Crisis. I should mention before I begin that I am speaking in my personal capacity. I do not speak for the Subcommittee or for its chairman, Senator Levin; however, I am happy to discuss our report and our investigation with you. I have prepared a short presentation about the background of the Subcommittee and a little bit about our hearing series into the Financial Crisis. As this is the first time I have ever spoken about it, I would encourage you to ask questions and interrupt me. Those of us who live in D.C. have a tendency to speak in acronyms, so if I use Washington jargon or financial jargon, please also interrupt and I will do my best to explain.

I am not an expert on structured finance; I am an expert on the Senate investigative process. We are generalists at the Subcommittee, and our topics change every year or two. I know quite a bit about specific areas of the Financial Crisis that I will do my best to address in-depth, and I will also do my best to address other areas of your interest. I just want to be clear that I am not an expert in structured finance. With that, I will start with the presentation.

I am going to play a clip. This is the trailer from the documentary *Inside Job*.[112] I think it does a pretty good job of setting the tone leading up to our investigation, and it includes excerpts from our hearings. [Plays movie clip].

I wanted to play that clip to show the feeling that day in the hearing room when Senator Levin was questioning Lloyd Blankfein. That was a hearing that lasted eleven hours, in part because of the way the Goldman Sachs witnesses had been coached to try to draw out the questioning and see if they could expire the Senators' patience and attention span. Next, I will talk a little about the Subcommittee so you understand where I work and how our investigative process works. Then, I will get more into the Financial Crisis.

112. INSIDE JOB (Sony Pictures Classics 2010).

The Subcommittee was started by then Senator Harry Truman in the aftermath of World War II. He had an *ad hoc* committee, and he traveled all over the county looking into profiteering during the war effort. The hearings were considered so successful in the Senate that the Senate passed a resolution that made the Subcommittee permanent, which just meant that it was established by a Senate resolution and not by another authorizing committee. Therefore, it cannot be disbanded by another committee. We are technically a subcommittee of the Homeland Security and Governmental Affairs Committee, but we are very much independent of it. In the early fifties, Senator McCarthy was the chairman, and of course, he led the infamous McCarthy Hearings. If you have seen the movie *Good Night, and Good Luck*,[113] it shows the Subcommittee at that time.

In response to the excesses of that era, our rules were changed to empower the minority "ranking member." The chairman is from the party that has a majority of the seats in the Senate, and the "ranking member" is the senior member of the minority party. For instance, the ranking member can hire his own staff. When that happened, Robert Kennedy became the minority chief counsel of the Subcommittee, and in that role he pursued a lot of anti-mob activities. We still have some old documents on our walls in the Senate, and you are welcome to come visit. I can show you around. We have diagrams of various New York crime families on the Subcommittee's walls. [Henry] "Scoop" Jackson was the chairman in the seventies, and he initiated investigations into energy prices and the oil embargo. I have been working for Senator Levin for seven years now, and when I started he was the ranking member. He is now the chairman, and it could go back and forth at any moment.

Some of Senator Levin's more notable investigations were into Enron, crude oil prices, abusive tax schemes – that is something he has been very much

113. GOOD NIGHT, AND GOOD LUCK (Warner Bros. Entm't 2005).

involved and continues to work on – and the United Nations' Oil for Food program. We had a series of hearings in 2007 on the credit card industry that culminated in the passage of the Credit CARD Act[114] in 2009. Much of the last two years – up until April of 2011 – has been dedicated to working on Wall Street and the Financial Crisis.
The Subcommittee is unique in a few ways. I mentioned that it is "permanent," so that allows us a measure of independence from the Senate. There is a very strong tradition of bipartisanship at the Subcommittee. Senator Coburn is currently the ranking member, and we work very closely with his staff. For instance, at every deposition that we hold or witness interview there are members of his staff participating. The files we collect over the course of an investigation are kept on a joint network drive. Senator Coburn has access to everything that I have access to and likewise. Senator Coburn has the right under our rules to initiate investigations that we staff. It is pretty much unique in all of Congress in that way. We work very closely with our Republican colleagues.

The Subcommittee has independent subpoena power, which means we can issue subpoenas with the signature of the chairman without getting permission from a vote of the Subcommittee or elsewhere in the Senate. Senator Levin has the power to sign a subpoena. As a result of these powers and traditions, we are able to do long-term in-depth investigations, and we are not responsive to a news cycle. That is also in part because we adhere to Senate rules, and follow a series of strict practices such that we can assure our witness on how we will use their information. In the seven years that I have worked there, we have never had a significant leak of information because we abide by these practices from investigation to investigation, from chairman to chairman, no matter which party is in power.

114. Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No 111-24, 123 Stat. 1734 (2009).

This enables us to do a level of investigation that is not available elsewhere in Congress, typically.

The life cycle of an investigation – and I would be happy to go into this in more detail, but I will go through it quickly and if you have further questions just let me know. First, we identify a possible issue. That could be something that Senator Levin brings up [or] something we read about in the paper. The Financial Crisis was obviously one we were not going to skip. Often a new issue is a tangent to an earlier investigation. There is occasion where a constituent or citizen submits a request. The credit card investigation was one that was inspired by stories we heard from people writing into us talking about their experiences with credit card companies. After we have a general idea of what we are looking at, we do a lot of open source research. Sometimes there is a whistleblower, and we will develop information from the whistleblower. As we begin to focus, we will begin to consult with experts and insiders. In the case of the Financial Crisis investigation, we conducted more than 150 interviews. Once we identify information sources, and the custodians of the information, one of the major steps is preparing a subpoena or document request. That usually sets the course of the investigation because we have identified the information we are interested in, and once a subpoena goes out it will be pursued until every last document is collected and all the information is developed. A great amount of time is then expended in enforcing that subpoena or document request.

It is not always necessary to subpoena a source. Sometimes people prefer not to be subpoenaed. If they will comply with a Chairman's Letter – a letter on Subcommittee letterhead signed by Senator Levin – then that can often be sufficient. However, we usually have to fight for months to make sure that we get everything we request. Then there is the process of organizing and conducting document review.

In the case of the Financial Crisis investigation, we collected about six terabytes of data, which we estimate to be equivalent to about 56 million printed pages. We have some software – that is probably similar to what you use in your capacities – to review that information. Then it unfolds like an enforcement investigation might work, although of course, we do not have enforcement power. We review the documents, then the staff conducts interviews of potential witnesses – anyone we think has relevant information. Usually, if someone agrees to participate voluntarily and in a relatively expedient manner, we will conduct an interview as opposed to a deposition. However, as it is a felony to lie to Congress, there is no real distinction between swearing a witness and not swearing the witness. An informal interview occurs in our conference room. We rely on our notes. Witnesses typically are more forthcoming and more comfortable in that setting. However, for example, during the Financial Crisis investigation, Senator Levin eventually determined that it was necessary to depose Lloyd Blankfein prior to our hearing. If it is the case that we issue a subpoena for a personal appearance, then that is conducted as a deposition.

After that, we pick the hearing witnesses. We spend months, sometimes a year or more, writing a report and preparing for the hearing. We have a press briefing the day before the hearing. This is a very collaborative process with Senator Levin. We spend hundreds of hours with him during the course of the investigation preparing questions for witnesses and determining which exhibits he thinks are important. He had a trip to Hong Kong before our first Financial Crisis hearing, and I must have sent him with a stack of a thousand pages of exhibits to review on his flight. When he arrived in Hong Kong, he called and asked me to FedEx another thousand more for his flight back.

After the hearing, if we think there is a violation of law that has been uncovered, we will refer the matter to enforcement agencies. Usually, there is significant legislative follow-up, so we work on having our hearings influence the legislative process. After that, we'll send comment letters and work to influence the regulatory process. That continues for years afterwards. So, that is how it works generally.

The case of Wall Street and the Financial Crisis was one of our biggest hearings and reports. It made international news for weeks, and we had to switch to a larger hearing room to accommodate the crowds. That is the first Goldman panel (referring to slideshow). That is the "Fabulous" Fab Tourre[115], who is famous for his emails about standing in the midst of the rubble that he created. He was the subject of the SEC action against Goldman for the Abacus deal. The SEC action was announced after we had already requested his appearance. The timing was such that it seemed to be coordinated with the SEC, but we had no idea of the SEC's action as it related to him until after we had requested his appearance at the hearing. That ended up helping to drive the press coverage.

So, Wall Street and the Financial Crisis. We did not attempt to do a broad look at every aspect of the crisis. One of the skills of the subcommittee is our ability to focus and to pick particular areas and dig deep. We picked four case studies. The first – and this is the one that I was the lead investigator for – was Washington Mutual (WaMu) and the world of high-risk home lending. I can speak to that with the most authority. I can try to speak to the other areas as well, but I am most knowledgeable about the first case study. The second case study was the Office of Thrift Supervision, which was WaMu's regulator and which was abolished by the Dodd-Frank Act, in part because of its failures in the WaMu case. We also looked at the credit rating agencies. Half of our report and eleven hours of our hearings were devoted to Goldman Sachs and the role of the investment banks in structured finance.

I will talk a little about WaMu and then we can look at whatever areas are of most interest to you. WaMu was founded in 1890. It was the nation's

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115. Fabrice Tourre was the former vice-president of Goldman Sachs New York office in 2007.

largest thrift, which is a financial institution that is required to have a large percentage of its assets in home loans. It was also the sixth largest bank. At its peak, it had 300 billion dollars in assets, $188 billion in deposits, 2300 branches, and 4300 employees.

At the end of 2004 and 2005, as the profit margins on the low risk home loans were narrowing for WaMu, there was a strategic choice made by the executives of the bank and its CEO, Kerry Killinger, to target the franchise towards high-risk home lending. They bet the bank on high-risk home lending and they lost. One thing that is astonishing about that was that the executives had correctly predicted the housing bubble at that time. They had identified it internally and, nonetheless, rushed headlong into it. They implemented the high-risk lending strategy, despite the bubble. The way we know that, and the way we know almost everything that went on at WaMu or any of these institutions, is that we have the documents. I have read thousands and thousands of internal WaMu emails, memorandum, presentations, etcetera.

I am going to read from a memo that we uncovered. It is a letter from September 2, 2004, and it is from a man named Jim Vanasek, who was a hearing witness. Mr. Vanasek was the Chief Risk Officer at Washington Mutual and was running around telling everybody that they were in the midst of a housing bubble and they had to tighten their lending practices. This is a memorandum he wrote. It is entitled "Perspective." He says:

> I want to share a few thoughts with all of you as we begin the month of September. Clearly you have gone through a difficult period of time with all of the changes in the mortgage area of the bank…. I [am] painfully aware of the toll this has taken on some of you and felt it important that we recognize it has been and continues to be difficult.

In the midst of all the change and stress, patience is growing thin. We understand that. We also know that loan originators are pushing very hard for deals. But we need to put all this in perspective.

At this point in the mortgage cycle with prices having increased far beyond the rate of increase in personal incomes, there clearly comes a time when prices must slow down or perhaps even decline. There have been so many warnings of a Housing Bubble that we all tend now to ignore them because thus far it has not happened. I am not in the business of forecasting, but I have a healthy respect for the underlying data which says ultimately this environment is no longer sustainable. Therefore, I would conclude that now is not the time to be pushing appraisal values. If anything we should be a bit more conservative across the board. Kerry Killinger and Bill Longbrake, [a Vice Chair of WaMu], have both expressed renewed concern over this issue.

This is a point where we should be much more careful about exceptions. It is highly questionable as to how strong this economy may be; there is clearly no consensus on Wall Street. If the economy stalls, the combination of low FICOs [credit scores], high LTVs [loan to value ratios], and inordinate num-

> bers of exceptions will come back to haunt us.[116]

He said that in late 2004. In early 2005, he corresponded with the CEO Kerry Killinger and there was a ton of stress on the risk managers coming from the sales force. WaMu was an organization that was heavily biased in favor of its sales team. They had the ear of the upper management and they were driving the bottom line. The sales team was constantly pressing for lower underwriting standards, more creative, innovative loan products, larger volumes, and Vanasek was desperately trying to be heard as the Chief Risk Officer.

This is an email exchange he had in March 2005 with the CEO Kerry Killinger.

> My group is working as hard as I can reasonably ask any group to work and in several cases they are stretched to the absolute limit. Any words of support and appreciation would be very helpful to the moral of the group. The folks have stepped up to fixing any number of issues this year, many not at all of their own making.[117]

Killinger replied saying:

> Thanks, Jim. Overall, it appears we are making some good progress. Hopefully, the Regulators will agree that we are making some progress. I suspect the toughest thing for us will be to navigate through a period of high home prices, increased competitive conditions for reduced underwriting

116. STAFF OF SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG, REP. ON WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 65-66 (2011), *available at* http://hsgac.senate.gov.

117. Id. at 67.

> standards, and our need to grow the balance sheet. I have never seen such a high-risk housing market, as market after market thinks they are unique and for whatever reason are not likely to experience price declines. This typically signifies a bubble.[118]

So, that is Kerry Killinger in early 2005, to which his Chief Risk Officer responded:

> I could not agree more. All the classic signs are there and the likely outcome is probably not great. We would all like to think that the air can come out of the balloon slowly but history would not lean you in that direction. Over the next month or so, I am going to work hard on what I hope can be a lasting mechanism (legacy) for determining how much risk we can afford to take….[119]

Jim Vanasek later testified that he approached Kerry Killinger and said we have to change directions. This is a disaster waiting to happen. He suggested that Washington Mutual put out a manifesto and publish it nationally as to what was happening in the housing market and how they could adjust to address that. He said that Mr. Killinger listened to him and nothing ever happened. Soon after that he retired because of the stress of not being able to create that mechanism to address the risk. That shows also how WaMu marginalized its risk managers.

Oh, one thing I should add, so this exchange was in early 2005, and it was just a month before that exchange that WaMu presented to the board what

118. Id. at 68.
119. Id.

they called the high-risk lending strategy. That was not pejorative. They were intentionally looking to a high-risk lending strategy specifically because Wall Street was paying for the riskier loans. Their gain on sale, the amount of money they made originating a fixed loan or a conventional mortgage, was much lower than what they would make originating an exotic mortgage like an option arm or a subprime loan. And their prices, the prices that they eventually set to the consumers, to our surprise, the process for pricing their mortgages started from their capital markets group. Their office in Manhattan saw what the appetite was on Wall Street and that is how they set the targets for the business and set the prices for the customer.

They identify the bubble at the end of 2004, at the beginning of 2005, and they nonetheless implement their high-risk lending strategy. Kerry Killinger testified at our hearing that they had intended the strategy, but they did not implement it because of the market forces; but when we looked at the internal documents, we could see that was not true. They recommitted to the high-risk lending strategy in 2005, 2006, and even in 2007, and the only reason they did not achieve their goals was because the market completely collapsed, not because of any strategic change in the business.

Washington Mutual's flagship product was the option arm, which is a mortgage that has the ability to negatively amortize. And it was underwritten in such a way that it depended on perpetual home price appreciation. As soon as prices stagnated and people could not refinance their mortgages, their entire portfolio quickly withered away.

I mentioned rewarding volume over quality. Washington Mutual securitized tens of billions of dollars of mortgages during the height of the bubble and contaminated financial markets. It is also worth mentioning the damage that it did to communities. Nine out of ten subprime loans went to people who already owned homes, and the effect of subprime lending, which had been justified to regulators publicly as broadening the ownership society and enabling people who could not otherwise own homes to buy homes, in fact had the opposite effect. More people lost homes that they already owned as a result of subprime mortgages than the reverse.

This is just a slide from a presentation to all WaMu employees, including risk managers, made by the head of home loans. Risk managers received a presentation that told, "We are all in sales."[120] I grabbed that just because I think it is quite telling. The Head Risk Manager in the home loans business, Cheryl Feltgen, subscribed to this message, in part because her compensation had a higher percentage based on achieving sales targets than it did on managing risk. Her bonus was pegged 30% to achieving certain sales targets and only 25% to certain risk metrics.

I mentioned that at the hearing Killinger tried to claim that they had not implemented the high-risk lending strategy. This is a slide from a presentation that Washington Mutual made in 2006; so, already subprime is heavily affected. Those are the historical figures from 2005 where you can see subprime is a thirty-four billion dollar business and in 2006 they are saying by 2008, they hope that subprime will be a seventy billion dollar business. Their fixed rate loan volume, which was in 2005 sixty-nine billion dollars, by 2008 they wanted fixed loan volume to be four billion dollars, only 2% of their business. So, their claims that they did not stick to the strategy are belied by their own documents.

I just want to mention, briefly, the other case studies, and if you have further questions about these I would be happy to try to field them. The Office of Thrift Supervision (OTS) was WaMu's regulator. WaMu was by far the largest institution under OTS and provided about 15% of OTS's funding through its fees. OTS was utterly captured by WaMu. OTS treated Washington Mutual with great fear that they could do something to upset them, and their lack of oversight contributed to the bank's failure, which was the largest ever. It is amazing to look through the records because you see, over and over and

120. Id. at 113.

over again, OTS identified the deficiencies in the lending practices. Five hundred times in five years they make note in reports of examination and other actions of the deficiencies at WaMu, and yet, never until way, way too late did anything to correct them.

One of the reasons that is so important, as well as what we saw about identifying the bubble in 2004, is that prior to this investigation there was a lot of talk in the media and just publicly that the Financial Crisis was a tsunami. It was an earthquake. It was described in terms of a natural disaster or an Act of God. That idea is terribly pernicious because this was undoubtedly caused by people, usually greedy people, making decisions in their short-term self-interest, and as part of an economic system that supported and rewarded that short-term self-interest with very little consequence or consideration to the long-term.

This is one example: not only did the bank know internally that they were in a bubble and that they were making high-risk decisions in the short-term, their regulator identified that over and over and over again and did nothing about it, largely because they were blinded by WaMu's short-term profits. Even as the lending practices worsened and loan losses increased, as long as WaMu was showing the short-term profits, OTS felt that they did not have a leg to stand on in challenging the practices. When the issues arose with risky products, for instance, Washington Mutual's subprime business was almost exclusively a securitization business. They held very little subprime mortgages on their books. They securitized almost 100% of the loans originated through their subprime business, which was known as Long Beach. OTS encouraged that practice because those loans, if they hit WaMu's books, endangered the safety and soundness of the bank, but if they were just polluted into the financial market then it did not endanger WaMu directly at that time.

That is a larger finding of the investigation into the Financial Crisis. There was no one watching the systemic risk. There were people focusing on the individual bank risk, but not on systemic risk.

One particularly interesting thing involves the FDIC. Because it had skin in the game, because if Washington Mutual failed the FDIC could be on the hook for the deposits, it often tried to be more aggressive in regulating Washington Mutual, and OTS protected WaMu from the FDIC. As Senator Levin memorably put it, OTS went from being a watchdog, to a lap dog, to a guard dog.

The credit rating agencies were our third case study. This is a story that has been frequently told and it is shown in great detail on the report, but the ratings obviously did not reflect the risk; they misled investors. It was not an accident. The ratings business was rife with conflicts of interest. The ratings agencies were being paid by the banks whose securities they were rating. They were competing with each other for a volume of business. They did not have the type of history of securitization performances to properly model the risk. It was a finding of the report that the first mass downgrades on residential mortgage backed securities and collateralized debt obligations, the first time there were downgrades of huge swaths, hundreds, sometimes thousands of securities in July of 2007, was the most immediate trigger of the Financial Crisis. That was the action that burst the bubble.

One very interesting thing that we learned when we looked at the credit rating agencies was that they started to realize their models were not accurate. And in 2006, they revised their models for new issuances but they did not re-rate their existing securities that they had published using shoddy models even though they are paid to continuously monitor and survey the ratings that they issue. Their models failed to account for fraud, shoddy underwriting, or the bubble. They had inadequate resources for rating surveillance, and as late as 2007, they continued to issue AAA ratings, which is what their customers – the banks – wanted. The banks were trying to achieve a certain percentage of AAA ratings so they could sell to institutional investors. As late as 2007, before the mass downgrades, the rating agencies were issuing AAA ratings at a record pace, and in fact, the week before their mass downgrades they had a burst of activity where basically they were trying to get paid on their last set of AAA ratings before the models came into effect and they could no longer keep the conveyor belt going.

Probably the sexiest portion of our investigation was of Goldman Sachs, and I can talk really briefly about their role. But it is amazing for me, having read through the tens of thousands of Washington Mutual emails how obsessed Washington Mutual was with Wall Street. They had for one hundred and fifteen years been a very successful mortgage bank, but they wanted to be taken seriously. They wanted to be a player on Wall Street. They wanted to have a huge securitization business, and they were totally focused on that. Goldman, of course, as the big dog on Wall Street, and other banks – Deutsche Bank and others – had created this huge appetite for the high-risk home loans, and WaMu, among others, just strove very aggressively to meet that need. But Goldman obviously securitized high-risk mortgages and increased the appetite for high-risk home loans as a result. They magnified that risk with structured finance using products like collateralized debt obligations and credit default swaps. They recognized the bubble before the market did and shorted it. They had the second largest subprime short on Wall Street after Paulson, made famous by *The Big Short*,[121] and at one point were nearly four billion dollars short on the subprime market. All the while they were still structuring deals and selling them to their clients, while they were taking adverse positions to it internally, huge adverse positions.

So, they aggressively pursued their own interests at the expense of their clients. Then they claimed at our hearing and elsewhere afterwards, that they had

121. MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (W. W. Norton & Co., 1st ed. 2010).

not taken a big short, even though we have lots of internal documents that prove otherwise and asked on the record, over and over again, the size of their short position. It was amazing over a two-year investigation, no one at Goldman, not Blankfein, not the CFO, not Viniar, not traders on the mortgage desk, no one could tell us the size of their short. But as soon as we calculated it ourselves using their documents and published it, all of a sudden they could tell us that it was not right, that they had a different short. For two years we asked them on the record for those numbers and, ultimately, they never provided an alternative.

There were four famously bad deals, and I am going to talk about one of them a little bit more: Hudson, Anderson, Timberwolf, and ABACUS. I believe it was Timberwolf, I could be wrong, where Senator Levin was briefly famous on C-SPAN for saying the word "shitty" eleven times in our hearing because there is an internal email where executives at Goldman were writing to each other "boy that timberwolf was one shitty deal," while they were trying to sell it as fast as possible.[122] And we were not sure how Senator Levin was going to treat that at the hearing, and he went for it, and his wife was offended. [Laughter].

ABACUS was the subject of the SEC action against Goldman, it has been widely covered, but I am going to talk a little bit about Hudson. Hudson Mezzanine 2006-1 was a synthetic CDO, which means that it did not have any real assets, it was betting on other assets. I can try to explain what a synthetic CDO is, but I think it is probably not worth the time. It is an extremely complex financial product that enabled financial institutions to sell securities even when they did not own the real underlying assets by using a reference entity, essentially making a bet on how another asset will perform. Goldman Sachs was the underwriter on the deal, the initial purchaser of the securities, the senior

122. *2008 Financial Crisis & Goldman Sachs* (C-SPAN3 television broadcast Apr. 27, 2010), *available at* http://www.c-spanvideo.org/program/CrisisD.

swap counterparty, the credit protection buyer, the collateral put provider, and the liquidation agent, so they had almost total control over that deal. When they sold it, when they marketed it to their clients, they said that their interests were aligned, that Goldman may invest, that it was sourced from the street, meaning that the assets that were referenced were purchased from third parties. They said it was not a balance sheet CDO, meaning it was not used to take bad assets off of their books. They claimed that they pre-screened the assets for portfolio suitability.

This is what really happened. Goldman said that their interests were aligned and it was true that they bought an equity tranche of Hudson 1 that was a six million dollar position. What they did not tell their clients was they had 100% of the short. They had a two billion dollar short and a six million dollar long, so that their incentives were not aligned. They said that they *may* invest in it and they said that they *may* take positions that could be adverse to investors, but at the time that they were circulating their marketing materials that stated that, they had already determined that they were taking a 100% of the short position. It was not in fact sourced from the street. All two billion dollars of the reference assets were obtained internally from Goldman without third party transactions. Countrary to their claims, it was a balance sheet CDO. The materials did not disclose that Hudson had been designed from the beginning to transfer risk from Goldman's balance sheets, and that 1.2 billion of Hudson's assets had been designed solely to transfer risks from their long position and came from in their own inventory. They said that they pre-screened to select for portfolio suitability, and again, no mention that Hudson assets were designed solely to transfer risk from their own inventory. And the word "suitability" is curious there because it seems to suggest that they screened that they were good investments. Goldman tried to take the position at the hearings that they were a market maker, but that is not what their materials suggested.

One of the most interesting things about the Hudson Mezzanine was that Goldman acted as the liquidation agent, which meant that they were obliged to sell the assets to limit the losses to the long investors. But as those assets declined in value, Goldman delayed selling them because, of course, they owned the short, so they profited at the expense of their clients from the short. In their role as liquidation agent, they delayed liquidation of those underlying securities, and it is fascinating to see. Morgan Stanley was one of the largest investors, if not the largest, in fact, they had almost a billion dollars invested. Their traders, their employees, kept asking Goldman to liquidate the assets in the CDO to limit the losses. I just want to read an exchange. This is a trader who is basically begging Goldman to meet its obligations and liquidate the assets in Hudson Mezzanine, and he writes to a colleague, "went down the road with Goldman on liquidation assets, now about a billion of eligible assets post downgrades. They told me they will 'continue to take my opinion under advisement' but provided no course of action. I broke my phone."[123] [Laughter]. Then, he is sending an email to a Goldman executive, and he says:

> Spoke… [about] Hudson today. Goes without saying that I remain very frustrated with the way [Goldman Sachs] is handling its liquidation agent role. There is almost [one billion] of eligible assets in that deal now, every one of which has lost value since it was downgraded. No good reason to wait other than to devalue our position. It is a shame…. One day I hope to get the real reason why you are doing this to me.[124]

123. STAFF OF SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG, REP. ON WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 392 (2011), *available at* http://hsgac.senate.gov.

124. Id.

And hopefully our report helped provide that reason. So, that is a little bit about Goldman.

I just wanted briefly to mention the impact of the investigation. There were weeks of worldwide press coverage afterwards, in part because we showed inside the operations, and we were able to show the internal documents and paint the story from the inside at the time of the Crisis. It is still being covered in the financial press. There are a number of journalists who continue to write about it regularly, including the controversial Matt Taibbi, who blogs about it on a fairly regular basis. Senator Levin referred our investigation to the DOJ, SEC, and other enforcement agencies, but perhaps most interestingly was how it influenced the course of the debate on Dodd-Frank. The financial reform bill had stalled in the spring of 2008. It had been referred to the floor of the Senate by the Banking Committee, but there was not an agreement to bring it to the floor for a vote. There was not really any sense whether or not it would be possible to pass it at all. So, Goldman Sachs, which was the last of the four hearings, occurred on April 27, and on April 28 that stalemate was broken and there was an agreement reached to bring Dodd-Frank to the Senate floor. But,Senator Levin was probably most motivated by creating a historical record of what happened, modeled after the Pecora Commission in the wake of the Great Crash and the Great Depression. So, that is what I have on the hearing.

I would be happy to open up to questions. Yes, Joe?

Joseph Spiegel: There have been no indictments, and it is three years later. What does the Senator think about that? This was the most devastating crisis ever created in the country and not one indictment. Not the President of WaMu, not anyone at Goldman Sachs, and what you presented in summary, and we are going to hear about the criminal ramifications in the next presentation, what does the Senator think about that?

Zachary Schram: So, I cannot speak to his opinion right now. I know that –

Audience Member: What do you think about it? I know that you are going to pay for it. [Laughter].

Zachary Schram: I will tell you what I think, but let me first, Joe, answer your question. Senator Levin is very careful to not influence the enforcement process. He referred our investigation to enforcement agencies, which means he thinks that laws are broken. But for him to take a strong position publicly puts political pressure on the enforcement agencies, which is something that can be used by the defense. So, he has to be very careful. But he devoted his staff to a two-year effort to write a 650-page report. I think you can read into those motivations. When we conduct these investigations we are not looking for criminal wrongdoing, we are looking for malfeasance, fraud, abuse, anything that can help us tighten the law. So, I am not reading it as a criminal prosecutor would. But as a citizen, I was astonished and outraged, and I think that people should be held to account.

Joseph Spiegel: How many staff people work for the Committee?

Zachary Schram: It varies. There were about six or seven full-time attorneys on Senator Levin's staff and a little less on Senator Coburn's staff, and then we have a rotating cast of experts, detailees, law clerks, and interns who really pitch in and contribute. I want to mention that Senator Coburn signed-off on this report. His staff was integral in completing it, and it is actually quite astonishing. He is a very conservative Senator from Oklahoma, and he read, as far as I know, every word of this. His contributions, and his edits, and his suggestions, and those of his staff were critical in coming up with this final piece. I think that is one thing that sets us apart from the Financial Crisis Inquiry Committee,[125] which did a lot of great work, but ultimately did not come up

125. The Financial Crisis Inquiry Commission (FCIC) is a ten-member committee that was appointed to investigate the causes of the financial crisis beginning in 2007.

with a bipartisan agreement on the causes of the crisis. This report is fully bipartisan.[126]

Audience Member: Did the committee investigate Fannie, Freddie, and the political muscle that kind of protected Fannie and Freddie from close inspection?

Zachary Schram: So there is a section, there is a small section in here about Fannie and Freddie.[127] They were a critical part of the story, undoubtedly. They were not a subject of one of our case studies, which is simply a matter of choosing resources and targets. They are addressed. They undoubtedly played a role. One of the most important roles that they played was that they, since they bought such a high percentage of the conforming mortgages, set the market terms for the thirty year fixed in a way that made that made those types of mortgages less profitable for originators, the margin was much smaller. So, their role in the subprime market is somewhat overblown in the sense that their direct involvement in subprime was late and relatively small. However, because they occupied such a large place of the prime market, the investment banks looking for margin went elsewhere – went to the subprime products and put a ton of money in the subprime products. Their role is a significant one. It is not a case study, [but] this in no way suggests that they were not intimately involved. One interesting aspect that the GSEs play

126. STAFF OF SENATE. PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG, REP. ON WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (2011), *available at* http://hsgac.senate.gov.

127. Freddie Mac (also known as the Federal Home Loan and Mortgage Corporation) is a stockholder-owned, government-sponsored enterprise (GSE) chartered by Congress in 1970 to keep money flowing to mortgage lenders in support of homeownership and rental housing for middle income Americans. The FHLMC purchases, guarantees, and securitizes mortgages to form mortgage-backed securities. The mortgage-backed securities that it issues tend to be very liquid and carry a credit rating close to that of U.S. Treasuries. Fannie Mae is a government-sponsored enterprise (GSE) that was created in 1938 to expand the flow of mortgage money by creating a secondary mortgage market. *Freddie Mac Definition*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/f/freddiemac.asp#axzz1l5MSkxFH (last visited February 1, 2012). Fannie Mae is a publicly traded company which operates under a congressional charter that directs Fannie Mae (or the Federal National Mortgage Association) to channel its efforts into increasing the availability and affordability of homeownership for low-, moderate-, and middle-income Americans. *Fannie Mae Definition,* INVESTOPEDIA.COM, http://www.investopedia.com/terms/f/fanniemae.asp#axzz1l5MSkxFH (last visited February 1, 2012).

in this report is WaMu started to sell some of its option arms to Freddie, and they had a contract, it expired in two years, and they were using that contract for leverage, actually, they were playing Fannie off of Freddie to try and get better deals from one or the other. But the GSEs were largely late to enter the high-risk lending game. They followed Wall Street there, also trying to increase margins. But, surely they had a huge role. If I think of something else on that I will come back to it.

Yes, do you have a question?

Audience Member: Zack, you mentioned that OTS stayed away from enforcement actions against WaMu. Were they taking enforcement actions against other institutions? And in your investigation, what evidence did you uncover about what WaMu if anything was doing to hold off OTS? Were there personal relationships; was there lobbying?

Zachary Schram: Ye[s], I would have to ask my colleague, Allison, who covered that investigation for the details. From my rough understanding, were they taking enforcement actions against, maybe from smaller and very egregious players. There were some before the WaMu action. I think BankUnited[128] is an example, but I am out of my area of expertise here. As far as holding off OTS, it was not even necessary for them to try to hold off OTS. OTS was afraid of offending WaMu. OTS was so timid because they were concerned about their clout. They felt a little disrespected as a regulator compared to the OCC and other bank regulators. Without WaMu they had no clout at all, so they were very, very careful not to offend WaMu. I can give you an example. It was not until late 2008 that WaMu entered into a memorandum of understanding (MOU) with the OTS director John Reich, and when John Reich delivered the news that they needed an MOU, he twice apologized to Kerry Killinger. And this is how he wrote it. He said:

128. On September 19, 2008, the OTS entered a cease and desist order against BankUnited that, in part, prohibited the origination of negatively amortizing loans. Order to Cease and Desist, SE-08-013 (2008). BankUnited was seized by the OTS on May 21, 2009 and handed over to the FDIC.

> Kerry, I am sorry to communicate by email – I've left a couple of messages on your office phone, but I am guessing you may be off for long weekend. . . . We almost always do an MOU for 3-rated institutions, and if someone were looking over our shoulders, they would probably be surprised we do not already have one in place. . . . We do n't consider it a disclosable event, and we also think that the investment community will not be surprised if they learn of it, and would probably only be surprised to learn that one did not already exist. Again, I am sorry to communicate this decision by email....[129]

So, that sort of characterizes their tone with OTS.

Zachary Schram: Yes?

Audience Member: What happened to John Reich?

Zachary Schram: He retired. [Laughter]. He testified very reluctantly at our hearing.

There were a couple of things in the WaMu area that I would like to mention, if I can, that I that thought would be particularly interesting to this crowd.

WaMu had two large portfolios that it directed. When a mortgage was originated, it was directed either into to its held for sale portfolio, which intended to stay for a short period of time before being securitized, or its held for investment portfolio in which WaMu hoped to keep it on its own books. The capital requirements are different and the tax obligations are different, so it is a fairly significant decision how to direct a mortgage to one pool or the other. For most of its history with the option arm, which it considered a prime product and its

129. STAFF OF SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG, REP. ON WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 210-11 (2011), *available at* http://hsgac.senate.gov.

flagship product, the option arms were put in the held for investment portfolio; but, at the end of 2006 they discovered in their own internal analytics that the option arms' rate of delinquency and default were increasing very quickly, but thus far were small enough numbers overall that the market had not noticed. The bottom had already fallen out of the subprime market, but the conventional wisdom was that the problem was contained to the subprime.

Well, WaMu notices internally in its held for investment portfolio that the option arms are not looking like a prime product after all, so the CFO says to his team, and I'm paraphrasing, "see what you can do about this." That starts a flurry of emails, which we went through in great detail at the hearing, where they say, "we have to figure out what to do with these option arms," and the decision is made to get rid of them. So, they perform a multivariate analysis of the option arms in their portfolio to determine what is leading towards rates of delinquency. That analysis is then provided to David Beck, who is the head of the capital markets group, who sat in New York and sold the securities on Wall Street. He gets the analysis and sends it to the head of Home Loans and Chief Risk Officer of Home Loans, Cheryl Feltgen, in an email that says:

> Please review. The performance of newly minted option arm loans is causing us problems. Cheryl can validate but my view is our alt a (high margin) option arms [are] not performing well. We should address selling [first quarter] (so now we are into the beginning of 2007) as soon as we can before we [lose] the opportunity. We should have a figure out how to get this feedback to underwriting and fulfillment.[130]

130. STAFF OF SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG, REP. ON WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 128 (2011), *available at* http://hsgac.senate.gov.

So, that email is particularly interesting because when he says "before we lose the opportunity," losing the opportunity in our analysis could mean two things. One, that the market learns what they already know, and therefore, is not interested in purchasing that product, or if the delinquencies hit those loans before they sell them, then they cannot be marketed in the same way. So, here is the head of their capital markets group basically saying, "we know that this product is turning out to be crap. Let us sell it before anyone else realizes."
The problem with that is, they have reps and warranties in the securitization, and their reps and warranties say, among other things: that they do not engage in adverse selection; that the loans picked for the pool in the securitization were picked on the basis of certain loan characteristics; and not for any other reason. So, in fact, they do this internal analysis and they send it all the way up their market risk committee, which is an executive committee at the bank, and they get permission to move three billion dollars' worth of their option arms into their held for sale portfolio, so every new option arm that fits that criteria – that is originated – goes to held for sale. But not only that, they are moving the option arms with criteria from their held for investment portfolio into their held for sale, and then they then sell that product without releasing that information.

I think, and this is just a couple of minutes, this is a particularly interesting exchange at the hearing. So, with that as background information, I think I have cued it [a video] up from the hearing. This also shows how Senator Levin operates. In order for him to get this admission on the record he has to really understand the documents and the detail because these witnesses have been coached not to give an inch. So, here is, this is Senator Levin. He spent half an hour going through the email chain to establish that this happened. He is now questioning David Beck, the head of capital markets, about this event and David Beck keeps saying over and over again that the investors knew the nature of those loans, but that was an evasive answer so, let us see if I can get this going.

[Video Begins]

Zachary Schram: (clarifying) "Were the investors notified?"

[Video]

Zachary Schram: So, this goes on for five more minutes and he does not answer anything. So, Senator Levin goes back and he uses up his time, which is a clever strategy, but Senator Levin does not give up.

[Video]

Zachary Schram: It is the next question after this.

[Video]

Senator Levin: When you said that investors were told of the characteristics of loans, they were told of all of the characteristics loans, did they know, were they informed that loans with those or some of those characteristics had a greater propensity towards delinquency in WaMu's analysis? Were they told that?

Mr. Beck: They were not told of the WaMu analysis.[131]

Zachary Schram: So that was the big pay-off.

Elliot Spoon: Folks, I would like to thank Zachary for a wonderful panel. We are going to be moving right into our insider-trading panel just as soon as we set up.

SESSION 4: INSIDER TRADING UPDATE

Elliot Spoon: All right folks, if you could take your seats we will get started. When we picked this topic for this panel, we did not know that the longest sentence ever to be given out in insider trading[132] would be the day before the conference. But it has and we are fortunate, timing-wise, to have a panel to speak about issues related to insider trading. With us we welcome back, Richard Zuckerman,[133] from Honigman Miller, and, there may be some irony to this, but he is surrounded by the government.

131. April 13, 2010 Subcommittee Hearing

132. United States v. Rajaratnam, 802 F.Supp.2d 491 (S.D.N.Y. 2011).

133. Richard Zuckerman is a partner with Honigman, Miller, Schwartz, and Cohn LLP. He is the co-chair of the white-collar criminal defense and investigations practice group.

[Laughter]. To his right, we welcome back from an earlier panel David Van Havermaat, from the SEC. To Richard's left is Nils Kessler,[134] who spoke at last year's conference and who is an assistant U.S. Attorney for the Western District of Michigan, and I am sure given the broad prospective here, it should be an excellent panel.

Richard Zuckerman: Well, my colleagues have nominated me to start this off and, as this is two-thirds a criminal panel, it is going to be chaotic because criminal lawyers are not very well organized. I guess we could start off by talking about the case in New York,[135] and the sentence, and perhaps, the SEC can tell us generally the elements of insider trading: how they would look at such a case, and how it would get over to [the] department. Then, maybe we can then go into what has become the topic du jour, or the slogan du jour these days, which is blue-collar tactics in white-collar cases. Apparently, the silk stocking New York and D.C. SEC bars are very upset that the government might actually be able to prove a case through wire-tapping. So, do you want to start off with something about insider trading and how you guys look at it and what you do with it?

David Van Havermaat: Sure. Insider trading at the commission is, not surprisingly, something we take very seriously. The dollar amounts of something that we would pursue in the insider trading realm does not have to be nearly as high as it would in an offer in fraud or a Ponzi scheme or something like that. And even lower probably, getting back to the discussion earlier, if it involves a gatekeeper. We have done cases with attorneys that are in the ten thousand dollar range and less, and it is because the Commission views the threat to the integrity of the market arising out of insider trading as that serious. We typically get the tips on insider trading from a variety

134. Nils Kessler is an Assistant United States Attorney for the Western District of Michigan.

135. *Rajaratnam,* 802 F. Supp. 2d 491.

of sources. A lot of times it will come from places like the CBOE[136] that will note a red flag on suspicious options trading, something to that effect; and the typical course is the staff attorney will attempt to determine - through blue sheet analysis, phone records, and bank records and the usual what be - who the trader is and where he obtained the source of the information. I think there is a difference in the types of cases that have been brought in the last few years. First of all, I think we do try and get [the] involvement of the criminal authorities earlier. It is something that - talking about the blue-collar, white-collar distinction - I think that some of the more recent actions have been better coordinated than they would have been in the past. Again, not to say that the Commission is instructing criminal authorities on what to do; they would not do that. But there is just much more overlap, much more coordination, and, combined with the rules, the cooperation – [and] the credit that is given for that - I think that it helped move these cases faster because that is always the difficulty here. I know there is a line of cases that says something like, in a typical insider trading case, there are two parties: there is the tipper and the tippee. And generally, neither one of those are talking. So, a lot of times these cases move slowly, but with the earlier involvement of the criminal authorities, we hope that that can be sped up a bit.

Nils Kessler: I think as far as the blue-collar, white-collar distinction, I can just speak personally from my own experience. What has motivated me in similar kinds of cases to use those kinds of tools – and what he is talking about: wire-tapping, wiring up undercover informants and sending them in, bringing people into the grand jury to testify – which are typically tools we would use in narcotics cases or organized crime cases. I think some of that may reflect just that this has become a higher priority for the department. So, you have moving of resources, which happens whenever priorities shift, and, for example,

136. Chicago Board Option Exchange.

my own experience[] has been after spending seven or eight years doing narcotics and violent crime, I was moved over to the white-collar section. I did not come from a white-collar corporate background where I knew how things used to be done. I knew how I did things in my own cases, in drug cases. I knew how to take down dope gangs, and you hand a guy a hammer, everything looks like a nail, right? I said, what are my tools? Ok, wiretaps, informants. You know, let us get a snitch. First thing I am thinking is let us get a snitch. Which is not normally how you think about those things, but you are moving people over with that type of experience and they put it to work to try and get results. I know where some of that comes from.

Richard Zuckerman: There is, in the civil area when you are talking about cases that discuss insider trading, what the cases refer to as a plus factor. In other words, can you make a civil case under these securities laws, which have their own particular elements to it, if all you have is a bunch of communication between people because you can see that from the phone records. And then, you have a trade where the assumption is that it was made from the communication, the contents of which you do not know, but which appears through speculation and conjecture, to have resulted in the trade which the SEC or government claims is insider trading. Now, that is in the SEC civil context. But when it comes to prosecuting an insider trading case, the government seems to be smart enough not to get involved in the complexities of the securities laws, but rather they default into much cleaner, simpler, easier to prosecute statutes like mail fraud or wire fraud.

David Van Havermaat: Absolutely.

Richard Zuckerman: Which are wonderful from the government's point of view. Maybe you can discuss whether or not you have had a case or two where you have had a variety of statutes to choose from, but you elect to go under mail fraud because it is much easier to prove and it is much easier for a jury to understand.

Nils Kessler: Yes, he is absolutely right. We do that a lot and you see that nationwide, especially at your average district attorney's office where they are mostly generalists. You have to do a whole lot of different kinds of crimes that come in so what we specialize in, if anything, is just courtroom litigation. We do not necessarily specialize in any substantive area of the law. I am not saying that there are not people who have great specialties, but I will speak for myself. I know how to run a trial, but I do not necessarily know all the underlying law. So, what I am looking for is can I catch somebody having lied to somebody and getting money out of it? Which is – frankly, I look at myself as not being that sophisticated about this kind of stuff, like synthetic collateral debt obligations. I cannot believe I remembered that from five minutes ago. [Laughter]. So, I try to look at it as just fraud scheme, and I think about the fact that I am going to be pitching this to jurors – many of whom have a high school education, some of them have more – and I figure if I cannot figure it out, they cannot figure it out. So, I have to come up with a theory that is fairly straightforward. I think for those of you here last year, I talked about a Ponzi scheme case that I had involving these Merkle brothers that are from not far from here?[137] It was from Williamston. That was one instance where I decided to go with an actual securities type of statute, the same one that was used in Galleon,[138] 15 USC 77ff,[139] which actually incorporates 10b5.[140] Basically, the only reason I did it in that case, and I had a lot of trouble finding a go by from around the country to use, was you kind of have your two sorts of Ponzi schemes, the ones that start out with somebody going I am going to rip off a whole bunch of people and get a lot of money, and I am going to flee the jurisdiction. And you have the majority of them are ones where they come up with what they think is going to be a le-

137. United States v. Merkle, No. 09-2079 (W. D. Mich. 2008).
138. *Rajaratnam*, 802 F. Supp. 2d 491.
139. 15 U.S.C. § 77(f) (2006).
140. 15 U.S.C. § 78j(b) (2006).

gitimate scheme to make money, but it is a hair brained scheme and does not pan out. And when it starts going south, they start robbing Peter to pay Paul. And they figure one of these days it will turn around and nobody will ever know. And in that kind of case, where they are going to have the legitimate ability to come in and sincerely tell a jury I never meant to defraud anybody, then it is a little harder under mail fraud for me to make the pitch for intent to defraud. I can say, "yes they did not have to have it from the beginning," but a jury is going to go "gosh, I don't know, they never really meant to hurt anybody." Whereas with your 10b5[141] and the 15 USC statute,[142] there is much more focus on did you omit, did you make a material misrepresentation, or omit something that the investors would want to know. And in that kind of case, I will do it because the one thing they are not going to be able to get away from is – I am going to be able to say – did you tell these investors that the money they would be getting was not really from oil or from gold, it was from their neighbor. And if the answer is no, then that is kind of the end of it. And then I have six hundred potential witnesses who could get up and testify that, "had they told me that, I would have never invested." But Mr. Zuckerman is right in the vast majority of cases, unless I have that kind of issue, I am just going to go mail fraud because it is easier.

Richard Zuckerman: Do you use the securities law as the net to sort of grab it and then make the determination to go either securities or mail fraud? Has Dodd-Frank increased your ability or increased the size of your net to go into the sea and pick out the bad guys?

Nils Kessler: No. The sea – it is like the fish are jumping in the boat and it is a matter of picking which ones you want to throw out. Honestly, it is, and I think I heard Mr. Havermaat talking about this earlier. There is no shortage of tips or cases being referred

141. *Id*.
142. 15 U.S.C. §§ 78A – 78Pp (2006).

to you and it is a matter of just trying to use your prosecutorial discretion. I think that accounts, actually, for part of what we were talking about a minute ago, with the eleven-year sentence for Mr. Rajaratnam.[143] I saw a lot of people say that is really long and it is long for insider trading; but with Ponzi schemes – and some of you may recognize with Enron schemes and things like that – people were routinely getting twenty-five year sentences for that sort of thing; and I think the difference is victims versus not victims. When you have a case where you are getting in front of a judge, nowadays when they are not bound by the guidelines anymore, when they hear one victim after another coming up at sentencing and saying, you know, a little old lady coming up, and saying "I lost my home" or "I cashed out my whole retirement to invest in this thing," or "I mortgaged my house to invest in this thing and they took my money," there is that emotional aspect that I think contributes to getting a long sentence. Whereas with the insider trading, it is not as obvious who the victim is. The victim is sort of the market at large and the pain is shared by society. I think that is part of the reason why we try to go after the cases sometimes that have the more immediate emotional impact.

Richard Zuckerman: Just a couple of things, there was a Ponzi scheme sentence in Detroit a couple of months ago involving a fellow named Ed May.[144] It touched on the securities area because he was selling his Ponzi scheme, essentially, sometimes through broker dealers who were unwitting, [and] sometimes not. He got sixteen years for a Ponzi scheme in the mid eight-figure range. So the eleven-year seems to be a lighter sentence than you may have expected if you compared the two. But you cannot ever really compare two cases. I have not seen the Department of Justice or the U.S. Attorney's Office start up a pure securities case without some preliminary, perhaps a

143. *Rajaratnam*, 802 F. Supp. 2d 491.
144. United States v. May, No. 09CR20482-1 (E. D. Mich. 2011).

lot of preliminary, work, done by the SEC first. Even if the SEC were to go from, which they do, start to finish, and try to get conjunction in the department and a large fine of some kind utilizing all of their statutes. More than likely, in the cases I have seen, the government's prosecutorial theory is usually mail fraud because it is much easier to prove. What you do as a defense lawyer, you sit back and say, "Well, if they take a securities route in front of a jury, maybe I can get one juror so confused because they do not understand the complexities of the elements of the securities laws, that I might get a hung jury." It is very difficult to hang a jury in mail fraud case because the elements are different, the types of proof, while the same, are argued differently. So it is not so surprising to see a criminal case prosecuted on different statutes. Maybe we can talk a little about technique of gathering information; we mentioned some of them. Usually, you find out there is something going on when nice agents show up, first with a search warrant, or they show up with a grand jury subpoena. And today, they show up generally with both. They do that because they want to come in before your computers delete stuff and seize. They have become more sophisticated now; they do not have to take your computer. They bring these nice devices that image your hard drive right there. Then they serve you with a grand jury subpoena on the way out, just in case they missed something. It starts the negotiations with the government about how to narrow the scope of what they want because they really do not want everything they ask for; they just ask for everything because then if they do not get something they can accuse you of obstruction. Which is generally true. If you do not ask for everything then if you do not get something you got some lawyer saying you did not really ask for this, and you asked in the present tense and you should have asked in the past tense. But if you ask give me everything and something does not show up, then the government likes to sit down and talk about maybe obstruction; because if a jury is confused by a case, even a mail fraud case, they are not confused by an obstruction count or a perjury count.

Nils Kessler: Another reason we often do the search warrant and the subpoena together – I never used to do that sort of thing in non-financial cases, but we use it a lot in, for example, a tax case – and it is actually to sort of lock out the defense's ability to bring in things you did not see coming. One good example is a tax evasion case that I had last year. Basically, I was trying to show – putting up in front of a jury – all these tax returns where the person was saying, "I only made six thousand dollars a year and that is what I put on my tax returns." But then they were going out and buying things that cost three, four hundred thousand dollars. It did not make any sense. So my whole theory was that they had to be lying on their tax forms because they bought more stuff then they said they had money for. The defense was trying to blind side me, coming in with a whole bunch of credit card statements saying, "no, no, no, we were not lying, that was all loaned money; we just put it all on the credit card so you have it all wrong." That is kind of where I learned my lesson that by doing the search warrant and serving the subpoena at the same time; when they try to come in later and say, "No, no, no, you missed all these documents that we now want to bring in as a defense." You can say, "Really? If you had those at the time you were supposed to turn them over to us. Either you have made them up – you have either generated them after the fact – or you were hiding them from us, and we are going to ask the judge to keep them out."

David Van Havermaat: I think it is a little different from the SEC perspective. Although sometimes we do have coordination with criminal authorities, a lot of times we are on our own. So, we are not going to have wiretaps; we are not going to have things of that nature. We do, obviously, have a lot of tech people because we will have hard drives brought to us, and we need to determine from what IP address accounts were accessed, that trades were made through. But, frankly, a lot of investigation into insider trading from the commission side is just boots on the ground work: talking with witnesses, reviewing bank records, phone records, emails, blue sheets of trading activity. It is a lot more grunt-type work, but just because of the nature of the crime; the few people that actually know about it are not talking. That is what you are left with essentially.

Nils Kessler: Let me follow up on that because it touches on something Mr. Zuckerman just said: when you are talking about having both parties and neither of them is really talking to each other. In the old days, you really had no way to find out what they were saying unless you could flip somebody and get someone to tell you what had happened. But nowadays, I am shocked at the number of cases that have people who work down the hall from each other. They are two doors down from each other and they are too lazy to get up and actually speak. So, they email each other from their desks, like from me to you, or they text each other over lunch, and all of that stuff leaves a permanent record. So, sometimes without even having to go talk to someone – and I know that was going on in the Galleon[145] case because you can see it as one of the overt acts of the conspiracy – is that one conspirator texts another one, "Do not buy this thing until I have checked out the insider information." That stuff is always going to be there; and better than it always just being there, if it is on your computer we will be able to get it off the computer. But without even having to do a search warrant, if I send a text to you – like from across the hall – that text is actually going from me, probably to Virginia somewhere, and then to you. So, it is going through a third party internet service provider, and we can execute a search warrant on the internet service provider without either one of us even knowing about it. So, we can have those texts before we even talk to anybody and reveal our investigation.

Richard

145. *Rajaratnam*, 802 F. Supp. 2d 491.

Zuckerman: If you are interested in the statute that allows them to play around with your text messages or emails it is called Stored Communications Act.[146]

Nils Kessler: Well, it is all through there; [Section] 2510 is where it starts. It is kind of all through there.

Richard Zuckerman: Well [Section] 2510 is wire-tapping; they kind of put all the stuff in one section. But in order to limit civil litigants to subpoena every ISP in the world for everyone's emails during the course of civil litigation, somebody pressured Congress into creating the Stored Communications Act, which limits what a civil litigant can get in just normal civil litigation. But, there are exceptions for the government; and it is that statute that the government uses to subpoena to get the content of the text messages. So, if you are in a case, and, in fact, you are dealing with subpoenas for text messages, or for emails, then you should take a look and become familiar with the Stored Communications Act.[147]

Nils Kessler: For what it is worth, we cannot get content with subpoenas anymore for the most part.

Richard Zuckerman: You need a search. That is a case in this circuit, some guy in Cleveland. I cannot remember his name, but he did something terrible. The government prosecuted –

Nils Kessler: Warshak.[148]

Richard Zuckerman: Warshak, right, and he did something terrible. The government prosecuted him. And his only issue was, "You should have gotten a search warrant. You cannot just subpoena the stuff," and he won, but he lost. I think it was sort of like the good faith exception. The government did not know they had to get a search warrant. So, they just used a subpoena and because they were in good faith, following the statute that they did not realize was semi-unconstitutional. What is the difference?

146. Stored Communications Act, 18 U.S.C. §§ 2701 – 12 (2006).
147. 18 U.S.C § 2701 (2006).
148. United States v. Warshak, 631 F.3d 266 (6th Cir. 2010).

Nils Kessler: Y[es], the interesting little tidbit is that there is a line of cases like that that started with a case called CDT.[149] It dealt with [pause]; I do not know how many people followed the BALCO Labs investigation. It was about Major League Baseball players getting juiced on steroids. And that is kind of where the court started getting queasy about it. We were getting information through the same process, and then you get into all the issues about what is in plain view on a computer. Where we would serve a subpoena on an internet service provider for particular kinds of messages. And, the next thing you know, you are getting the list of like every baseball player who ever talked in confidentiality with the commission, the Major League Baseball commission, and revealed that they were actually using steroids, but were really sorry and will stop now. So, we are getting all the stuff in plain view. And so, that is where the whole line of cases, where the courts are kind of wrestling still with what is in plain view on a computer. And obviously, I can tell you, this is my personal position, just knowing that files on the computer are often not labeled exactly what they are. Say we were looking for child pornography. You can only look for jpeg picture files or only things that are labeled child pornography. We are not going to find anything. You have to look. It is sort of like sending somebody into a house, saying, "You are only allowed to take things that are in files marked 'evidence of fraud.'" [Laughter]. I mean nobody does that. So, as you are going through everything you are going to run across stuff, and I think the better practice is to let us look through everything. And if we do not have probable cause to search for this particular thing, but it is obviously evidence of fraud, like the lists of social security numbers, and driver's licenses, and whatever, of ten thousand identity fraud victims, then we go back and get a new search war-

149. *See* United States v. Comprehensive Drug Testing, Inc., 621 F.3d 1162 (9th Cir. 2010).

rant. But do not tell us that we have to pretend we did not see it.

Richard Zuckerman: That is why on your computer you should label your files something like "Sunday School Lessons," and then encrypt them with ten 24-bit security encryption. [Laughter].

David Van Havermaat: And I think the next frontier though, and a lot of that getting into the content of the communications, that there has been some discussion in the SEC, and it is certainly a grey area at this point, are things like Google© search histories. There are a few that subscribed to various Google© services. They will keep a log of every search that you have done over the last however, the three to six months, and there are questions as to whether that is accessible by subpoena. Not something that we have done up to this point, but I see that as down the road, certainly in terms of insider trading investigations as potentially key evidence that someone knew something they should not have and traded upon it.

Nils Kessler: But at the same token if you happen to be into literature and you like Vladimir Nabokov. Do not search for Lolita[150] because someone will come knocking at your door. I mean that is exactly the sort of thing they look for. Do you know what I am talking about? I mean that is a typical string.

Richard Zuckerman: Do not say "yes" or they will come knocking at your door. [Laughter].

Nils Kessler: But he is absolutely right, what you look for tells us a lot about what you might be doing.

Richard Zuckerman: Since this is supposed to be insider trading, if you are dealing with the SEC and you are dealing with an insider trading case. Keep in mind what I said earlier. And that is, they do not necessarily have content. They have inferences. They have the fact of communication between insiders and then they

150. VLADIMIR NABOKOV, LOLITA (1955).

have a trade. There are cases that talk about whether you can draw inference on an inference and utilize simply the existence of some kind of communication. And then, depending on the time period between the communication and the trade, you have a trade which is clearly something that is suspicious, and whether that is enough to make an insider trading case under the securities laws. Like I said, there are these cases floating around that say, "No, you need more." And then, there are cases saying, "You do not need more." So, that is in the kind of civil area, and that is the kind of thing a mail fraud case might avoid giving the defense. So you have searches. You have grand jury subpoenas. You have all of the crazy stuff about what you can get electronically and what you cannot get. And then another thing, which could happen in a case, the government does search homes, as well as businesses. During the course of the search, the government likes to isolate the people who are on the premises to start to question them. Have you ever done anything like that before?

Nils Kessler: Personally?

Richard Zuckerman: Well no. Government lawyers are not supposed to go out on searches because then they become witnesses.

Nils Kessler: Yeah, we never do. But yeah, absolutely you do want to. I would definitely tell the agents who were executing the search warrant to start the questioning right then. Because, frankly, it is when we get our best admissions. You know, people are – I do not know. I cannot think of a better term of art for this, but they are freaked out. When there [are] a bunch of agents crawling through their stuff and they suddenly realize, "I am in a lot of trouble." And a lot of people, especially white-collar people, just want to try to talk their way out of things. So, one of two things happens. They either make some admissions like, "Oh my gosh, this has been weighing on my conscious and now you are here. Let me just tell you what happened." You know, sometimes hoping for leniency; sometimes just wanting to get it off their chest. Or, they lock themselves into one particular defense, and that is just as valuable to us as, you know – almost as valuable as getting a confession is if they lock themselves into one story, "No, I did not know about that; it must have been Angela, my secretary. She is the only one who could have done it." Then, by the time they go talk to a competent defense attorney who is like, "You should have said 'X,'" they cannot do that anymore, and they are stuck with what they told us the first day.

David Van Havermaat: And if they have varying stories of their time, that itself can be the plus factor.

Nils Kessler: Absolutely.

David Van Havermaat: That is enough to bring a circumstantial case, too, if the shifting and contradictory explanations to your trades, that, along with sufficient circumstantial evidence, has, in many instances, been deemed enough to bring an insider trading case.

Richard Zuckerman: Do you think if you interview an individual in a room that he has been isolated to during the course of the search – he is in custody?

Nils Kessler: Well that is an interesting question, I mean that is –

Richard Zuckerman: Meaning do you have to give him Miranda warnings?

Nils Kessler: That is what it always comes down to on whether you have to give somebody Miranda warnings. For those people who are not criminal practitioners here, the question is whether they are in custody, or more specifically, whether a reasonable person would have believed he was in custody. And there is a line of cases that says it is not the reasonable guilty person because a reasonable guilty person always thinks they are in custody. So, it is just what does an objectively reasonable person think. And, frankly, when it is in a home, I have litigated that a bunch of times. When you are in your own home, even if there is a bunch of agents around, there is a presumption that you are a little more comfortable. And, it is all about whether it is coerced or not. If you come down to the jailhouse and start talking to agents, then the ball is starting out a little more in the defense lawyer's court, because there is a presumption that when you are in a police station you cannot just come and go as you please. So, I always tell agents, "You know, if you are not going to Mirandize somebody, you make very clear to them – and, you know that is generally what it turns on – you make very clear to them that they are free to go and free to terminate the questioning whenever they want and that they are not under arrest. And do not stand near the door or block the door or anything like that." And then I have the agent testify to that at the suppression hearing. What did you tell him?

Richard Zuckerman: Irrespective of the truth. [Laughter].

Nils Kessler: Whether it really happened, [jokingly] he would say that. But, you know, if I have three FBI agents say, "We all told him he could go whenever he wanted and he did not have to stay," you know, that is usually going to make the difference. And, we usually, [pause] the agents will usually not put you in a room either. They will actually take you out of the house so that you are out of the way, and then it is less of an issue.

Richard Zuckerman: There are some cases that suggest unless you are actually asked to leave and are refused, then you are not in custody because you are not, [pause] you have not been formally arrested. And you are not otherwise detained unless you ask to leave, and you cannot leave. So, most of the agents that I dealt with in a variety of searches, including a search conducted by the FBI having to do with an SEC related type case – they do not give Miranda warnings. But, they do stand by the door. And the other thing they do is, during a search, everyone's armed because they do not know what is, [pause] what is going to transpire. And so, they will stand by the door, and their jacket will be back, and their gun will be exposed, and they will have their little badge over here or around their neck. And, there are usually two of them because, if there is a statement, they want a witness. And, it is very difficult for the employee to mentally decide he is going to say, "I am leaving." One of the things corporate law firms do for their clients, however, is you can create a handout that is given to a plant manager, an office manager, or somebody like that, that is really captioned, "Your Rights During a Search," or "Your Rights When Served With a Subpoena." You have got to be careful. You cannot tell them, "Do not talk to the government," because you might feel that is obstruction. But, you can say, "You do not have to talk to the government if you do not want to." But, educating employees about what to do when the government shows up is a pretty important thing to do. So you have all kinds of searches: electronic, physical, you have grand jury subpoenas, you have witness interviews. What does the government do when it gets fifty gigabytes of stuff? I mean, they have a great time. They go out. They conduct a search. They serve a subpoena. Now you get fifty gigabytes of stuff what are you going to do?

David Van Havermaat: Find someone junior to spend a long time reviewing documents.

Richard Zuckerman: You should be in a big law firm; that is a good philosophy. [Laughter].

David Van Havermaat: I mean that is a problem, obviously, is that we do not have the resources to review every document of a box car full of documents so it is generally: try to image them, do targeted searches, things of that nature to the extent possible. It is a resource issue every time. It depends on what we have found up to that point, but it really is done on a case-by-case basis. And sometimes, we do devote, have people devote, weeks of time to review documents if necessary. Other times it is a much more surface analysis.

Richard Zuckerman: What about negotiating a search term list and a date range list with defense counsel. Will you do that?

David Van Havermaat: Sure, in the appropriate circumstance. Again, make sure that we have covered everything that we are seeking, that all of the alternative searches are covered as well. But yeah, I think that benefits both parties. We certainly do not want to be dumped upon with a ton of irrelevant documents that we have to later sift through because that just impedes our investigation as well.

Richard Zuckerman: Well, we would never want to do that.

David Van Havermaat: Of course. [Laughter].

Richard Zuckerman: Of course, because we are all good citizens. One of the things you do think about as a defense lawyer, is does it help or hurt your client's position to go in and try to facilitate or review the documents? As we just discussed, you can try to go in and do a search terms list negotiated with the government, and sometimes, maybe you do not want to negotiate with the government. Sometimes, you want to, if you are the one who comes up in the subpoena. They have got their own problems if they image your discs. It is their problem, generally, but if they are subpoenaing you, and there are a bunch of computers or servers that they missed, and now they are asking for specific things in the subpoena, you have got to think about whether you want to go in and negotiate a list with them. And maybe, you just want to do your own list and tell them what you did, and then see what their response is. But this kind of process to winnow down what it is you have to produce is important from the point of view of what defense you may have, and also important economically because clients are very cost-conscious, irrespective of the size of the client these days. What do you do if you serve one of these wonderful subpoenas that you laugh about when it goes out the door, but now you got fifty gigabytes coming at you?

Nils Kessler: I have not actually done that sitting down and negotiating it, other than in terms of a cooperation agreement. And that, I think, is another kind of issue we might want to touch on here. If you, as a defense practitioner – especially in a insider trading case I think – if you have that client who might want to consider cutting a deal for themselves, I think that the insider trader case is probably one of the cases I would most be interested in having what we call a "flipper" on the inside. A story teller, somebody who can actually, not just making inferences from documents, but somebody who could actually testify at trial that, "me and him had a deal. I was going to pass him insider information; he was going to trade on it and give me a cut of the profits." We would be willing to give that person a pretty large benefit at sentencing. I should say the court would give it to him, but we would be asking the court to give him a downward departure. So, if I had somebody who was cooperating with me like that, as Mr. Zuckerman was saying, that one of the most helpful things would be somebody who could come in and go, "Do not waste your time sifting through these fifty documents, fifty boxes of documents, or this huge hard drive that you found in that room. Let me show you what the important documents are." That would be invaluable.

David Van Havermaat: That is certainly key from our perspective as well, for exactly the same reasons. And I think the cooperation aspect is very similar. We obviously cannot guarantee in most circumstances that any quanta of cooperation will result in a *quid pro quo* of a reduction in disgorgement, but there are certainly cases out there where you will have individuals that have cooperated to some degree in an insider trading context. One defendant, for example, will be ordered to pay disgorgement plus a penalty equal to one times that disgorgement amount. A cooperator will be ordered to pay half the disgorgement amount in the penalty. And, in some of the recent insider trading cases, you are talking hundreds of thousands of dollars. It is significant.

Richard Zuckerman: Is the SEC limiting their cooperation benefits to the first-in, only?

David Van Havermaat: It is not limited, but that is one of the factors. There was a policy statement that has been put out fairly recently that certainly makes that a factor. First-in is important. The real question is, how helpful has this information been. You can be first-in, but if someone that comes in later has something better, there is the potential for getting cooperation credit there, too. It is really a big picture analysis, not limited to the first person in the door. And it does go to other things that are relevant in the criminal realm as well. Again, we ask, what is your level of cooperation? Are you going to guide us through the documents and show us things, for example, things that we might not have seen otherwise? If so, you are probably going to get a better deal as opposed to just doing what you are legally obligated to do, like producing documents and showing up for testimony. You are not going to get cooperation for that.

Joseph Spiegel: How do you inform the potential "flipper," to quote Mr. Kessler, what the nature of the investigation is without violating your internal policies, and not telling people what your investigation is? In other words, someone comes in, they want to cooperate; how do you inform them of what you want, without disclosing the true nature of what you are looking at?

Richard Zuckerman: They know they are guilty. [Laughter].

Joseph Spiegel: We know that.

Richard Zuckerman: Come on. But give a real answer. [Laughter].

David Van Havermaat: Generally it will be [pause]; it becomes apparent through the investigative process. It is not as if we have to disclose to someone what the context is, or what materials we are looking for. It certainly becomes apparent to them, and things are disclosed through the course of an investigation to witnesses that otherwise could not be disclosed to the man on the street. So, I think it is you kind of walk a fine line there, but it is a little more than a wink and a nod. I think everyone understands, generally, in these circumstances where you are going and you can certainly tailor a line of questioning to that as well so you can guide things in a particular direction.

Richard Zuckerman: A lot of the stuff is not actually hidden. Each of the divisions of the Department of Justice, the SEC, and the U.S. Attorney's Office has published, in various places, the various types of cooperation frameworks under which they work. The SEC's has recently been enhanced and "codified," in quotes, but take a look at their enforcement manual. It is all in there. It is very thorough and – likewise if you are dealing with an agency for the first time and do not want to hire somebody that has dealt with them before – then, you can go to a website and "how to cooperate" is very prominent these days. Just from your office's point of view, do you have a policy on the max you will give on a 5K[151] or Rule 35[152]?

Nils Kessler: No, there is no set policy on that. And just so anybody who is not familiar with those, 5K is the sentencing guidelines rule that says we can move for a downward departure prior to sentencing, and Rule 35 is for cooperation somebody gives after sentencing. They are both requests to the court to cut somebody's sentence down and it actually differs from office to office. When I was in the New Orleans office, we would ask for it in terms of percentage. I have been to other offices where they would ask in terms of years off. We ask in terms of levels off, like total offense levels, which affects how long you would go to jail for. I can just tell you that, as a rule of thumb for me, if somebody comes in and – I just had one the other day – if they come in and proffer to me. They tell me the information that they are willing to testify to, and then I turn around and call the other co-defendant and say, "Hey your buddy just did you." And he is going to testify to this in court, right? And that guy decides to plead guilty. I am usually going to give like two levels for that as just kind of a rough rule of thumb. It gets up to three or four if they have to testify in open court because it is obviously more difficult. It might hurt their reputation, etc. And then, the sky

151. U.S. SENTENCING GUIDELINES MANUAL § 5K1.1.
152. FED. R. CRIM. P. 35.

can be the limit. I have had one guy I will throw out there, as just a kind of outlier example who, in a drug case, wore a wire for us, made multiple buys, like kilo quantities of cocaine with a guy who actually had stripped him naked the first time he went in there, and who had actually blown up another witness's house. So, this is a guy who knew that he was likely to be strip searched at any time, and he was going to wear a wire for use after that anyway. And, he might be killed if it was found out. I asked for even more levels and he received a very favorable sentence. So, it just depends on what you do. Those are the things we look at – how useful it is to us and how much did you stick your neck out.

Richard Zuckerman: Well, in the Eastern District of Michigan, generally the policy is they calculate a guideline range based on some extreme interpretation of the guidelines and then they give you half off. So, you know, that is great, it is like being up at three in the morning and watching one of these information shows where usually [something sells for] $99.95 but today, a $1.20.

[Laughter].

Nils Kessler: But you have to act now.

Richard Zuckerman: But you have to act now. Well, that is true with the government. You better act fast if you want to get cooperation because the later you go in the less valuable you are. There is a danger; however, and that is now that the guidelines are not mandatory but advisory, courts can do what they want. And if you agree with the government on a guideline range, most plea agreements in the Eastern District say, "Ok, we have agreed and you are going to plead guilty but the court can do what it wants. If the court wants to go above the range, too bad; you cannot back out because we are not agreeing to a specific sentence plea agreement." I had a case involving spamming with some SEC aspects to it because part of the spamming is what is called the pump and dump. And David can tell you what a pump and dump is, but everybody of the top six people who were indicted – and there were about fifteen people indicted totally – everybody had a range negotiation. The top six people all got above the range because the judge just did not like this, especially the pump and dump aspects.

David Van Havermaat: Yeah, I think that in connection with.

Richard Zuckerman: Maybe they do not know what a pump and dump is.

David Van Havermaat: Oh, a pump and dump is essentially – a pump and dump and scalping are variations on the same theme: you purchase or have acquired stock in a company and cause someone to promote it to cause the price to rise, and as the price is rising you sell into the rising market, or into the flat market as the case may be. Essentially, you are not disclosing to the ultimate purchasers that you are the source of this positive information that at the same time that you are putting out this positive information you are taking advantage of the rising market you have created. The other thing that I was going to mention in terms of the cooperation [pause]; we do have the same issues that the criminal authorities do in that the Commission is the final arbiter of what any settlement or any sanction is going to be. So, we can certainly recommend to the Commission and we are instructed to specify what the nature, extent, helpfulness, and timeliness of any information provided is. However, the Commission has the final word as to whether it deems that more important than perhaps the punitive aspects of what would otherwise be the sanctions. So, we cannot make any guarantees other than in certain extreme circumstances. But we can essentially tell a defendant that, "We will do what we can for you."

Richard Zuckerman: I am going to pose a question. I guess you could call what is insider trading, or about insider trading. The SEC's powers, other than referring to the Department of Justice, which Joe Papelian indicated this morning was the 800 pound gorilla in the room, is basically civil. That they can debar you. If you are a CPA and they debar you, you cannot sign financial returns and you are essentially out of work. They can enjoin you, and they can grab some money from you. But, sometimes lawyers defending these cases where the SEC is adamant, and assuming the client has the guts and the money, the client may want to have a civil trial because, ultimately, it is the judge at a civil trial who imposes the penalties, and if you get the right judge and the judge may view the securities violation or your client's culpability in a civil context somewhat different than the SEC might. Have you ever had someone roll the dice when you guys were adamant, go to trial on a civil case, and wind up better off? Other than the fact that it costs a lot of money.

David Van Havermaat: Yeah, I have not personally, but I know that it happens. It depends on what, it depends on the judge. There are reasons that the Commission, I think, would elect to go down that route, certainly. It primarily is, the Commission wants to make sure that if we have someone, whether it is insider trading or whatever sort of violation, the Commission would look really bad if they let someone off lightly and allowed them to go back into the industry and they did it again. That would be the worst possible outcome, obviously. So the Commission has no problem with rolling the dice in those situations. And, I mean yeah, there have been times in insider trading cases where complaints have been dismissed on the motion to dismiss stage. I do not necessarily think that that means that in most contexts the Commission would do things differently. I think that there is a need to be out there, to be prosecuting the matters that we do. And, simply, you do roll the dice. You lose sometimes; you win sometimes.

Richard Zuckerman: Well, the point is, is it something for you to consider if you are representing someone? If the Commission is adamant, and you do not think there is a referral in the wind, then you may want to try going to trial if you have a read on the judges in your district – of course, you cannot pick your judge – and take a shot at it. Because you could wind up better, even if only incrementally.

David Van Havermaat: You could wind up worse, too.

Richard Zuckerman: But, you could wind up worse.

David Van Havermaat: In the case of the Galleon[153] trades, I think that was some of the comments that the judges made there specifically, that: you rolled the dice, you bet on your future, and you lost. So, there is a potential upside, but there is also a big potential downside.

Nils Kessler: That is probably more marked on the criminal side. Not only because you lose the points you would otherwise get for acceptance of responsibility, you lose the appearance of having accepted responsibility, which is much more important now that the guidelines are not binding. If the judge looks at it as "you were not going to admit you did anything wrong until we proved it," then when you say you are sorry, I think most courts, and at least I tend to, think that you are only sorry that you got caught.

Richard Zuckerman: Well, let me pose this question then: let us suppose there is a parallel investigation, and let us suppose that the civil case is going to go first, which it may not – and I am going to get into a little bit of the nuances of parallel investigations - and the civil case, the defendant goes to trial, wins or loses, and now he is being pursued, and he wants to plead to get a deal. Is he admitting responsibility because he does so in the criminal case, but in the civil case he rolled the dice? He has already litigated, won or lost, now you guys are pursuing him and he wants three points off for acceptance because he is willing to plea.

Nils Kessler: I do not think it would affect it, but I have never seen it in that order. It is almost always the other way around. Where I get people who would otherwise admit responsibility on the criminal side in order to get some benefit, but they are reluctant to do it because they do not want to get sued by their victims or lose the money on the other side.

Richard Zuckerman: Yeah, whether it is insider trading or something else, the real issue is, how do you strategize the

153. Galleon Group was a hedge fund management firm founded by Raj Rajaratnam that closed in 2009 amid an insider trading scandal.

case when you know you have the SEC and the Department of Justice chasing your client because there are some trade-offs in connection with having those two cases move parallel? The case law, as I understand it, does not require that the criminal case be stayed or the civil case. It does not give you the opportunity to stay as the defense lawyer one of the cases because you are put in an impossible position. The government may move to stay the civil case, have you ever done that?

Nils Kessler: Ye[s], we have. And, one of the big problems people run into when they have got the civil case going on is, obviously, if [they] have just the criminal case going on, we could never make you testify. Alternatively, on the civil side, if people are suing you, they are going to have the right to depose you, and you are going to have to lock your story in one way or the another. It is very difficult on your civil case if you have to "take the Fifth" because you know you have got criminal proceedings going on. So, yeah, a lot of times it is the defendant that wants the civil stuff stayed while they are taking care of the criminal side of it. Depending on the situation, I know we have done that.

David Van Havermaat: We have had some. Again as many things do, it depends on the facts of the case. A lot of times the Commission will not oppose a motion for a stay, certainly, if it is brought by criminal authorities, but it has no great interest one way or the other because in our cases if a defendant takes five, we can ask the court to draw an adverse inference there. So, there are advantages to us to having it go forward and let the defendant take five; we will use that.

Richard Zuckerman: That is really the problem is if you have a defendant who is being pursued by both authorities. The question is, what is more important to the defendant, an injunction and some money or going to jail? And if the defendant cannot get the civil case stayed until the resolution of the criminal case because criminal cases usually take priority [pause], then when the SEC asks for documents, or the SEC subpoenas the defendant to be in for a deposition, or statement, because it is not really a deposition –

David Van Havermaat: Testimony.

Richard Zuckerman: Yes, and we can discuss that in a second. What do you do? Because you know as a criminal lawyer advising someone in a parallel investigation, you say, "Take the Fifth." And, they will say, "I am going to lose everything, I am going to lose my house, I am going to lose my money." It really is not that bad right away, I mean, you can have an adverse inference drawn, which really does not take effect until you go to trial because it really comes out in the form of a jury instruction. Where you could get hurt in the civil case is if you use the Fifth Amendment to refuse discovery then you could have your answer struck, your affirmative defenses struck. And if your answers and affirmative defenses are struck, you are going to have a judgment entered against you. But there is a way to handle discovery in a way where you really do not necessarily put yourself into that box. But, you are going to have to balance, and the client is going to have to balance, what is more important to the client, the civil consequences, or going to jail because he admits in the course of the statement that he did certain things, which meets one or more of the elements that the criminal people are interested in pursuing and have to establish beyond a reasonable doubt. What is the SEC's position on the nature of these statements that they take from people? I mean if you go to one of these things you get a nice instruction sheet. It is a [1662 form][154] and they give you in advance, when you are sitting down, there are a bunch of warnings about what this really is, and what is this really?

David Van Havermaat: Are you talking about just the testimony that is taken?

154. SEC. AND EXCH. COMM'N, FORM 1662, *available at* http://www.sec.gov/about/forms/sec1662.pdf.

Richard Zuckerman: Yes. Right.

David Van Havermaat: I mean that is our fact-finding investigation. The bottom line is we are there to develop the facts and determine whether a recommendation for enforcement is warranted.

Richard Zuckerman: Is it a deposition?

David Van Havermaat: It is similar to a deposition.

Richard Zuckerman: But the SEC does not consider it, they tell you it is not a deposition.

David Van Havermaat: It is not. There are certain other provisions for example, the limitations on who can attend a testimony; whereas, in theory, anyone under the sun can attend a deposition. The testimony is limited to the party and attorneys. You are not able, necessarily, to take your transcript of your testimony and distribute it to the world at large.

Richard Zuckerman: You are not necessarily entitled to the transcript at all. You have got to have a form.

David Van Havermaat: Right, right.

Richard Zuckerman: It is a minor detail. You cannot distribute something you do not even get. [Laughter]. But, you have to ask for it. Ever use the phrase "we control the record"?

David Van Havermaat: Oh, all the time.

Richard Zuckerman: What does that mean?

David Van Havermaat: That means, it means exactly what it says. We are on the record until I say we go off and the defense counsel is essentially there to occasionally –

Unknown: Get a glass of water. [Laughter].

David Van Havermaat: Yeah, pretty much. There are a lot of instances where that is the case. It is. The objections are very limited in the testimony context in comparison to a deposition. It is a lot more one-sided, and that is the way we like it. [Laughter].

Richard Zuckerman: If you want a copy you have got to send in a form and, generally, they say send in the form and we will approve it, but they do not have to. There are theoretical limitations on who you can give that to after you get it.

David Van Havermaat: You cannot keep copies of your exhibits.

Richard Zuckerman: Yeah, you cannot do anything. You do not object like you do in a deposition, you know stupid objections you do in a normal civil case, because you want to throw the examiner off base. You can interpose objections based on privilege, which is really probably the only legitimate thing you can say during the course of these statements. But they are statements and they have the same operative effect as any other statement by your client. And you have to think downstream about what is going to be made out of this, and does the client testify or not. Let me get off onto another subject; if you testify and then you decide in the middle of it, "oh my god," and then you hear something as the lawyer and the client says "I do not want to answer the next question" and then they take the Fifth. Have you ever litigated a Fifth Amendment waiver case?

David Van Havermaat: No, I cannot say that I have.

Nils Kessler: I have not, no.

Richard Zuckerman: I guess I asked the question because I did. I have done it on both sides of the fence. I have defended them and I have gone after someone for Fifth Amendment waiver. But that is a very important thing to consider, is when your client is asked a question in some context if, in fact, downstream you decide, or in the middle of it, you decide it is a bad idea and so then the client decides to take the Fifth. Certainly, I have seen the U.S. Attorney's Office in Detroit – and we used to do this in the strike force, all the time if anyone was dumb enough to talk to us at all – we used to go right after the fact of what is called a subject matter waiver rule. [The rule is that] if you testify on a subject, and that is where the fight is, to convince a judge what the subject was such that it was not just the question that was answered, but everything that flows from that question, you might wind up having a client who has waived his Fifth Amendment rights and that can be very bad both for the client and for you as a lawyer if you did not know there was such a thing as Fifth Amendment waiver. I do not think the SEC would necessarily be that aggressive, but the U.S. Attorney's Office can be, and on certain occasion has been. How much time do we have? Five more minutes? Have any questions? Yes?

Audience Member: Is there much of a trade-off by going mail fraud, as far as sentencing goes, sentencing guidelines, or a sentence in going with mail fraud, as opposed to insider trading?

Nils Kessler: Well insider trading is not the statutory name for the crime, but are you thinking of securities fraud, for example?

Audience Member: Yes.

Nils Kessler: No, there is really not. They are both going to fall under the same guidelines they both have the same statutory maximum sentence, which is twenty years. And you rarely see, unless it is one of the most egregious cases, you are not going to get up to that statutory max anyway. It is really more [pause], I would select one over the other more because of the kind of proof I am going to have to put up. But, as far as sentencing guidelines, they all go back to, for those of you who deal with the guidelines much 2B1.1,[155] which is your Economic Crimes Guideline and it is mostly driven by the amount of money. It is either the actual gain to the defendant, or the loss to the victim, whichever is greater. That is pretty much what drives it, plus some other things like how many victims you had, etcetera.

Richard Zuckerman: Who would be the victim in an insider trading case?

Nils Kessler: That is the whole reason why I was saying I think that it accounts for them historically getting lighter sentences is that there is not really an identifiable victim. I guess the victim is who[m]ever you owed the fiduciary duty to. So, if you were trading on the company stock, and the company expected you as their lawyer or gatekeeper, for example, to keep their confidential information to yourself, but in-

155. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1.

stead you used it to sell a whole bunch of their stock or whatever and make money off of it, then the corporation is going to be the victim.

David Van Havermaat: I think in the historical context of insider trading that is probably true, but I am trying to remember if it was Galleon or one of the recent major insider trading cases.

Nils Kessler: O'Hagan[156] maybe?

David Van Havermaat: No, it was one of them brought in last couple years, but one of the few times where there was an identifiable victim because now that you have hedge funds involved and these expert networks it is not the situation you had typically ten years ago where maybe a brother-in-law heard there was going to be an acquisition or something like that. You have got earnings announcements that are moving the market significantly, and I think it was in one of the Galleon transactions where they had so much, like millions of shares of stock and they were going to private purchasers and saying, "Hey, what will you bid for the two million shares that I have here?" They ended up nine dollars a share being sold and the next day it moved 50%. So there are a few cases where there are identifiable victims in the insider trading context.

Richard Zuckerman: But would not it generally, in an insider trading case, as opposed to cooking the books – which cooking the books and the company collapses then you have all kinds of complexities that you can get involved with – but insider trading is not just the money the guy puts in his pocket?

David Van Havermaat: In terms of the disgorgement?

Richard Zuckerman: No, no in terms of the loss under 2B1.1.[157]

Nils Kessler: It all depends on whether you can quantify the loss. Like I said, it is the gain to the criminal or the loss

156. United States v. O'Hagan, 521 U.S. 642 (1997).
157. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1.

to the victim, whichever is greater. And we actually go with intended loss, if that is higher. If you meant to steal a million but you only got out five hundred thousand, it is going to be a million. So, it really depends. There could be a case I suppose where by cooking the books you only get, you put a couple hundred thousand in your pocket but the company collapses, and if you could reasonably foresee that you were going to cost the company ten million dollars, then ten million is going to be the number.

Richard Zuckerman: I think under cooking the books you could have huge numbers. I think under insider trading, generally, it is going to be what you put in your pocket as a profit that you should not have. Any other questions?

Elliot Spoon: Any questions for the panel? If not, let us thank them for a great presentation.
[Applause].

SESSION 5: BROKER-DEALER ARBITRATION AND LITIGATION UPDATE

Elliot Spoon: Our last panel is a broker-dealer arbitration and litigation update. For this panel we are welcoming back all of our folks from last year, and the year before that, and the year before that, because they provide such excellent information. It is a little different than the presentation last year; last year they did a play. This year, they are going to take a more traditional approach to this subject matter. Rather than introducing all the panelists, I am going to let my co-chair, Joe Spiegel, do that.

Joseph Spiegel: Thank you. What we are going to do today is, Mr. Henney[158] is going to take on the topic of fiduciary duty. Felecia Fox,[159] from FINRA, and Mark

158. Raymond Henney is a partner of Honigman Miller Schwartz and Cohn. Mr. Henney is the Co-Chair of the firm's Securities and Corporate Governance Litigation Group.

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

Kowalsky[160] are going to deal with an issue that affects us all and that is this new Michigan Supreme Court rule about the practice of arbitrations if you are not a Michigan lawyer. Mr. Pozza[161] is going to talk about MUSA. Eric Richards[162] is going to claim to do a five-minute presentation on trading away curious threats, and he is going to talk about

160. Mark L. Kowalsky is a partner at Jaffe, Raitt, Heuer & Weiss, P.C., and a member of the Firm's Litigation and Securities Practice Groups, specializing in civil litigation with concentrations in securities law and commercial disputes. He is routinely involved in handling disputes that relate to securities investments, brokerage industry employment, contracts, non-competition agreements, trade secrets, employment, shareholders, partnerships and dissolutions. He also represents clients in securities enforcement and regulatory matters. In addition, Mr. Kowalsky regularly provides advice and representation to regional and national securities firms, public and privately held corporations, and individuals. He has extensive experience in federal and state courts, arbitration, mediation and in securities law regulatory matters that often involve requests for immediate injunctive relief and the use of Alternative Dispute Resolution (ADR), including arbitration and mediation. A frequent speaker and published author, Mr. Kowalsky has accepted appointments as an arbitrator for the Financial Industry Regulatory Authority (FINRA), American Arbitration Association (AAA) and other fora. He also has served as counsel to a court appointed receiver and has sat as a case evaluator for the Oakland County Circuit Court and District Court. He is currently Co-Chair of the Firm's Litigation Practice Group.

161. 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.

162. Eric Richards has extensive experience in securities arbitration, commercial litigation and aviation law. He earned his B.A. degree cum laude from Michigan State University in 1983, and his J.D. degree magna cum laude from Wayne State University Law School in 1986. Eric has served as a federal judicial law clerk on both the United States Court of Appeals for the Sixth Circuit and the United States Bankruptcy Court for the Western District of Michigan. Eric has practiced law in both the District of Columbia and in Grand Rapids, Michigan. Eric has authored several articles and he has also served as an adjunct professor at the Thomas M. Cooley Law School, Western Michigan University, Grand Valley State University, Grand Rapids Community College and Davenport College. Eric is also an arbitrator for FINRA-Dispute Resolution, Inc. He is a member of the State Bar of Michigan, the District of Columbia Bar, the American Bar Association, the Federal Bar Association, the Grand Rapids Bar Association and the Lawyer-Pilots Bar Association. Eric has been recognized in Michigan Super Lawyers and The Best Lawyers in America. He is also a founding member and past president of the Grand Rapids Lawyers Chapter of the Federalist Society. Eric is an instrument-rated private pilot and lives in a fly-in community. He recently earned his Black Belt ("Shodan" rank) in Judo.

annuities. Mr. Trogan[163] is going to finally talk about common law. We are going to start with Mr. Henney. Obviously, we have an issue with fiduciary duty; it is up to you sir.

Raymond Henney: Thank you so much. I am extremely pleased to discuss this issue. It is a very interesting issue. It has a tremendous impact on the securities industry. The Dodd-Frank Act suggested strongly to the SEC that they impose a rule on the duty of care, both on broker-dealers and investment advisers. The rule, if and when promulgated, could have a significant effect on the standards of liability for broker-dealers and how broker-dealers deliver their services to retail customers. The backbone of the fiduciary duty standard is section 913 of the Dodd-Frank Act, which authorizes the SEC to enact such rules as may be necessary to address the legal or regulatory standards of care of broker-dealers and investment advisers.[164] The section requires the SEC to conduct a study concerning the effectiveness of existing legal and regulatory standards of care. The Dodd-Frank Act section 913 specifically amends section 15 of the Securities Act,[165] which concerns the registration and regulation of broker-dealers, and section 211 of the Investment Advisers Act of 1940,[166] which is basically the enabling act for the SEC to do such rules and regulations necessary to further the requirements of the Act.

The interesting aspects about the amendment is that it indicates the SEC may promulgate rules concerning a standard of care or standard of conduct for brokers when providing "personalized investment

163. Mr. Trogan has been practicing law in the Detroit area for over 30 years. He graduated from Wayne State University School of Law in 1971. Mr. Trogan has extensive legal experience in the areas of business and commercial law and litigation in addition to being a specialist in Plaintiff's securities law. In 2001, Mr. Trogan opened his own firm in West Bloomfield, Michigan to specialize in claims against stockbrokers. He began working in the securities area in 1979 as a defense attorney and initially represented major brokerage firms in several hundred securities and commodities cases nationwide. Beginning in 1987, with the stock market "crash" he began representing customers. He now confines his practice exclusively to customers' claims.

164. Dodd-Frank Wall Street Reform Act § 913.

165. Securities Act of 1933, 15 U.S.C. § 77a *et seq*. (2006).

166. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1-80b-21 (2006).

advice" about securities to a "retail customer."[167] The same standard of care for the brokers should equally apply to investment advisers under section 211 of the Advisors Act.[168] That standard of conduct will be something along the lines of acting in the best interest of the customer without regard for the interests of the broker, or the investment adviser, and that the standard of conduct provided by such rule must be "no less stringent" than the standard applicable to investment advisers under sections 206(1) & (2) of the Investment Advisers Act of 1940.[169] Sections (1) and (2) of 206 of the Investment Advisers Act has been interpreted as providing for federal fiduciary duty standard. The language of the statute is almost identical to rule 10(b)(5); it prohibits fraud and manipulative activity. However, judicial interpretations, specifically Supreme Court interpretations, have imposed a duty of loyalty, which is to act in the best interests of the client and to avoid any conflicts, and the duty of care, which can include reasonable diligence in making recommendations and the duty to monitor investments and the duty to consider client's entire financial or investment portfolio before providing investment advice or managing a client's investments. The Act says it can be no less stringent than section 206(1) and (2) and the interpretations thereunder, but section 913 places limitations on the standard of care that the SEC can impose. The standard of care shall not prohibit commissions, compensation based commission transactions; therefore, it is not necessary to have fee based only transactions with respect to broker-dealer regulation. Second, it shall not require a continuing duty of care or loyalty to the customer after providing the personalized investment advice. Once you make the recommendation, that ends the duty of care and the duty of loyalty. Third, the standard of care shall not prohibit the sale of proprietary or limited range products. Those are significant limitations on the

167. Dodd-Frank Wall Street Reform Act § 913.
168. 15 U.S.C. § 80b-1.
169. 15 U.S.C. § 80b-6-6(a).

standard of care because those are things that are prohibited under investment adviser's fiduciary duty standard.

With respect to what a retail customer is, [Section] 913 defines a retail customer as having three elements: a natural person, cannot be a business or entity; second, who receives personalized investment advice about a securities from a broker or investment adviser; and finally, who uses such advice primarily for personal, family, or household purposes.[170] There is no guidance for what primarily for personal, family, or household purposes are. The prevailing thought currently is that it will be the same as under the tax code with respect to using an automobile, and whether you can take a deduction for it. On January 21, 2011, the SEC released its study required by the Dodd-Frank Act.[171] The study recommended the SEC established a "uniform fiduciary standard for broker-dealers and investment advisers for providing personalized investment advice." Again, the statute's language, "about securities to retail customers."[172] Again the statute's language, "that is no less stringent." Again the statute's language, "than currently applied under sections 206(1) and (2)."[173] So, basically they said, "Yeah, it is a good idea, we should be doing that." In doing so, the study rejected eliminating the broker-dealer exemption under the 40 Act.[174] Broker-dealers were exempt from the fiduciary duty standards and the other standards of the 40 Act, and the study said that the exemption should not be re-

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170. Dodd-Frank Wall Street Reform Act § 913.

171. SEC. AND EXCH. COMM'N, STUDY ON INVESTMENT ADVISORS AND BROKER DEALERS (2011), *available at* http://www.cgsh.com/files/News/d6d2d0bc-3d46-4745-bb4a-f941000f5ac2/Presentation/NewsAttachment/945f412c-6c6c-4cbd-b7a1-0097f67da36b/CGSH%20Alert%20Memo%20-%20SEC%20Study%20on%20Investment%20Advisers%20and%20Broker%20Dealers.pdf

172. *Id.* at ii.

173. *Id.* at 101.

174. *Id.* at 144: The "40 Act," or Investment Company Act of 1940, was created in 1940 through an act of Congress. This piece of legislation clearly defines the responsibilities and limitations placed on fund companies that offer investment products to the public. INVESTOPEDIA.COM, http://www.investopedia.com/terms/i/investmentcompanyact.asp#axzz1rlUFqnq0 (last visited April 9, 2012).

pealed.[175] It also recognized the distinction between the broker-dealer business model and investment adviser business models, and the SEC rulemaking should "particularly focus on assisting broker-dealers with complying with the minimum requirements of the uniform fiduciary standard."[176] The study further recognizes that the fiduciary duty does not mandate the absolute elimination of any particular conflicts, nor does it mandate the avoidance of all conflicts. Rather, the study recommends that the SEC should facilitate disclosure of conflicts to retail clients. That seems extremely confusing if you think through the judicial interpretation of the requirements of [Section] 206, the federal fiduciary duty. Then, to make matters worse, the study states, however confusingly, that under the new uniform standard, existing guidance or precedent under the Adviser's Act regarding fiduciary duty would continue to apply to investment advisers and be extended to broker-dealers.[177] So the study had a lot of mishmash of different perspectives with the conclusion that 206(1) and (2) should be applied to broker-dealers, mindful of the broker-dealer business model, which provided very little guidance. That has had a negative reaction in many corridors, the first being in Congress.

Barney Frank, the Frank of Dodd-Frank, wrote a letter to the SEC dated May 31, 2011. In his letter, he expressed his concern that the SEC study had not properly understood Section 913 in suggesting the fiduciary duty standard of Section 206(1) and (2) be extended to broker-dealers.[178] Mr. Frank reminded the commission that the Dodd-Frank Act was intended to encourage the SEC to impose the investment adviser's standard on broker-dealers, but to insure that the new standard would not be a "watered down" version of the investment adviser's

175. *Id.*

176. *Id.* at 111.

177. *Id.*

178. Letter from Barney Frank, Member, U.S.H.R., to Mary Schapiro, Chairman, SEC (May 31, 2011), *available at* http://media.advisorone.com/advisorone/files/ckeditor/Barney%20Frank%20Letter.pdf.

fiduciary standard. "If Congress intended the SEC to simply copy the 40 Act and apply it to broker-dealers, it would simply have appealed the broker-dealer exception, an approach Congress considered, but rejected."[179] He concluded his letter by indicating the new standard contemplated by Congress is intended to recognize and appropriately adapt to the differences between broker-dealers and registered investment advisers.[180] SIMFA, Securities Industry Market Financial Association, also sent a letter to the commission on July 14, 2011.[181] It takes issue also with the study's suggestion of extending the fiduciary standards of Section 206 of the Adviser's Act to broker-dealers. It is particularly critical of imposing such a duty without a better cost-benefit analysis by the commission. SIMFA does urge the commission to adopt a general uniform standard of care or fiduciary duty, but it also asks for a number of limitations: it should only be on personalized recommendations about securities; all that should be required is that material conflicts be disclosed, not that there not be material conflicts; and that unless otherwise agreed upon, there should be no continuing duty after the recommendation is made.[182] I think, very interestingly, the letter also indicates that in the customer agreement between the broker and customer, that the broker-dealer should be able to define the duty of care, and exclude various components, such as any kind of continuing duty, or the need to consider the investment portfolio of the customer outside of the account. The SIMFA letter also indicates that the term personalized investment advice should consist of only specific recommendations, and it indicates that the commission should establish clear guidance on the disclosure of accounts, securities conflicts, and cir-

179. *Id.*

180. *Id.*

181. E-mail from Ira Hammerman, Senior Managing Dir. and Gen. Counsel, Sec. Indus. and Fin. Mkt. Ass'n, to Mary Schapiro, Chairman, SEC, (July 14, 2011), *available at* http://www.sifma.org/issues/item.aspx?id=8589934675 (follow hyperlink to the right of the page that begins with "SIFMA Submits Comments to the SEC").

182. *Id.* at 16.

cumstances when conflicts exist. The thrust of the letter is to try to get a rule that is sympathetic to the broker-dealer model and is black and white with respect to the obligations of broker-dealers under their duty of care.[183]

In addition to the SIMFA letter, what I will call opposition, there was strong opposition by two SEC commissioners who voted against releasing the study in January. Those two commissioners said that the study failed to show that a uniform standard would enhance investor protection. Importantly, they wanted a more rigorous analysis rooted in economics and data; those thoughts have been echoed by various House Republicans sitting on important committees for the securities industry. They have, in fact, urged the SEC not to create a uniform standard, and they are highly critical of the SEC study for its lack of factual data, supporting meaningful cost-benefit analysis.

That battleground has particular significance because this past summer the DC circuit, in the *Business Roundtable v. SEC,* struck down the SEC rule concerning shareholders nominating directors.[184] The court found that the "commission acted arbitrarily and capriciously for having failed to adequately assess the economic effects of a new rule,"[185] which is the exact criticism that the SEC study had been under with respect to its conclusion of applying a uniform rule that is akin to section 206(1) and (2) of the Adviser's Act. Presumably, based on Congressional questioning of the SEC's study and the dissent among the commissioners about the SEC study and the *Business Roundtable* decision, the commission has delayed promulgating any rule until after it has a further study on the cost-benefit analysis. So, we are not any closer to getting a fiduciary duty standard than we were before.

What I do think is important with respect to the debate on fiduciary duty is how different these concepts are with respect to an investment adviser and

183. *See generally id.*
184. Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).
185. *Id.* at 1148.

broker-dealer. And when the Act says that it can be no less stringent than the investment advisor fiduciary duty, but has to take account for the business model of broker-dealers, what are we really left with? We are left with a duty of care that is much different than the duties of care that we have. And I pose these among the questions that will be very interesting to see: how will the new standard of care effect the application of FINRA's new suitability rule, which, I would say, is more paternalistic with respect to the broker-dealer client relationship? Second, will the new standard of care provide customer claimants in FINRA arbitration more or less grounds for finding liability against brokers? When you say fiduciary duties are being expanded to brokers, that would seem to imply that, yes, it would be expanded. However, if there is more of a black and white rule with respect to what conduct is acceptable and not acceptable, it may undermine the more amorphous arguments about suitability that one faces in arbitration.

Joseph Spiegel: When do you think all these things will be resolved? Do you have a guess of a time table?

Raymond Henney: I think it is optimistic that I will be talking about what the new rule is next year because I think the *Business Roundtable* decision[186] is so difficult on the commission because the study they struck down with respect to the proxy ballot was not a bad cost-benefit study. And for it to be deemed arbitrary and capricious means the commission needs to do some very careful cost analysis.

Joseph Spiegel: So, what do you advise your clients as a defense guy, and then what do you say to a plaintiff?

Raymond Henney: From the compliance standpoint?

Audience Member: From the compliance standpoint.

Raymond Henney: From the compliance standpoint, I have to tell you I have two reactions to this. One is, I think the new FINRA suitability rule is probably going to be something like the standard of care when all is said and done, and that making your appropriate compliance standard around that new rule will probably

186. *Id.* at 1.

carry the day. My second thought about it is that plaintiffs or claimants in arbitrations now really have something to talk about. Yeah, you know, they have always talked about fiduciary duties and so forth, but now they have something else to talk about with respect to the need for protection.

Clarence Pozza: Ray, let me express a worry and see how you would address it. My worry is that there is this huge body of fiduciary discussion out there, way beyond SEC FINRA rules, and it is all over. It is in cases. It is in articles. So, how are you going to, in an arbitration case where we do not have a federal court, and let us say one of our brethren on the panel says, "fiduciary duty," and cites this massive amorphous body – how are you going to work with that with an arbitration panel?

Raymond Henney: You know, my thought is from the broker-dealer side, you have to look at the limitations that the Dodd-Frank in [Section] 913[187] puts on the standard of care. You do not have a continuing duty to monitor. You just have to disclose conflicts. You do not have to avoid conflicts. Commission-based sales are appropriate. So, what I would do is look at those and Barney Frank's letter.[188] It is not a trustee's fiduciary duty when we are talking about fiduciary duty with respect to brokers.

Joseph Spiegel: One of the comments this morning was the Department of Labor withdrew their fiduciary duty proposal, I think, pending trying to resolve this. I think fiduciary duty comes up with respect to IRAs. Department of Labor had waited on it, as we heard this morning, and then they withdrew that proposal. So, I think it is a big toss-up at this point as to the eventual outcome. You know, I think, as to Mr. Pozza's comment, it is confusing.

Clarence Pozza: My worry is, at the end of the case, someone stands up and says, "They were a fiduciary, which means they could not recommend anything other than…" [Laughter]. And it just washes out because that

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187. Dodd-Frank Wall Street Reform Act § 913.

188. Letter from Barney Frank, Member, U.S.H.R., to Mary Schapiro, Chairman, SEC (May 31, 2011) *available at* http://media.advisorone.com/advisorone/files/ckeditor/Barney%20Frank%20Letter.pdf.

word carries so much baggage with it. We imagine people in blue suits and hoods and walking around saying – "I am a fiduciary" [Laughter]. It just carries so much with it, which I do not think it should.

Gary Saretsky: I wonder if I am doing something wrong because every case that I see and defend, I have a creative, opportunistic claimant's counsel on the other side who accuses my client of being a fiduciary already. [Laughter]. So, I wonder, as important as the discussion is, I wonder whether, for us on a practical level, this will end up being a tempest in a teapot because in every case that I see, the statement of claim includes an allegation of breach of fiduciary duty. And what I hear routinely in arbitration is the accusation, in opening, as a theme throughout the examination of witnesses, and in closing, that fiduciary duties apply.

Raymond Henney I think that is right, Gary. Again, if the standard of care turns into the new suitability, you know, something akin to the new FINRA suitability rule,[189] I think you are right. There is an opportunity, though, for the SEC to be more rule oriented and more black and white with respect to the standard of conduct, which might change things.

Mark Kowalsky: Ray, how do you factor in the fact that we are now seeing more and more all-public panels, and you do not have somebody in the industry to put this into context?

Joseph Spiegel: And that morphs into Felicia's section, so I am going to let Felicia answer that question. [Laughter].

Felecia Fox: Oh, Ok, Mark.

Joseph Spiegel: Thank you, Mark.

Mark Kowalsky: You are welcome. [Laughter].

Felecia Fox: Ok, so I am going to present to you, this afternoon, some information about the new rule allowing investors to select all-public arbitration panels, and we are also going to give you some information about the public arbitrator pilot program, and that preceded this new rule change. And then I am going to give you some statistics from the pilot and a

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189. FINRA R. 2111.

few statistics that I can give you comparing the current program and the pilot. As a disclaimer, I would like to say that any comments I make today are my own. They are not necessarily those of my colleagues, nor of FINRA. So to start, I am going to give you a few statistics about where we are this year at FINRA. So, case filings decreased in 2010, compared with 2009. In 2010, we had 5,680 cases, which was a 20% decrease compared to 2009.[190] Customer claims decreased by 28% in 2010 compared to 2009. And, through 2011, arbitration filings continued to decrease compared to 2010.[191] That is about a 12% decrease right now. In 2010, to date, over one-third of the cases involved only industry parties, and that is driven mainly by the volume of promissory note cases that we are seeing. And, through August of 2011, customers are receiving damages in approximately 46% of cases that are going through to a hearing.[192] Hearing cases are also closing in 15.8 months, through August of 2011.[193] The top five causes of action that we are seeing in 2011 are breach of fiduciary duty, negligence, misrepresentation, failure to supervise, and breach of contract.[194]

Now, turning to the new rule, on January 31, 2011, the FCC approved a rule change providing investors the option of having an all-public arbitration panel, which greatly increases investor choice in FINRA arbitration. The rule change expands to all investor claims, the core elements of the public arbitrator pilot program that gave investors the opportunity, with certain firms, to have an all-public panel. The pilot program ran from 2008 through January 2011, and fourteen firms agreed to voluntarily submit a set number of cases that did not in-

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190. *Dispute Resolution Statistics*, FINRA (Feb. 17, 2012), http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/.

191. *Id.*

192. *Public Arbitrator Pilot Program Summary Sheet With Interim Results*, FINRA, (Feb. 17, 2012), http://www.finra.org/ArbitrationAndMediation/Arbitration/Rules/RuleGuidance/NoticestoParties/P124054.

193. *Id.*

194. *Dispute Resolution Statistics*, *supra* note 186.

volve an associated person. The rule change applies to all investor disputes involving any firm and includes associated persons. It also applies whether the investor is a claimant or a respondent. It does not apply to cases involving only industry parties. So, under the rule change, FINRA provides customers with the option to choose between two different panel selection methods before we send the list of arbitrators to the parties. One option continues to provide for a panel of one chair qualified arbitrator, one public arbitrator, and one nonpublic arbitrator. And that is what we call the majority public panel option. The new option, under the rule change, allows parties to select an all-public arbitration panel; we call that the all-public panel option. Only customers are allowed to choose the panel selection method. Neither associated persons, nor firms can choose the selection method. Customers can choose the all-public option in their statement of claim, or in the papers accompanying their statement of claim. If they have not done that, FINRA will send them correspondence asking them to make a decision within thirty-five days. If they do not give us a written decision within thirty-five days, it will default to the majority public panel option.

Under either selection option, FINRA will continue to send the parties three lists: one with ten chair qualified names, one with ten public names, and one with ten nonpublic names. The rule change continues to permit each party to strike up to four arbitrators on the chair list and on the public list, leaving at least six names on both of those lists. However, the process for striking arbitrators on the nonpublic list is different, depending on which panel selection process has been selected. So, if the case is proceeding under the all-public panel option for selecting arbitrators, any of the parties can strike up to all the names on the nonpublic list. We will not appoint a nonpublic arbitrator if the parties collectively strike all the names or any of the remaining arbitrators on the nonpublic list are unwilling or unable to serve. If that is the case, we are going to go to the next remaining public arbitrator who is available, or if there are no public arbitrators available, we will go to the chair list. And if there is nobody remaining on the chair list, we are going to randomly appoint a public arbitrator to fill that third spot on the panel. So, by striking all of the arbitrators on the nonpublic list, any party can ensure that the panel will have three public arbitrators.

Now, contrast, if the case is proceeding under the majority public panel option for selecting arbitrators, each separately represented party may exercise up to four strikes from the nonpublic list, and in that case, we are going to appoint the most highly rated nonpublic arbitrator. If there are not any nonpublic arbitrators remaining or able to serve from the list, we are going to randomly appoint another nonpublic arbitrator. So, customers choosing the majority public panel option can ensure that there will be a nonpublic arbitrator on the panel. Now, as for statistical analyses, as of September 22, 2011, customers in 77% of eligible cases have chosen the all-public panel option.[195] This compares to 54% in the pilot program. As of September 22nd, customers choosing the all-public panel option had chosen to rank one or more nonpublic arbitrators on the list in approximately one-third of the cases, and that compares to 49% in the pilot program.[196] Customers in 14% of cases proceeding under the all-public panel option have ranked four or more nonpublic arbitrators, and industry parties have ranked one or more public arbitrators in 98% of cases and ranked four or more nonpublic arbitrators in 91% of cases.[197] It is too early right now to analyze the award results.

To date, we have only had six awards issued by majority public panels and one issued by an all-public panel, so I do not have any data on that for you. Now, as for the Public Arbitrator Pilot Program that ran between October 6, 2008, through January 31, 2011, when the SEC approved the rule

195. *Public Arbitrator Pilot Program Summary Sheet With Interim Results*, *supra* note 188.

196. *Id.*

197. *Id.*

change for the all-public option. So, while the Pilot Program is now closed, FINRA continues to update and evaluate the Pilot Program results according to a number of criteria, including the following: we look at the percentage of eligible investors who chose to participate in the Pilot Program; also the percentage of investors who chose an all-public panel after electing to participate in the pilot program; also the results of Pilot Program and non-pilot program investor cases, including the percentage of settled cases that settled before the award and how quickly they actually settled. We also look at the use of expert witnesses in pilot program and non-pilot program cases; and, of course, award results. We intend to evaluate the new rule change using similar criteria. As of September 22nd, 20% of cases in the Pilot Program are still pending; so, accordingly, the Pilot Program data are not yet complete. We do post an updated detailed summary sheet on our website. Regarding investor election and arbitrator ranking by investors, as of September 22nd, during the Pilot Program period, 54% of eligible cases participated in the pilot. That resulted in 590 total cases. Investors opting into the Pilot, given the power to eliminate all nonpublic arbitrators, still chose to rank one or more nonpublic arbitrators 49% of the time, and this means that in 73% of eligible cases, the investor opted for a nonpublic arbitrator, either by choosing not to participate in the pilot, or by ranking one or more nonpublic arbitrators after opting into the pilot.[198] As for the number of nonpublic arbitrators ranked by investors and firms, as of September 22nd investors in 29% of pilot program cases ranked four or more nonpublic arbitrators.[199] Firms ranked 96% of nonpublic arbitrators in those cases.[200]

Regarding award outcomes, all-public panels in the pilot program cases awarded damages to investors approximately as often as did majority public pan-

198. *Id.*
199. *Id.*
200. *Id.*

els in the pilot.[201] However, pilot program panels, irrespective of the panel composition, awarded damages to investors more often than did majority public panels in non-pilot three arbitrator customer cases. Of note, investors were awarded damages in twenty-four of thirty-six contested pilot program cases, so that is 66% that were decided by all-public panels.[202] Investors were awarded damages in seven of eleven contested pilot program cases, that is 63% that were decided by majority public panels.[203] And that compares to, in 2010, arbitrators awarded damages to investors in 48% of non-pilot three arbitrator cases.[204] So, how did the pilot program cases close? Well, as of September 22nd, pilot program cases were resolved via settlement more often than non-pilot program cases involving three arbitrators. Settlement was reached 82% of the time in pilot program cases with all-public panels and 81% of the time with majority public panels, and that compares to 71% of the time of all three-arbitrator customer cases closed in 2010.[205] Also, fewer pilot program cases concluded by award than non-pilot program cases with three arbitrators, and here we are looking at 13% of pilot program cases with all public panels and 9% of pilot program cases with majority public panels, and that compares to 19% of all customer cases with three arbitrators that were not in the pilot.[206] As for processing time, the pilot program cases with all public panels that went to award took a bit longer compared to non-pilot program three arbitrator cases, and here we are talking 15.5 months compared to 14.6 months.[207] Settlements were about the same in the pilot program as not in the pilot program and expert witnesses did not really factor into all public

201. *Id.*
202. *Id.*
203. *Id.*
204. *Id.*
205. *Id.*
206. *Id.*
207. *Id.*

panel cases. It was about the same usage in non-public panel cases and public panel cases.[208]

Joseph Spiegel: So, there has been a substantial increase in all public selection process?

Felecia Fox: Yes.

Joseph Spiegel: Now, Mark, would you talk a little bit about who can practice in these cases?

Mark Kowalsky: I will, thank you. Good afternoon everyone. I have the responsibility of talking a little bit about something that is very important to practitioners in Michigan and maybe even more important to practitioners outside of Michigan because it relates to who is now eligible to practice in arbitration matters that are taking place in Michigan. You should have in your packet today a copy of a handout which discusses the new rule and some of the complexities of the new rule. As part of this, you will see about six pages in, a checklist of what steps you have to take if you are going to follow the new rule which will be covered as part of my presentation. In very broad summary, Michigan Court Rule 8.126 was amended, effective September 1, to clarify that out-of-state attorneys practicing in arbitration proceedings in Michigan must now move the arbitration panel to be granted temporary admission to practice in Michigan.[209] And I use the word "clarify," and that will come up later, because there is a question as to whether or not this is truly a new rule or simply a clarification of an existing rule. So, what are the basics? What do you need to take away from this presentation? A Michigan attorney must now apply to the arbitration panel on behalf of an out-of-state attorney for temporary admission if that out-of-state attorney wishes to appear in an arbitration proceeding. The second take-away point is that the out-of-state attorney is limited to appearing in five litigation or arbitration matters per year. The third takeaway, and this might relate to why the rule was adopted, is that it creates revenue in that you have to pay a $135 fee to the State of Michigan

208. *Id.*
209. Mich. Ct. R. 8.126.

for the privilege of appearing in a Michigan arbitration. The effective date of the amendment technically was September 1, 2011, and I understand, and Felicia can confirm this, that in new matters now being filed in FINRA, that FINRA will make counsel aware of the fact that Michigan now has this new rule in effect. The Michigan Attorney Grievance Commission plays a significant role in this new process and there is a view from the Attorney Grievance Commission that this, in fact, is not a significant change at all; that it is simply a clarification. In the Commission's view, under previous law and the previous rules, an out-of-state attorney who came into Michigan and practiced law already had the duty to take steps to be admitted. As a result, there is lack of clarity as to the impact of the rule on pending matters. On one hand, you can say that the rule is a new rule and that if your case was pending as of September 1, you do not have to do anything different. And, in fact, you can call up the Commission and pose this question and depending on who answers the phone [laughter], you may, in fact, get that answer. However, if you call and someone else answers, they will say, "No, this is simply a clarification," and even though the case was pending you better immediately, if you are out-of-state counsel, be admitted to practice. This is having a real world application because just within the last two weeks, a FINRA panel, acting on its own, adjourned a matter to allow out-of-state counsel to be admitted.

Joseph Spiegel: Who did they [FINRA] charge the fees to?

Mark Kowalsky: As the last sentence says, "This order is being issued by the panel *sua sponte* and there will be no assessment of cost for this adjournment to any party."[210] So, in this case, just a couple of weeks ago, the panel, on its own, discussed the fact that there was out-of state counsel involved in a matter, they issued an order on Friday, late afternoon, before a Monday hearing, adjourning the matter and attaching for counsel's reference a copy of the new

210. Information available to attendees.

rule and giving the parties thirty days to try to pick a new date. So, if you are involved in matters where there is out-of-state counsel, it is very possible that you will get a similar letter, and you may very well want to seek direction from the panel on an affirmative basis to find out the panel's view. One of the requirements or limitations in this process is that if you are going to apply to be admitted to practice, your application is limited to five times in any 365-day period.[211] In calculating that period, there are some tricks or considerations. It is the granting of admission that is the triggering event. You apply to the panel, the panel grants you admission. If the case settles the next day, let us say you never even file an answer, it is that early in the matter, that still counts against your five time annual limitation. Also, the conclusion of the matter does not impact the calculation of the number of appearances. It is on a rolling basis. You look back in the last 365 days to see how many times in those 365 days have you been admitted to appear in Michigan. Now how is this calculated? Is it an honor system? Well, not really, because the panel, and we will get to this as we get through the checklist, the panel is obligated to send the order of admission to the Commission to allow the Commission to monitor the number of admissions. And now that FINRA is giving notice at least to counsel, there should not be a situation where anyone is ignorant of the rule and that, to the extent the panel does its job and reports back to the Commission, there will be an accurate accounting of how many times within 365 days you have appeared.

Let's review the checklist of how you apply and how you comply with this rule. First of all, you are faced with a situation, if you are out-of-state counsel, how do you proceed? You know you have to come to Michigan; you have an arbitration scheduled. The first thing is that out-of-state counsel must identify and retain Michigan counsel, and there is a question. The case is just filed; you are a

211. Mich. Ct. R. 8.126(A).

New York securities firm. Do you then have to make the decision right out of the box who is going to be the in-house counsel responsible for the matter? You may assign someone and then three months into the case, the case is transferred internally to someone else. You have to start the process over again and now have this new person involved and you must have this new person identified as out-of-state counsel and obtain permission for that person to practice. If you do that, you now have two people using one of their five appearances during the year. Another question that comes up is what is really the practice of law? If you are an out-of-state securities firm, you have in-house counsel assigned but the general counsel is going to come to the hearing and is going to sit there as a representative of the firm. To the extent that in-house opens his or her mouth and advocates a position, is that now practicing law, and does the company representative, who happens to be an attorney also have to comply with the rule? That is an open question. After counsel is identified, I suggest that before you take any further steps there be an informal discussion to verify whether or not out-of-state counsel has appeared within five times. If they have, you might as well identify someone else from the firm who can help out. Again, if it is an out-of-state firm, maybe someone else from the firm can handle this Michigan matter. The first step relates to money. To start the process, there has to be a fee paid to the State Bar and you cannot do anything with respect to applying until you receive confirmation that the State Bar has received and accepted the fee. The rule specifically requires the State Bar to have a three-day turnaround, and, as part of the packet, and also here, you have a sample letter which the State Bar sends out to the person sending in the money acknowledging that the fee has been paid in accordance with the Rules.[212]

Joseph Spiegel: I notice your name is on that, so were you the applying attorney?

212. Mich. Ct. R. 8.126(A)(1)(d).

Mark Kowalsky: In this case, I was applying on behalf of out-of-state counsel.

Joseph Spiegel: Does the claimant's counsel get that, or is that just –

Mark Kowalsky: The claimant's counsel gets it, in that there is a requirement that this letter has to be attached to your motion.[213]

Joseph Spiegel: Ok.

Mark Kowalsky: So, it would be disclosed at that point. You have paid the fee; you can now prepare the pleadings to file. You prepare the required pleadings to file with the forum; they do not go to a court. They go, actually, to FINRA or the applicable forum. You have to file two different documents, one being a motion for admission, the second being an affidavit in support. The motion itself must contain a statement from the Michigan attorney that the attorney has read the second pleading, the out-of-state attorney's affidavit, and that the Michigan attorney has made a reasonable inquiry concerning the statements made in the affidavit and that you believe that the out-of-state attorney's representation are true, and you agree to insure that the procedures of the rule are followed.[214] On paper, that looks pretty simple, and when you type it up and you put it in the motion and sign it, it is pretty simple. But let us take a moment and think about what you are saying when you sign that pleading as a Michigan attorney. What due diligence do you have to do? What responsibility are you opening yourself up? If, in fact, you get the phone call, out-of-state attorney says, "Hi, I have an arbitration coming up. I heard great things about your firm, can you help me with this paperwork?" You draft up the paperwork and you sign it. If, in fact, something in the affidavit is not true, that there is a misstatement regarding disciplinary history or state bar admissions, have you now, as a Michigan attorney, opened yourself up to responsibility? Probably, to some extent, you have, so you have to be very careful about what you sign,

213. Mich. Ct. R. 8.126(A)(1)(a).
214. *Id.*

and not just sign it thinking this is a non-contentious situation.

You have to attach to your motion a certificate of good standing for out-of-state counsel.[215] Those are relatively easy to obtain. Most states now will transmit those by fax or e-mail, and you also have to attach, as Joe mentioned, there is a specific requirement that the motion has to have attached to it the letter from the state bar confirming that the fee has, in fact, been paid. Going back a second to the request to the Grievance Commission, or the communication with the State Bar, there is recognition that there is a short turnaround time, and it appears that they are willing to operate via fax or even e-mail to expedite the process. So, you have prepared the motion, the next document is the affidavit of out-of-state counsel. The affidavit has to state that the out-of-state counsel is familiar with the Rules of Professional Conduct, the Michigan Court Rules, the Michigan Rules of Evidence; it has to list the bar admissions and it has to list disciplinary actions.[216] There, again, is a question in preparing this as to whether you have to have a discussion to make sure out-of-state counsel is aware of the significance of making these representations, and that how you, as Michigan counsel, will have to put your blessing on it.

A question also relates to the logic or the purpose behind a statement that, in fact, you are familiar with the Rules of Evidence. In FINRA arbitration, we know there is a specific rule that the Rules of Evidence do not necessarily apply. But the state requires that you commit that you are knowledgeable of them. I have listed a third pleading here, obviously optional, but to speed the process, you may want to prepare a proposed order granting admission so it goes quicker. So, once you have prepared these two pleadings; what do you do with them? The Michigan attorney, not out-of-state counsel, the Michigan attorney must file it directly with the

215. *Id.*
216. Mich. Ct. R. 8.126(A)(1)(a)(i)-(iv).

forum and you must send a copy at the same time to the Michigan Attorney Grievance Commission.[217] Again, I understand that they will accept it via e-mail. The next step as far as the checklist, you have submitted these pleadings. Sometimes time is short, you want to make sure things do not get lost. I recommend that you verify with the Commission that it has received the material, and that it is, in fact, processing that material. And the rule gives the Commission a seven-day turnaround to process, and either accept or reject this application.[218]

Here is a letter from a few weeks ago in which the Commission is sending directly to FINRA, and the Commission has to provide this directly to the forum. And it is a letter to Patrick Walsh, which acknowledges that it has received the motion, and that the required fee has been paid, and that the out-of-state attorney has not been admitted *pro hoc* previously in Michigan more than the five times. And it concludes that the court, which is inaccurate because it is not a court, it is the forum, but the form letter says court, the court has advised that it is to provide the Commission with a copy of its order granting or denying the motion upon entry of the order.

So, let us take a step back and think about this process and what it means that we have submitted this to the Attorney Grievance Commission? We know that you are required, as part of this, to submit an affidavit that list the disciplinary actions, if there are any, of out-of-state counsel. An open question is when the Grievance Commission receives this, does it simply do the math and the arithmetic to see if this person appeared five times? Or does the Commission look at the disciplinary history and say, "Boy, this guy was sanctioned in New York previously; this person was suspended in Florida." Will the Grievance Commission say, "This guy has never appeared in Michigan and we want to keep it that way? We are going to reject it."

217. Mich. Ct. R. 8.126(A)(1)(b).

218. *Id.*

We do not know if they are going to look at that. If they do look at that, is there a due process element that the out-of-state Attorney can challenge it and say, "It was a mistake, it was overturned, these are the things they have done to address the disciplinary history?" It is unclear, but certainly, there has to be a reason as to why the out-of-state counsel has to disclose his or her disciplinary history. Now we have opened up a new question as to what the Grievance Commission is going to do with this information, and what happens if a problem does develop. The rule is very specific that the panel can grant the motion only after it receives confirmation of compliance with the rule from the Commission. Again, you have seen the letter from Mr. Walsh acknowledging that the Commission did, in that case, promptly send something to FINRA.

The next item on the checklist is that, once you send the material to FINRA, you want to make sure FINRA recognizes that this is a motion that should be considered on a timely basis. It is probably important to send a follow up email or to call the person at FINRA to confirm they have received the motion, it is being processed, and that is has been sent to the panel for a decision. The last item, as part of the checklist, is to, and I recommend that you verify that, in fact, FINRA, who has the responsibility, notifies the Commission that it has either entered an order approving the admission or rejecting a request for an order. Let me explain why you want to do that because I can tell you from personal experience that the Commission keeps a log of matters in which they have approved a person's qualifications, to check against whether or not a court or a tribunal has, in fact, allowed this person to practice. I was involved in a situation with out-of-state Counsel. We went through the process, the person was granted temporary admission, but, for whatever reason, the Commission was never notified of that by the Tribunal as was required. I, as the in-state counsel who requested this, got a pretty nasty letter from the Grievance Commission saying, "Tell us what is going on here, there was an obligation that we be advised of whether or not this person was admitted." It was not necessarily a show cause, but it was pretty close to that, that you better tell us right away, so we can document whether or not this person has been admitted." So that onus is clearly on FINRA to advise the Grievance Commission as to what happens with the motion, but for your own self-interest, I would include that on the checklist to make sure that the Grievance Commission, in fact, receives the order.

Now, the last thing I have here is, "It has been granted, go ahead and arbitrate!" But the analysis really does not end there because there is another open question that, especially in view of the fact that as Michigan counsel you made certain statements and representations, you should understand what the Tribunal's expectation as to what, if any, role you should have going forward. Is it simply enough for in-state counsel to move to have the order entered and then disappear from the process? Should you go to the first hearing to introduce yourself as the person who has moved to have out-of-state counsel admitted? Do you have an obligation to stay for a longer part of the hearing? I do not think that has be fleshed out, every panel might have a different view on it, but at least keep in mind that by taking the lead, by agreeing to help out-of-state attorneys through this process, you may have some ongoing responsibilities.

Joseph Spiegel: I have a question for Felicia. When someone sends in their letter with their statement of claim and they ask that it be held in Indiana, as opposed to Michigan, how does that process work? In other words, you have border counsel, counsel say in Ohio. He has a number of cases, these cases all are assigned to Michigan, how is it that you are now essentially, possibly, illuminating that foreign attorney, i.e. an Ohio Attorney, from practicing in Michigan? Does that attorney have a right to have it heard in Cleveland or Indianapolis, even though you have no facilities there? I do not know the answer. Mr. Pozza?

Clarence Pozza: I say erect a wall between Michigan and Indiana. [Laughter]. No, this is new. In fact, Paul and I had a case this week and in the adjacent room were lawyers from Minneapolis and Washington that we went through this process with and I did not know there were so many open questions. I am a little worried about what we signed. [Laughter]. I know Robert Mauraghet is here, and he signed some papers. [Laughter]. There is a lot going on. This is a fairly, intricate process.

Anthony Trogan: Felicia, I think Joe caught you flat footed. The question is, if you are a Toledo attorney, with a Toledo client, suing a Toledo broker in FINRA arbitration because Detroit is closer to Toledo than whatever your Ohio location is, the case will be assigned routinely to the Detroit area for the arbitration hearing. Mr. Pozza and I have done this before and we have tried to pick, successfully, the location of where we wanted the case to be heard. I suppose you could say, when you start the case "I want the case to be heard in Cleveland or Cincinnati or wherever it is, but what do you do if you are that Ohio lawyer and you are halfway through that case? You have a Michigan panel.

Audience Member: Where is the arbitration?

Anthony Trogan: Here [in Michigan].

Felicia Fox: Is there not an issue of federal preemption? I mean, it would be one thing if you were arbitrating a construction dispute, or something like that, but this is a federal agency. To me this rule would not apply in federal court.

Mark Kowalsky: I have an answer to that.

Joseph Spiegel Federal rules specifically state that the laws of the particular States, herein, as far as practicing law, applies. FINRA takes a total hand[s] off approach to who can practice law within the borders of this State. It is up to the ethical rules and the bar association of each individual state.

Mark Kowalsky: I can add to that because a number of years ago in California, California adopted provisions of who was eligible to sit as arbitrators. At that time, I think it was the NASD[219] still, and the NASD challenged that and said exactly what you [Felicia] said, "federal preemption – you cannot tell us who will be arbitrators," and FINRA ultimately prevailed on

219. National Association of Securities Dealers.

that. California had to change or exclude those rules. However, in this situation, because there was a test situation in Florida and some other states who have tried this earlier, I did check with FINRA's general counsel office, and FINRA is taking the position that they are not going to try to challenge this procedure.

Joseph Spiegel: One other quick question, what is FINRA going to tell its arbitrators about this, if anything, in training? In other words, what are you going to tell the arbitrators?

Felicia Fox: We are going to tell the arbitrators to listen to the party's arguments and make a decision.

Joseph Spiegel: So, you are not going to take a position? You are not going to say anything? You are not going to tell them about the procedures, other than sending out the letter?

Felicia Fox: Right, we are not interpreting the rules. We are not enforcing Michigan's rules. It is the practitioners who are going to need to educate the arbitrators as to what the rules are, and it is your licenses that you are worried about. So, you are going to have to make those arguments to the panel.

Anthony Trogan: My next question, Mark, what is my obligation?

Mark Kowalsky: We know our obligations. As attorneys, if we see the rule being violated, we have self-reporting obligations.

Anthony Trogan: If I appear at a hearing and the panel, probably consisting of two lawyers and someone else, says, "Mr. Trogan you are wrong, we are not obligated to do anything. We are not going to issue an order, and the hearing will now proceed." What is my obligation? Do I get up and walk out? Do I argue with the panel? Do I try the case and then grieve the attorney who has not been admitted or do I grieve the panel? What do I do? Do I grieve everyone?

Mark Kowalsky: Now is this before or after you hear the result? [Laughter].

Anthony Trogan: That is another issue. [Laughter].

Joseph Spiegel: We are going to leave these open issues open. What I would like to do is move on to another topic and Mr. Pozza is going to talk about something simple that we know about: The Michigan Uniform Securities Act.[220]

Clarence Pozza: Elliot and Joe, great job! Prior speakers, it has been fantastic and I am delighted to be on this panel. This looks like that Senate Committee. [Laughter]. I asked for an hour, and they gave me five minutes, and it is going to be less. Michigan Uniform Securities Act, we handed out this booklet, and separately a case from Judge Rosen. There has not been a lot of case law under the new Act. However, Judge Rosen made a decision, printed September 22, 2011, in the *Perfecting Church* case, where he analyzed [pause]; he referred to the new Act[221] and said, "because of the filing date of this case, the old act applied." [222] I command you to read it, and I have some extra copies here. It really is an excellent example of how a Federal Judge analyzes a State Blue Sky Act claim and the defenses. Judge Rosen, who has written a number of security opinions, is a former partner of mine, and Tom Cox and I think it is really a terrific opinion. For the students in the room, if you really want to see how a Federal Judge and his clerks think through an issue, you really ought to read it; it is a really good opinion. I will not go into the details; he granted a partial summary judgment on behalf of the Church, which had accused an operation of securities fraud under the Act.[223] We also cited in our booklet, Judge Steeh's opinion in the *Retirement System for the City of Detroit vs. UBS case*. [224] The only point in that decision, as of this point, is that he denied remand,[225] and Judge Steeh will keep it in the Federal court.[226] One of the claims in that case is under the Michigan Uniform Securities Act;[227] it is a fairly large case, so you may want to follow it.

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220. MICH. COMP. LAWS ANN. § 451.2101 (West 2002).
221. Perfecting Church v. Royster, Carberry, Goldman & Assoc., Inc., No. 09-CV-13493, 2011 WL 4407439, at *2 (E.D. Mich. 2011).
222. *Id*.
223. *Id*. at *7.
224. Gen. Ret. Sys. of Detroit v. UBS, 799 F. Supp. 2d 749 (E.D. Mich. 2011).
225. *Id*. at 753.
226. *Id*.
227. *Id*. at 756.

Joseph Spiegel: Was it filed under the new Act?

Clarence Pozza: Well, it was filed in 2010, so it was filled under the new Act.[228] The other cases are from other states. A Kansas case on the Uniform Securities Act and their defamation and privilege provision is in there for you to look at if you are interested.[229] There is a Colorado case on whether various federal laws preempt the Colorado Uniform Securities Act.[230] Then, there is the *Risdall* case,[231] which is about a violation of state registration under Minnesota's Blue Sky Act. I get a kick out of *Risdall*. I have seen this over the years. A lot of the Blue Sky Act cases are somewhat hilarious with respect to the parties because you have folks who are selling securities non-registered and they have great names. This one was Funeral.com, which claimed it was exempt under Regulation D of the Securities Act of 1933.[232] Contemplate Funeral.com. After we pass away, we convey our spirit through the internet. [Laughter]. Anyway, [Laughter]. Funeral.Com is in the Blue Sky Act case, you may really want to look at it and it really is an exemption case. It is a nice, little discussion of state security regulation verses federal exemption, if you want to see it. So, that is what we have. The last comment, Joe and I have talked about for years. Back in the 1970s, 10-B and Michigan Uniform Securities Act cases were very common because almost all of the litigation was in court, State or Federal Court. Once FINRA got involved, NASD Arbitration was affirmed. Most of it has gone into arbitration, so you do not see many published decisions now, unless somehow there is not an arbitration agreement. So, a lot of the law, in many ways, has stopped in terms of court development. However, the Uniform Securities Act is still out there, even with Dodd-Frank[233] and everything else. I do urge that you read Judge Rosen's opinion

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228. *Id*. at 749.
229. Information available to attendees
230. Information available to attendees
231. Risdall v. Brown-Wilbert, Inc., 753 N.W.2d 723, 725 (Minn. 2008).
232. *Id*. at 727.
233. Dodd-Frank Wall Street Reform Act § 913.

and follow the *UBS Retirement System* case.[234] It is a large one; I think Judge Steeh will end up writing a fair amount on it. Also, Eric has a Michigan, Michigan State tie on.

Eric Richards It is just a Michigan State tie.

Clarence Pozza: Almost time to think about football. My son is a Michigan State graduate, he and I are going to have dinner in about an hour, and we will debate the merits of two institutions. [Laughter].

Joseph Spiegel: Eric, given your Michigan State tie, can you tell us a little bit about "trading away?"

Eric Richards: Thank you Joe, and thank you, Elliot. Yes, I am a proud Spartan. My name is Eric Richards and I am with the law firm Mika, Meyers, Beckett & Jones out of Grand Rapids, Michigan. I specialize in securities arbitration and it is a real honor to be on this panel. These folks are top-notch here. If you recall, I spoke last year and we did a skit, and I was the guy with the bald wig. Joe asked me to have appropriate headwear for today and I really could not decide which of my favorite hats to wear. I was going to wear this one, [Detroit Tigers cap] which is one of my favorites. Then, I thought, well, maybe this one [MSU cap], because it kind of matches my tie. [Laughter].

Clarence Pozza: I like that. I like that. [Laughter].

Eric Richards: Well, and then I thought, "I will bring this one along [U of M cap]. I do not really have that much use for it. I prefer to be associated with a winning team." [Laughter]. But it occurred to me I could use it as a prop. I do not have a "magic lantern show and tell," but I am going to try and illustrate the arguments of a selling away case in a one-man skit in five minutes or less. It is a two-act skit. For those of you that are not familiar with the concept of selling away, a registered representative of a broker-dealer is only allowed to sell specific investments that have been pre-approved by the firm. So, the question becomes, what happens when you have a rogue broker who is running a Ponzi scheme on the side, unbeknownst to the broker-dealer firm? And there

234. Gen. Ret. Sys. of Detroit v. UBS, 799 F. Supp. 2d 749 (E.D. Mich. 2011).

are two issues: there are regulatory issues and civil liability. On the regulatory side, just two weeks ago, Merrill Lynch got hit for a million dollars by FINRA for failing to detect and prevent a Ponzi scheme that was run by a guy by the name of Bruce Hammond out of San Antonio, Texas.[235] Also, it indicated in the news release that Merrill had fully compensated all the victims, even though this was a Ponzi scheme that they, the Merrill managers, were not aware of, and that the broker was selling away. So you have got the regulatory side and the civil liability side.

The following skit illustrates the civil liability side. A little old lady, by way of background, gets a million dollars in a wrongful death suit from her husband's death. She walks in with a wheelbarrow, into the bank to deposit it, and the teller says, "Gosh, that is a lot of money. You ought to go see our brand new financial advisor up on the corner, he can help you." So, she wheels the money over there. He says, "Gosh, that is a lot of money. We need to set up a financial account for you." She puts it in the financial account. A week later, he goes and visits her at her house and says, "Jeez, you know, those mutual funds are nice, but I have got this new Christian charity fund that I am starting. You are a good Christian; I am a good Christian. This will all be very Christ-like. Give me the million dollars; it is a donation, and if everything works out you will get two million dollars in six months from now." "Ok," [she says]. So six months come and go; no two million dollars. She then goes to the bank, "Where is my money? Where is my broker?" He is gone; the money's gone. What do you do?

So, what you do is file a claim in FINRA and, although it is difficult now because they have tightened up the rules on dispositive motions, FINRA

235. *See* Bill Singer, *FINRA Hits Merrill Lynch With Historic $1 Million Fine For Circumventing Mandatory Arbitration During Collection of Employee Promissory Notes*, FORBES (Jan. 26, 2012, 9:57 AM), http://www.forbes.com/sites/billsinger/2012/01/26/finra-hits-merrill-lynch-with-historic-1-million-fine-for-circumventing-mandatory-arbitration-during-collection-of-employee-promissory-notes/.

Rule 12504(a)(6)(B) says that "the panel cannot act upon a motion to dismiss a party or claim under paragraph (a) of the rule, unless the panel determines that, (b), the moving party was not associated with the accounts, securities, or conduct at issue."[236] So, representing the good guys, the broker-dealer firm, I am going to move to dismiss on the basis that my broker-dealer firm, as opposed to the no good broker, was not associated with the accounts, securities, or conduct at issue.

Act One: I make my argument to the arbitrators: [acting as respondent broker-dealer's counsel and wearing MSU cap]: "Ladies and gentlemen of the panel, they brought a claim for respondeat superior, claiming my broker-dealer client is responsible, but obviously this Ponzi scheme on the side was all for his own benefit. It was not within the scope of duties, and so you cannot be held liable under classic *respondeat superior*."

[Acting as Claimant's counsel and wearing U of M cap]: "Did I tell you my client was a widow, and she is a really nice lady, and now she is broke." [Laughter].

Broker-dealer firm's counsel [wearing MSU cap]: "Ok. Well, they also argued agency, and they are saying that the broker-dealer firm is liable under some kind of agency theory. Well, there is express agency and apparent agency. Obviously, there is no express agency here because we did not know anything about this crazy Ponzi scheme. We did not approve it, we certainly did not authorize it, and he was not acting as our agent. As far as apparent agency goes, there is nothing to indicate we had anything to do with it. He was doing this on the side, out of his own house, and this was his own deal. This was like he knocked her on the head on the way home from the bank; we had nothing to do with it."

Claimant's counsel [wearing U of M cap]: "My client is a widow [laughter], and she is really nice, and now she is broke." [Laughter].

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236. FINRA R. 12504(a)(6)(B).

Respondent broker-dealer firm's counsel [wearing MSU cap]: "Well, and then they throw out controlling person. And if you know anything about the securities laws, there is controlling person liability, but only for the acts of people that are working as the registered representative, and again it is someone analogous to the *respondeat superior*. This is outside the scope of his duties. This was his own gig, this was his own deal, and this was his own fraud. The broker-dealer firm got no benefit from it, they should not be held liable."

Claimant's counsel [wearing U ofM cap]: "Widow. Nice. Broke." [Laughter].

Respondent broker-dealer firm's counsel [wearing MSU cap]: "All right, last one's negligent supervision. Ok, I agree my client does have a duty to supervise, but under NASD Rule 3010 all they have to do is have reasonable supervisor procedures in writing and follow them, which they did.[237] We had rules against outside business activities. We had reporting requirements. We monitor the emails. We monitor all the correspondence going in and out. We monitor the activity inside the account. There is no way we could have known about this. No red flags. My client was not negligent, and there is no evidence that my client was negligent. So you have to dismiss."

Claimant's counsel [wearing U ofM cap]: "She is a *widow*."

Audience Member: [Participating in the skit]: "The money was gone?"

Eric Richards: Broker-dealer firm's counsel [wearing MSU cap]: "[The] money's gone. The broker's – "

Audience Member: [Participating in the skit:] "You did not know that?"

Eric Richards: Broker-dealer firm's counsel [wearing MSU cap]: No, it was not in our accounts! It never got into the broker-deal[er] account!"

237. NASD R. 3010. (FINRA is currently establishing a consolidated FINRA rulebook. Until the completion of this rule consolidation process, the FINRA rulebook includes NASD Rules (National Association of Securities Dealers). Eventually, the NASD Rules will be entirely eliminated with the consolidated FINRA Rules taking their place. *FINRA Rules*, FINRA, *available at* http://www.finra.org/Industry/Regulation/FINRARules/ (last visited February 6, 2012)).

Audience Member: [Participating in the skit]: "She gave it to you!"

Eric Richards: Broker-dealer firm's counsel [wearing MSU cap]: "Not to me! She g[a]ve it to the rogue broker!"

Audience Member: [Participating in the skit]: "She put it in your . . ."

Eric Richards: Broker-dealer firm's counsel [wearing MSU cap]: "No, no, no! Well, she put it in the bank; it came in, but then it went back into her bank account. We never saw it go to the goofy investment." [Laughter]. So, anyways, [pause].

Claimant's counsel [wearing U of M cap]: "My client is a widow, she is broke, and she is really nice. I rest my case."

Ok. Act One: done. Act Two: Deliberations.

Arbitrator A [wearing U of M cap]: "You know, that poor lady [pause], she is a widow, she is really nice, she is broke. [Pause]. I am from Ann Arbor, I am, you know, kind of a liberal bleeding heart [laughter], and I am with the people that are occupying Wall Street. I am not with those dastardly broker-dealers. We ought to give her a million dollars, plus all of her attorney's fees, and her interest, and punitive damage[s]. I think we ought to give two million dollars."

Arbitrator B [wearing MSU cap]: "Well, I went to Michigan State University. And, you know, they have a pretty rigorous academic program there. [Laughter]. You know, I have a heart too, but I would like to think we follow the law somewhat, and it really would be a gross abuse of due process to award any damages against the broker-dealer firm. The broker – he is the bad guy, and she should sue him. And I understand he might not be collectable, but really that broker-dealer could not have detected this. [They] could not have stopped it."

Chairman of the arbitration panel [wearing Detroit Tiger's cap]:

To claimant's counsel: "You know, you make a good point. I feel bad for the little old lady too."

To broker-dealer counsel: "Yeah, you are right, as a matter of law they really did not prove anything."

"You say she should get two million. You say she should get a million. You know, the ball game starts in five minutes here, and we have to go. What do you say we split the baby – a million bucks?" "Done."

The end. [Applause].

Joseph Spiegel: That is not far from the truth. We are going to follow that with – Mr. Saretsky is going to talk about annuities.

Gary Saretsky: Good afternoon, everyone, I am Gary Saretsky.[238] Given the time of day, I am going to spend three minutes total with my presentation. I was charged with the responsibility of talking about annuities. Picking up on Eric Richards's widow, who we know is really nice, [laughter], she has purchased a variable annuity. What do you need to know? You need to know three words: suitability, suitability, suitability. That is all you need to know. At every stage, given her – this widow's age, her situation in life, her investment experience, her financial situation, her financial needs, her objectives, her risk tolerance, and the intended use for this annuity – these are among the considerations that a good broker would, and should, consider before recommending. There are both, in your packet of materials, PowerPoint and memos that we have prepared on two topics, annuities and on due diligence, and I encourage you to read those.[239] So, with the remainder of my time, as brief as it is, I want to pick up on something that Felecia Fox was talking about because I think that it is absolutely fascinating. The statistics that Felicia mentioned are dizzying. They made me want to take a Xanax, but they are also riveting and fascinating because what the driving point behind this public arbitrator – all public arbitration panel issue seems to revolve around – one core statistic, which Felecia mentioned. And that is that 46% of the time, customers prevail or obtain

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238. Gary Saretsky is a founding shareholder of Saretsky Hart Michaels & Gould PC out of Birmingham, Michigan. His litigation practice is concentrated in the areas of securities, commercial, and employment litigation. Mr. Saretsky has been designated as a Certified Regulatory and Compliance Professional (CRCP) by the FINRA Institute at Wharton, which enables him to consult with, advise, and represent members of the securities and investment advisory industries on compliance and legal matters. *Saretsky, Hart, Michaels, & Gould Attorneys*, SARETSKY.COM, http://www.saretsky.com/who_Bio_GarySaretsky.shtml (last visited February 6, 2012).

239. Information available to attendees.

awards in arbitration. It is an interesting statistic, but I just do not think FINRA should be in the business of caring or legislating what the award patterns should be. And I do not think that FINRA should be in the business of worrying about a target for what the award patterns should be. The target should not be 66%, the target should not be 50%, and the target should not be 46%. There should not be a target. FINRA provides a service for the resolution of disputes, and it should not be in the business of establishing a target. There used to be a time and a day – and many of us in this room are old enough – there used to be a time and a day when having an industry arbitrator on the panel was considered a virtue, that it would help people and parties to better understand the workings of a securities firm. So, what are we dealing with here? Are we dealing with a situation where claimants' attorneys, prominent and successful claimants' attorneys, like Tony Trogan and Joe Spiegel, for example, have the perception that securities arbitration is unfair? I do not think that they think it is unfair. Are there always improvements that can be made to the process? Sure. But I think it is amazing, and I think you should think it is amazing, that FINRA's in the business of telling us as parties, as attorneys, or as arbitrators of what a result should be in a case.

Joseph Spiegel: Felecia, do you want to respond?

Felecia Fox: There was a statistic given, there was no goal given [laughter], there was never – there has never been a goal. [Laughter]. The arbitrator's decide what they decide and it varies in any case, in any year.

Raymond Henney: Felecia, let me come to your defense a little bit. [Laughter]. I know why they keep that statistic. It is because arbitration, particularly consumer arbitration and customer arbitration, has come under such attack by various Congressmen. Ed Markey, in fact, wanted to ban securities arbitration – mandatory security arbitration – and has legislated it several times.[240] I think the effort to keeping the statistics is

240. Ed Markey is a United States Representative serving the Seventh District of Massachusetts. *Directory of Representatives*, U.S.H.R., *available at* http://www.house.gov/representatives (last visited February 6, 2012).

to try to indicate that there is a fairness in the form, or, be it a tool to evaluate fairness; the fairness of arbitration.

Felecia Fox: Thank you, Ray.

Audience Member: Can I make a statement? What about the hurdle of the dispositive motion that you have to go through now? Is that not a part of it?

Raymond Henney: The dispositive motion is – you mean, it has been so watered down now?

Audience Member: Yeah, I mean, they practically beg – tell you not to do it.

Eric Richards: In fact, they go one step further and they say they will penalize you if you bring one.

Audience Member: Yes.

Eric Richards: My case, I think, is one of the very few grounds where you actually can bring one, in a selling away case, where you are literally saying, "Look, the broker-dealer firm had nothing to do with this." But the way I look at it is kind of rough justice in the sense that, "Ok, as a broker-dealer firm respondent, I want to force them to arbitrate because I am scared to death of juries and the cost involved with it. But I recognize that I give up some of my procedural defenses that I might otherwise have if we were to fight it out in federal or state court." And as Rocky says, we do not have those cases that much anymore. So, I kind of view it as a trade-off. But you are right. As a result, a lot of frivolous cases are going to go to a final hearing now that would have otherwise been dismissed before hearing.

Gary Saretsky: What is the customer win rate in court? Anyone know?

Audience Member: Yeah, I can tell you there was a study in 2005 by the Department of Justice, nationwide, about 16,000 cases. For civil tort cases, the rate was about 48%. It is only a single year. If you narrowed it to the subset of non-medical, professional liability, the win rate was about 38%.[241]

Gary Saretsky: And FINRA with its existing roles was at 46%.

Audience Member: Felecia, if they are not going for a target, what is the purpose of having an all public panel versus a

241. Editor unable to verify this information.

majority panel if they are not trying to change the result?

Felecia Fox: FINRA is not trying to change any results. Its arbitrators are independent. However, we are giving customers, who perceive there is a bias in the forum, an option of different ways to go. Not necessarily the results would be different either way, but now there is an option that they have. They can – even if in the option, if they opt into an all-public panel – they can look at that industry list and decide, "This list looks good; I want an industry arbitrator on my panel." So, it is just another option to help with the perception of fairness and give the customer what they might want to see.

Audience Member: Is it not almost like peremptory challenges? Not because the jury will be fair, but because each side believes the jury is fair.

Mark Kowalsky: The reason you use your strike, in my view, is to get rid of someone who does not belong in the array at all. That is the only reason you use it. And when you elect the public option what you get to do is what we used to be able to do way back, which is strike everybody. And I always used to look at the list, and if I got fifteen horrible selections, I was as happy as a clam because I could strike them all and get rid of all the people or most of the people in the Detroit array who should not have been on the panels in the first place. And then I was left with one to six other rankings of people who were, eh, in the ballpark. I was happy with them. A fair panel, but I did not have a stacked deck against me. So you want that strike. And if I could have a complete section strike for everybody, I would love it. I would never use it, and I do not use it when I have the all-public when I get to strike all the industry people. I have never used ten strikes, but I want to get rid of the ones that should not be there in the first place.

Joseph Spiegel: What this means is it is more of an art than it is a science. In fact, the arbitration process, as I have always said, is more of an art than a science. It is twenty to five. We have run a little bit longer, but this is a great panel. This is a terrific panel. [Applause].

Elliot Spoon: Folks, thank you. This is the last panel. This is the end of our program. I want to thank you all very much for attending, and we will see you next year.