National Regulatory Service
Fall Investment Adviser and Broker-Dealer Compliance Conference
September 9-12, 2001
Arizona Biltmore, Phoenix, Arizona

Managing Regulatory Investigations and Examinations for Cause

by

Paul B. Uhlenhop
Michael Wise
LAWRENCE, KAMIN, SAUNDERS & UHLENHOP, L.L.C.
Chicago, Illinois

National Regulatory Service
Fall Investment Adviser and Broker-Dealer Compliance Conference
September 9-12, 2001
Arizona Biltmore, Phoenix, Arizona

INDEX

NATIONAL REGULATORY SERVICE
FALL INVESTMENT ADVISOR AND BROKER-DEALER
COMPLIANCE CONFERENCE

By: Paul B. Uhlenhop, Esq.*
Michael Wise, Esq.
Lawrence, Kamin, Saunders & Uhlenhop, L.L.C.
Chicago, Illinois

MANAGING REGULATORY INVESTIGATIONS AND EXAMINATIONS FOR CAUSE

I. Introduction

The number of for-cause examinations and investigations by the SEC and self-regulatory organizations ("SROs") and state securities departments ("state") has increased markedly over the last several years and will probably continue to increase. High volume, new products and the market downturn have resulted in an increased number of complaints to regulators resulting in more examinations for cause. It is critically important that broker-dealers or investment advisors recognize when an examination by the SEC, an SRO, or a state is an examination for cause. Equally important is to know how to deal with a for-cause examination or investigation. This outline is intended to detail how the SEC, the SROs and states conduct for-cause examinations and investigations. More importantly, this outline provides practical advice as to how to handle such investigations and what can be done to minimize discovered deficiencies or violations.

II. Sources of For-Cause Investigations

A. General

The sources of for-cause examinations are many and varied, some of which are detailed below. Although in most cases examiners will not disclose their source, review of the sources used by regulators may result, with some accuracy, in a knowledgeable determination of the source. Knowing the source will usually assist in responding to the examination.

B. Routine Examinations That Result In Examinations For Cause

The SEC conducts routine examinations of investment advisors and broker-dealers, as well as oversight examinations of SROs. On a scheduled basis, a broker-dealer's designated examination authority ("DEA"), usually the National Association of Securities Dealers ("NASD"), the New York Stock Exchange ("NYSE") or the Chicago Board Options Exchange ("CBOE"), will conduct a routine examination. Other exchanges or trading markets that are SROs will from time to time conduct separate examinations of trading activities. In most cases, routine examinations are coordinated among the self-regulatory organizations. The DEA conducts the principal examination, sometimes with assistance of one or more of the other SROs that surveil trading and markets in which the broker-dealer participates. As discussed below, the routine examinations by the SEC, the DEA or other SROs provide the basis for and result in a large number of examinations

* Mr. Uhlenhop is a member of the bars of the states of Illinois and of New York. Mr. Wise is a member of the bar of the State of Illinois.

for cause. The NASDR has announced that it will increase examinations of branch offices. *See* Section III B for a discussion as to how to detect when a routine examination has become a for-cause examination.

C. Computer Monitoring of Trading by SROs, Principally Trading Markets, and by the SEC

The SROs and the SEC maintain sophisticated computer systems designed to detect trading anomalies which may indicate insider trading, market manipulation and trading rule infractions, such as front-running, short-selling or position limit violations. Discovered trading anomalies are investigated by the SEC, and in many cases by the SRO for the particular market where the securities are traded.

D. Complaints

The SEC, the SROs, the states, and trading markets receive literally thousands of complaints each year. Furthermore, broker-dealers and their associated persons are required to report complaints to the NASD or to the NYSE. *See, e.g.*, Form U-4, Form B-D, NYSE Rule 351. These complaints are categorized and screened. The SEC and the SROs monitor complaints by computer to determine patterns. A number of complaints regarding a particular office or account executive will usually generate a for-cause examination with respect to that office, the account executive, and/or the broker-dealer. Likewise, if the complaint is with respect to a particular product, such as variable annuities or the recent callable CDs, a for-cause investigation may be undertaken or a firm-wide or industry-wide basis. The NASDR recently announced that it is targeting for cause examinations the trades of brokers with a history of complaints.

E. Referrals From Enforcement Agencies or Other Governmental Agencies

The SEC, the SROs and the states refer complaints to each other depending upon the gravity and nature of the suspected violation. The Commodity Futures Trading Commission ("CFTC"), the commodity futures exchanges, the Federal Reserve Board, the Treasury Department and other financial regulators also regularly make referrals to the SEC. Sometimes agencies may conduct a joint investigation. Whether or not an investigation is joint, agencies often coordinate their investigations. States also make referrals to the SEC and SROs. In case of local problems, the SEC and the SROs regularly make referrals to the states. In many cases, if the conduct is localized, the state will conduct the investigation without the assistance of the SEC or SROs, although many times the federal agencies will track the state investigation or vice versa.

F. Media Reports May Provoke an Investigation For Cause By Any of the Agencies

The SEC, NASD and NYSE staff regularly review a number of financial and other publications for articles of interest and possible violations. Recent examples include the *Wall Street Journal* articles with respect to flipping and other IPO practices. Regulators also are increasingly monitoring the Internet for violative conduct.

G. Filings with the SEC and SROs

The SEC and the SROs review broker-dealer filings, risk assessment reports, 17a-11 notices and various other filings. SROs and states also review filings. These reviews may result in examinations.

H. Informants

Informants have provided the SEC and the other enforcement authorities with a number of major cases. The names of informants are generally protected from disclosure by the SEC and states, but not always by the SROs.

I. Industry and Market Participants' Complaints

Complaints by other broker-dealers and market participants are a significant source of SEC enforcement investigations, particularly in connection with insider trading and manipulation cases. Market makers, specialists and others who are disadvantaged by reason of inside information or manipulation are sometimes the first to notice and to complain. Likewise, in the sales practice area it is increasingly common for broker-dealers or investment advisors to complain about abuses or violations by other industry members that create a perceived competitive disadvantage.

J. Sweeps

Over the last ten years the SEC has conducted a number of sweeps. These are examinations of a number of broker-dealers or investment advisers focusing on a particular issue such as soft dollars, online trading, NASDAQ trading practices or best execution. Likewise, some state regulatory organizations have conducted limited sweeps in particular areas. These sweeps are primarily designed to obtain information with respect to the practices in the market place and how broker-dealers or investment advisers handle certain types of disclosures and other issues. A sweep investigation generally does not involve an in-depth examination for cause, but will result in referral of possible violations to the enforcement division, which will then conduct an investigation for cause.

III. Routine Examinations That Become Enforcement Investigations

A. General

It is difficult to determine when a routine examination by the SEC, an SRO, or a state will become an examination or investigation for cause. However, there are certain hallmarks which signify a shift, discussed in this section. When it appears that an examination has shifted from routine to an examination for cause, it should be handled differently as explained in this outline.

B. Some Hallmarks of a Routine Examination Becoming an Enforcement Examination

1. Who is Conducting the Examination?

It is important to know the organization of the SEC, SROs or states, and particularly whether the individual examiner or investigator is from an enforcement division or branch. If the SEC is conducting an enforcement inquiry, it is usually conducted by the Enforcement Division. Routine and sweep examinations are conducted by the regular audit staffs of the SEC Office of Compliance, Inspections, and Examinations ("OCIE"). However, OCIE may conduct examinations for cause as a result of complaints and then refer the matter to the Enforcement Division.

The SROs also conduct routine examinations. The same SRO staff conducting routine examinations may also conduct examinations for cause. However, when an examination reaches the point where it may result in enforcement activity, usually an examiner or an official from the SRO enforcement section or division is added to the team. Consequently, it is useful to obtain the business cards and titles of investigators and determine their division or section and to whom they report. Generally, the SEC or SRO examiner will identify their office, branch or section.

With state examiners, it is sometimes more difficult to determine if they are enforcement personnel. In the larger states, such as Illinois, the routine examiners are generally separate from the enforcement staff. In most cases, state investigators will identify themselves and to whom they report. If an investigator discloses he is from the U.S. Attorney's office, a state's attorney's office, a sheriff's office, the FBI, Postal Service or the Treasury Department, it is highly likely that the matter is a criminal investigation.

2. Ask

In most instances an examiner, if asked, will disclose whether a routine examination has become an examination for cause. Likewise, at any point in an examination where it appears that the examination is becoming an enforcement investigation or an examination for cause, there is no reason not to ask. While in most cases examiners will tell you, in some cases they will not. While there is no particular guideline, the SROs are less likely to tell you. However, in trading investigations, the market SROs such as the NASD, NYSE, and CBOE will in most cases disclose whether your firm is the subject of an enforcement examination or whether your firm is only a third-party provider of information.

3. Interviews on the Record

If an employee is to be interviewed on the record with a court reporter or a taped interview, it is likely that the matter is an enforcement investigation or an examination for cause. If, prior to the interview, the examiner reads the employee his rights, it should be treated as an enforcement examination.

4. Formal Order and Subpoenas

In SEC investigations and state investigations, if a formal order of investigation is produced or if there is a subpoena or a subpoena duces tecum served, it is likely that the examination is an enforcement matter.

IV. For-Cause Examinations and Enforcement Investigation Procedures

A. General

While this section discusses enforcement procedures of the SEC, the states and the SROs, it does not discuss in detail criminal investigative procedures.

B. Criminal Investigations in General

The federal securities laws and state securities laws generally provide that most violations of such laws or rules thereunder may be prosecuted criminally. The SEC usually conducts investigations to determine whether there are violations and then makes a determination if there are potential criminal violations. If there are such criminal violations, the SEC will refer the matter to the U.S. Attorney's Office, which may prosecute the case with the assistance of the SEC. In some investigations, the SEC may involve the U.S. Attorney's Office early in an investigation. In major market centers such as Chicago and New York, the U.S. Attorney's Office and the local SEC office have a very close liaison. The U.S. Attorney may also use FBI agents, postal inspectors and the grand jury process to obtain documents and testimony. The SEC generally refers for criminal prosecution cases involving insider trading, manipulation, Ponzi schemes, unregistered securities and "hard-core" fraud, such as diverting customer funds or securities for personal benefit. However, the decision as to what will be referred as a criminal matter still remains with the SEC and is a facts and circumstances test. Consequently, lurking in the back of every examination or investigation for cause is the possibility of criminal charges, particularly where there is a significant financial loss or injury.

The possibility of criminal charges also exists in state investigations. In most cases, the states do not prosecute criminal cases except for manipulation, Ponzi schemes, hard-core fraud or the sale of unregistered securities. Depending upon the state, the securities department will make a referral to the local state's attorney or state attorney general only after the case has been completely developed. In other cases, the state securities department may work directly with the state's attorney and the state police in connection with an examination for cause.

As noted above, if at any time an FBI agent, U.S. Attorney, state's attorney, sheriff's police or state police are involved in the examination for cause, it should be treated as a criminal matter. Likewise, if the allegations involve significant financial loss in connection with the sale of unregistered securities, a Ponzi scheme, manipulation, insider trading or hard-core fraud, the matter should presumptively be considered a criminal matter.

C. SEC Enforcement Investigations

1. In General

As explained above, the SEC conducts examination for cause for a number of reasons. In many cases, an examination for cause does not start as an enforcement investigation, but originates as a routine inspection or examination, which may generate a referral to the SEC Enforcement Division, which will conduct a more formal investigation. However, on occasion, the staff conducts both a routine examination and an enforcement investigation as a combined investigation.

The SEC conducts two kinds of investigations, informal and formal. The rules of the SEC regarding investigations are set forth in the SEC Rules of Practice Fed.Sec.L.Rep. CCH [Permanent] ¶ 59,191 *et seq;*. 17 C.F.R. 203 *et seq.*

An informal investigation is generally conducted by the SEC Enforcement Division staff. Each of the SEC regions has an enforcement group usually headed by an associate regional administrator with several branches. Each branch consists of from five to ten investigators, attorneys, and accountants. In Washington, D.C., the Division of Enforcement has a very large staff, some of which are specialized for particular types of investigations. The enforcement staff may be aided by one or more other examiners who may have initially conducted a routine examination or a field examination for cause. Other reasons why non-enforcement personnel of the SEC may participate in an enforcement examination may be expertise in a particular area or past experience dealing with a particular entity or persons under investigation.

2. Informal SEC Inquiries

To determine whether an investigation is informal or formal, the best way is to ask the staff whether there is a formal order of investigation. The staff is required to tell you if it is operating pursuant to an SEC formal order of investigation. *See* Section III C3 below. In an informal inquiry, the SEC does not have the power to subpoena witnesses for testimony or subpoena documents through a subpoena duces tecum. Many investigations start as an informal investigation but become a formal investigation because of the SEC staff's need to obtain documents or testimony from third parties who either will not appear or produce documents.

Inquiries may commence by the SEC staff making a series of telephone calls to employees or customers inquiring about particular transactions or asking for documents. In such case, testimony or production of documents is voluntary. In some cases, the SEC will request that sworn testimony be taken on the record. In other cases, they will request interviews.

If the matter is a more serious matter, the SEC staff almost invariably obtains a formal order and takes testimony on the record, under oath, after reading rights to the individual. In SEC investigations, formal or informal, a transcript may be purchased by the witness in most cases. SEC Rules of Practice Rule 203.7(a); 17 C.F.R. 203.7(a). However, the Commission may, for good cause, deny such request or put limits on its use, but in any event, the witness may inspect the official transcript of his testimony. SEC Rules of Practice Rule 203.6; 17 C.F.R. 203.6. The SEC Rules provide that all witnesses shall be sequestered. In the discretion of

the SEC staff officer conducting the investigation, no other counsel or witness may accompany any other witness during the examination. SEC Rules of Practice Rule 203.7(b); 17C.F.R. 203.7(b).

You should not be lulled into a false sense of security simply because an inquiry is labeled as "informal." The SEC is not required to recast an informal inquiry as a formal investigation, before proceeding to an enforcement recommendation. An informal inquiry can, and often does, result in an enforcement proceeding. *See* Part V, L below.

3. Formal Investigations

A formal investigation is conducted pursuant to an order of investigation issued by the Commission at the request of the staff. The order authorizes designated staff personnel to conduct an investigation into a broadly specified area, to issue subpoenas for the appearance of witnesses and to issue subpoenas duces tecum for production of documents. In order to obtain a formal order, the enforcement staff usually prepares a memorandum to the Commission summarizing the potential violations of the securities laws and the need for the proposed enforcement investigation. Based upon the memorandum, the Commission usually issues a formal order which describes in very broad terms the matter being investigated. The scope of the order does not preclude the staff from expanding its investigation by obtaining an amended order nor as a practical matter does it limit the scope of any subsequent enforcement proceedings.

In a formal investigation witnesses still may testify and produce documents voluntarily. There is some benefit to producing clients or documents voluntarily to demonstrate cooperation, which may or may not, depending on the circumstances, benefit the individual from whom the SEC seeks testimony or documents. As noted above, witnesses may be accompanied by counsel and usually may purchase a transcript. *See* Section V.H. for further details regarding SEC procedures when a witness testifies.

The SEC subpoenas duces tecum generally are very broad, asking for a significant amount of documentation. When the subpoena duces tecum is too broad and presents a significant burden, the staff is usually willing to listen to arguments as to why the subpoena duces tecum should be modified. In most cases, the staff reserves the right to ask for production of all of the documents covered in the original subpoena duces tecum if needed at a later date even though they may not initially require production. In many cases, the staff is receptive to arguments that part of a subpoena duces tecum is burdensome, duplicative or not relevant. Staff members, like you, are pressed for time and appreciate organized information that is not duplicative. With respect to producing documentation, see Section IVG below dealing with handling SEC investigations.

4. Wells Submissions

Upon completion of the investigation, the SEC enforcement staff will prepare a "Recommendation Memorandum" when the staff believes charges should be brought. At about this time, the staff will generally orally inform counsel for potential respondents or defendants of the nature of the charges against them in very broad terms. Under SEC practice (but not as a matter of right), the potential respondent is entitled to make a submission, called a Wells submission, to the Commission explaining why charges should not be brought. *See, William v. Dickinson*, 79 F.R.O. 341 (SD NY 1978). Wells submission content has evolved where a potential respondent now may include discussions of fact, law or policy. It is advisable to bring to the

Commission's attention mitigating circumstances or additional supporting facts. The Wells submission, together with the staff Recommendation Memorandum, is submitted to the Commission. The Commission will then determine, based upon these submissions, whether charges will be issued.

Whether or not to submit a Wells submission may be a difficult question. In most cases, attorneys recommend submitting a Wells submission because the submission may result in no charges or reduced charges. However, a detailed Wells response may have the unwelcome effect of "educating" the staff, and may result in a continued investigation or different charges to avoid potential defenses. While the individual SEC Commissioners may not read all of the Wells submissions, SEC staff in Washington is assigned to read the submissions and bring particular issues to the Commissioners' attention. The Commission occasionally may ask for additional submissions or, in rare situations, ask for an appearance by an attorney representing a respondent to orally answer questions regarding legal issues.

5. Settlement Discussions

When the SEC staff informs potential respondents or their counsel regarding proposed charges, it is important to consider whether or not settlement negotiations should be undertaken. A great number of SEC proceedings are settled at this point. The staff prefers in most cases to present the Commission with proposed charges, together with a representation that the matter will be settled. The staff may or may not raise the subject of settlement, but if it is in the client's interest, little will be lost in exploring settlement during the Wells submission phase. In some cases, when the Commission grants the staff authority to bring charges, the Commission may also suggest to the staff that they consider negotiating a settlement and often may give them parameters for a settlement. In other cases, the staff, once they have the Commission's authorization to bring charges, may itself initiate settlement discussions. If the matter has not settled at this point, Commission charges will be brought and the case will proceed to hearing or trial. Hearing procedures are beyond the scope of this outline.

D. Self-Regulatory Organization Investigative Procedures

The self-regulatory organizations' examination for cause and investigative procedures generally follow those of the SEC, but are somewhat less formal. SRO enforcement staffs do not use orders of investigation and do not have the authority to subpoena third-party witnesses or documents. However, all self-regulatory organizations have provisions in their rules requiring their registered individuals and members to cooperate in any investigation, including furnishing testimony and production of documents. *See, e.g.*, NASD Rule 8210(a). If a member or associated person refuses to testify or produce documents, the SROs generally will seek to bar the member or associated person from membership, resulting in an automatic bar from the securities business. If third-party testimony or documents are needed, the SRO will usually attempt to obtain the documents and testimony voluntarily, or failing that, refer the investigation to the SEC. This means that SRO investigations are largely confined to investigations where customers and others will cooperate and testify, or investigations where the necessary testimony or documents may be obtained from members and associated persons.

Generally, the SROs provide for a Wells type procedure somewhat similar to the SEC's procedure. In some cases, a proposed statement of charges is provided, but other SROs may

provide only an oral or written summary of suspected violations in very broad terms. As in the case of SEC investigations, the SROs often discuss the possibility of settlement at the same time that they discuss possible charges. Today, the practice is generally to provide a summary of charges that the staff proposes to submit to the Business Conduct Committee of the SRO. The person under investigation may respond to the proposed statement of charges in the form of a letter or memorandum which is then submitted to the SRO Business Conduct Committee. In some cases, the response may result in the staff dropping or amending the charges. However, sometimes the response educates the staff as to defects in charges, resulting in different or amended charges. Consequently, the nature of the response needs to be considered carefully.

If a settlement is not reached prior to a statement of charges by an SRO, there is usually an opportunity at a later date under the SRO's rules to submit an offer of settlement to the Business Conduct Committee. In some cases, an offer of settlement may be submitted as a right. In most cases, unless the staff agrees with the offer, an offer of settlement will be rejected by the Business Conduct Committee. Usually the SROs do not permit a memorandum as to why an offer of settlement should be accepted unless the staff concurs with the proposed settlement.

E. State Enforcement Investigations

State enforcement investigations generally follow the SEC and SRO pattern, but vary considerably from state to state. *See, e.g.*, 815 ILCS 5/11. In most states, the enforcement division within the department of securities conducts the investigations. Most state securities laws provide for orders of investigation and provide authority to issue subpoenas for witnesses and subpoenas duces tecum for documents.

The states tend to use less formal procedures with witnesses. State investigators often interview witnesses, although from time to time they take testimony on the record. In all states, a witness is entitled to counsel. In most states, a witness may obtain a copy of the transcript of the testimony of the witness.

In some states, a Wells submission procedure is followed. In most states, notice of proposed charges is provided to the respondent. However, a state may initiate proceedings without giving individuals or registrants an opportunity to comment on proposed charges or submit a response. This often occurs with respect to the sale of unregistered securities or activity by an unregistered broker-dealer or associated person. In such cases, the states may issue cease and desist orders or seek injunctive relief on the theory that the activity must be immediately halted.

Like the SEC and the SROs, many state proceedings are settled, and the state may offer settlement before or after filing charges. In some cases, the state enforcement personnel will negotiate a settlement. In other cases, settlement is offered on a take it or leave it basis. The states also may require certain types of undertakings or contributions to various state funds as part of a settlement. Furthermore, some of the states require and negotiate civil restitution to victims as part of any settlement.

V. Practical Points For Handling For-Cause Examinations and Investigations

A. General

The most important thing in any for-cause examination is to know what is happening and to control it. It is important to know with whom you are dealing and to the best of your ability why they are investigating. Once an examination for cause commences, it is important to stay ahead of the examiners. As soon as possible, the firm should conduct its own investigation in order to surround all the documents and witnesses and to identify the problems and potential violations. This requires a significant amount of work in a very short period of time, but it pays enormous dividends because it will enable a firm to meet the investigation with the appropriate response. If serious problems are immediately apparent, outside counsel should certainly be consulted. It also may be important to consider whether an independent counsel should be retained to conduct an internal investigation of the questionable conduct. *See* Section VI below discussing internal investigations. If there are potential criminal issues, experienced criminal counsel must be consulted at the earliest possible time.

B. Know Who is Doing the Investigation and Why

As explained above, when the investigators arrive, it is important to ask for their identification to determine their position in the regulatory organization. It is reasonable to ask why they are there. Sometimes they will tell you, but in other cases they will not. It is also appropriate to ask if this is an investigation for cause or a routine examination. If it is an investigation for cause, it is also important to ask whether the firm or any of its employees are targets. In most cases, the staff will be unable, or will refuse, to answer that question. However, in some cases they may be able to answer and will answer affirmatively or negatively. In all cases, they will add the caveat that even if the firm or an individual is not now a target, later facts may make the firm or person a target.

In some cases, the firm is asked for documents or witnesses with respect to violations by third parties. In these situations, the SEC, SRO, or state investigators will usually explain that the firm is not a target and that the documents are to be used in the investigation of another party.

C. Prepare a Chronology and Surround the Facts As Soon As Possible

In any examination for cause or regulatory investigation, the facts must be surrounded as soon as possible. This means interviewing potential witnesses, ascertaining what documents are relevant and examining them. A chronology of events should be drafted, summarizing the interviews and describing the relevant documents, whether called for production or not. As documents are produced, they should be incorporated into the chronology. Likewise, as individuals are interviewed or testify, relevant parts of their testimony should be included in the chronology.

The chronology is a necessity for preparing witnesses, but more importantly, the chronology will show additional areas that need to be clarified, documents to be obtained, and other witnesses to be interviewed. The chronology will show inconsistent documents, incorrect statements, and possible gaps in testimony. Most importantly, it will show possible defenses and

good faith business reasons why certain activities were undertaken. More often, it will also show mitigating facts that should be brought to the staff's attention at an appropriate time. If at all possible, a firm needs to conduct its own investigation and prepare its own chronology before the first document or witness is produced. This is sometimes not possible, but it should be an on-going project to surround the facts. *See*, Section VI below regarding Internal Investigations.

D. Appoint a Point Person

The entity under investigation should appoint a coordinator, generally someone who will not be involved personally as a witness. The person should be a relatively senior person in the management of the firm. The point person should be the principal contact with the investigating regulator. All requests for documents or witnesses should flow through that one individual. The individual should have a second person who is available if the primary appointed person is not available.

The primary coordinator should have a thorough knowledge of the company, and its management and philosophy, and be the person who assists in surrounding relevant facts and documents. If outside counsel is used, there should be an in-house coordinator with whom the outside counsel works and who is the principal spokesman for the firm. For small or medium sized firms that do not have adequate internal personnel with the time to coordinate an investigation, the firm must necessarily use outside counsel to fill this role. In investigations pointing to serious questionable conduct, outside counsel should usually be retained for this role.

E. Relations With the Staff

Throughout the investigation, the primary coordinator or the outside counsel should maintain contact with the investigating staff. Such contact will assist in obtaining information about where the investigation is going and why it is going in that direction. Sometimes the staff is fairly candid and in other cases the staff is very closed-mouth. However, by contacting the staff on a regular basis, dealing with the staff in the production of documents and arranging for witnesses, a good deal of information may be obtained.

It is also important to be cordial in order to understand where the staff is coming from and why. Careful interaction with staff will sometimes result in a clearer understanding of the investigation's direction and scope. It is also important to be credible and candid with the staff, and one of the worst things that counsel can do is undermine credibility. If you say you're going to do something, do it. If you need an extension of time, be sure to explain to the staff why in detail.

Sometimes the staff may be unreasonable or take positions that are contrary to the regulatory entity's procedures or guidelines. In such cases, it may be necessary to contact a superior such as the branch chief or an associate director. These contacts must be made diplomatically. In most cases, it is best to inform the staff attorney conducting the investigation that you would like to talk with his branch chief or associate director and arrange a meeting where the investigator is present to discuss the problem. Branch chiefs and associate directors will support their subordinates, but at the same time they know the rules. In many cases, senior staff have been reasonable in correcting mistakes or overreaching by inexperienced junior staff.

F. Stop All On-Going Violations

As soon as a firm becomes aware of possible violations, the questionable activity should cease. The firm should, in writing, direct the immediate cessation of such conduct by all employees engaged in areas where there is likelihood of significant violations or deficiencies. These direction letters must be prepared carefully. Firms should not characterize the conduct as violative or even questionable. Nevertheless, the letter must be clear that the questionable activity must cease. A record should be maintained to show that the questionable activities ceased.

The firm may also need to institute revised supervisory procedures. If necessary, these should be put into effect as soon as possible. There is always the possibility that revised procedures may be used as an admission that earlier procedures were inadequate. However, carefully prepared wording will generally prevent that result. Further, the regulators encourage correction where there are questionable procedures and generally do not use the changed procedures as the basis for charges. Importantly, the cessation of the questionable conduct and the institution of revised supervisory procedures are often mitigating factors that may persuade the staff that it is not worth the regulatory organization's enforcement efforts to pursue the historical violation. In any event, if proceedings are brought, such cessation of activity by the firm will be a mitigating factor which should serve the firm well in settlement negotiations.

G. Document Production

Whether documents are produced voluntarily, pursuant to a subpoena duces tecum or pursuant to an SRO order, it is critically important that the documents be produced carefully and with thought. In SEC and state investigations, the failure to produce or the destruction of documents may involve serious criminal penalties. Failure to conduct a reasonable search may also involve serious penalties. In searching for requested documents, one should document the search that is being undertaken, who is undertaking what search, and the written directions for conducting the search. Furthermore, the directions should specifically state that no documents are to be destroyed. If additional documents are found after a search is conducted, those documents should be immediately produced to the regulator with an explanation as to why the production was delayed.

Retrieved documents should be carefully scrutinized for applicable privileges. All documents that might conceivably be privileged should be examined by an attorney to determine if a privilege should be asserted. In some cases, it may be wise not to assert the privilege; however, the decision as to whether or not to assert the privilege is complex and difficult. Failure to assert the privilege for a document may waive it for all documents dealing with the same subject.

All documents that are to be produced should be sequentially numbered and identified so that if they are later used by the regulator, the firm can identify their origin. A duplicate numbered set of documents should be maintained for all documents produced. The documents should be subject to an indexing or filing system so that they can be easily retrieved. As noted above, relevant documents should be incorporated into a chronology of events including document numbers so that they are easily retrievable.

Often a production request asks for numerous documents. As noted in Section III B3, if there are burdensome or difficult production requests, it is important to sit down with the

examiners to see if you can pare down their request. As noted above, in most cases, if the requests are pared down, the examiner will reserve the right to request additional documents at a later date if needed. The more knowledgeable investigators generally are more precise with their document requests because they know the securities industry and what they need for an enforcement case.

The SEC has rules for handling the production of documents on a confidential basis. All such documents must be marked as confidential. *See,* SEC Rule 200.80; 17 C.F.R. 200.80. The SEC will generally not enter into a confidentiality protective agreement. However, the decision as to whether or not the documents produced to the SEC will be held confidential will be made if and when the documents are requested under the Freedom of Information Act ("FOIA"). The SEC will notify the firm if there is a request for the documents under the FOIA, and at that time the firm may argue as to why they should be held confidential. States and SROs are generally more amenable to a confidentiality agreement.

Although production of documents under a subpoena duces tecum usually will be resolved with the SEC staff by negotiation, if it cannot be resolved, the SEC staff will file a subpoena enforcement action in United States District Court. Alternatively, counsel for a respondent may petition the court to quash a subpoena duces tecum. States generally provide for like proceedings in state courts to enforce or quash subpoenas. *See, e.g.,* 815 ILCS 5/11. As noted above, failure to produce documents to an SRO may result in the bar of the member or the associated person refusing to produce the documents.

H. Witnesses

In formal investigations, testimony will be under oath before a court reporter. As noted above, the SEC staff may request an informal interview without taping, a court reporter or the witness being under oath. In all cases, the witness should be prepared just as if the person was going to testify under oath. With respect to the SEC and states, it is generally a criminal offense to make a false statement (whether under oath or not) to an SEC or state investigator. *See e.g.,* 18 U.S.C. §1621 and 18 U.C.S. §1001. The SEC has been aggressive in pursuing criminal perjury cases when the staff believes that a witness has testified falsely in an investigation. Likewise, a false statement to an SRO investigator may be the basis for a bar or sanctions under the SRO's rules. *See, e.g.,* NASD Rule 8220.

For these reasons, the witness should be prepared with care using a chronology as discussed above. All of the events and documents about which inquiries are expected should be reviewed with a witness before testimony. The witness should be informed and understand that violations of the securities laws may result in criminal penalties, and that the witness has the right to assert the Fifth Amendment privilege against self-incrimination. A thorough explanation of the testimonial procedures, applicable rights and possible ramifications of testimony should be made clear to the witness.

Because self-regulatory organizations may bar someone who doesn't testify, in most cases securities professionals will testify notwithstanding their Fifth Amendment rights. However, if there is a serious insider trading problem or other possible criminal conduct, careful consideration should be given, even in informal interviews, to asserting the privilege against self-incrimination.

The rights of witnesses appearing before the SEC are set forth in a written statement which is provided to counsel and the witness prior to testimony. The rights include the witness's rights under the Fifth Amendment, Wells submission procedures and a variety of other rights. The witness is asked to read the statement before testifying. At testimony, the witness is first sworn by the SEC staff and then is asked to acknowledge that he has read the rights statement and has had the opportunity to confer with counsel regarding its meaning.

If documents are produced before or at the time of testimony, the SEC generally will proceed meticulously through the list of requested documents, followed by the background of the witness and then turn to the witness's substantive testimony. The SEC, as a matter of course, asks witnesses if they discussed the matter or their testimony with anyone other than their counsel. If there has been discussion with other witnesses or other individuals, the SEC then generally will minutely review with whom the witness discussed the matters under investigation and what was said. The SEC staff is always concerned about a conspiracy to commit perjury or otherwise coordinate testimony. Thus, it is usually best to inform a witness at the start of an investigation that the witness should not discuss actual or proposed testimony with anyone other than counsel.

In SEC investigations, the witness may request a copy of his transcript for a fee and should do so. *See* SEC Rule of Practice, Rule 203.6; 17 C.F.R. 203.6. It can often be several months before a transcript is provided. Portions of the transcripts may be garbled because the court reporters are relatively inexperienced and do not understand financial terms. Consequently, the transcript should be read carefully and any corrections noted to the SEC staff. The SEC may request that, as a condition to providing a transcript, the testimony not be shown or provided to any third party. At one time, this was the SEC's general practice. However, today such request is not made except in unusual circumstances. After the interview, the testimony should be integrated into the chronology and the chronology should be again reviewed for missing testimony, inconsistencies between documents and proposed testimony or actual testimony.

I. Counsel and Conflicts

As noted above, the rules of the SEC, SROs and states permit a witness to have his own counsel present during testimony. If the witness's counsel is also counsel to his employer company under investigation, there may be a potential conflict in representing an officer or employee witness. In many cases though, the conflict is not apparent immediately because the interest of the employer company and the employee witness may be parallel with respect to the investigation. If the employee is a target, consideration should be given to the use of separate counsel for the employee since the interest of the employer company and the employee witness may diverge.

It is in the firm's interest that its employees and officers be represented by competent counsel. The employer company must determine whether it will pay for separate counsel because, in many cases, employees will not have the means to hire experienced counsel. In some cases, the employer company advances the money. If the individual is an officer or director, indemnification may be required or permitted under state laws or the by-laws of the entity. In certain cases, directors' and officers' liability insurance may also provide for attorneys' fees for witnesses or potential targets under investigation.

In any serious investigation, it is recommended that employee and officer witnesses have independent counsel because of the potential for conflicts. One benefit is that independent counsel gives the appearance (and in most cases the reality) that the testimony of an employee is not being manipulated by the employer. If counsel proposes to represent both an employee and the employer company, counsel should do so only with the consent of both the company and the employee after disclosing the potential conflicts that may arise. It is recommended that the disclosure and consent be in writing. In some cases, the conflict consents provide that counsel will no longer represent either party in the event a material conflict develops. In some cases, however, the consents provide that the counsel will continue to represent the company if a conflict develops and will no longer represent the employee. If such is the case, the employee must be specifically informed and consent to such arrangement.

At the start of an investigation or examination for cause, counsel must be particularly concerned about conflicts. It is important that counsel not give the appearance to employees that counsel is representing them unless counsel in fact has a signed conflict consent letter. When interviewing employees or officers, counsel must make it very clear that counsel represents the employer company and not the individual employees. If counsel is going to represent the employees, counsel will need to resolve the conflicts that are stated above.

J. Counsel for Other Witnesses and Entities and Defense Counsel Privilege

It is important to know counsel representing each of the targets as well as third-party witnesses. Often it is in the interest of each counsel representing a particular client to obtain information concerning the scope and direction of the investigation. As a result, counsel from time to time will exchange information freely. At other times, it's a bit of a poker game as to what information counsel will exchange with each other. In all cases, there should be an understanding between counsel that information exchanged is subject to the joint defense counsel privilege. *See, e.g.*, United States v. Schwimmer, 892 F.2d 237 (2nd Cir. 1989). It is also important in such exchanges that confidential business information remain only with counsel and be discussed with clients only on a need-to-know basis. In large cases with multiple defendants, there are usually complex joint defense agreements allowing counsel for the parties to exchange information. Joint defense agreements sometimes also include sharing expenses of expert witnesses and sharing lead counsel fees. The detail of such agreements is beyond this outline.

K. Advocate the Client's Case

Throughout the handling of the investigation, mitigating factors should be proactively brought to the attention of the examiner or investigator. To do so, it is important to understand all of the facts as soon as possible in the investigation. Only by doing so will counsel recognize potential mitigating factors. From the beginning of the investigation to the end, it is important to present and advocate the case for no proceeding, or if a proceeding is certain, for a limited proceeding or settlement.

L. Making it Go Away as Painlessly as Possible

1. General

The goal of any investigation from the respondent's standpoint is to assure that no charges are brought by the investigating entity. To do that, one must handle the investigation as aggressively as possible. Many investigations do not result in charges. However, the SEC does not generally open investigations without a reasonable basis. Once an investigation is open, the investigating staff will invest a considerable amount of time and generally will seek charges as an appropriate conclusion, in the staff's view, to the investigation. If the investigation proceeds to the point where charges are certain to be filed, one must determine whether to fight the charges in a long, very expensive proceeding or whether it is time to commence settlement discussions to resolve the dispute and the violations as quickly as possible with the least amount of pain to the organization and to the individuals.

2. Settlement

If one is not able to avoid charges, there is always the possibility that some type of settlement may be negotiated involving an agreement to undertake remedial action but without a formal order or other sanctions. This is particularly true with SROs and in a few cases with the states. The entry of a formal sanctions order presents a number of problems, including disqualifying the entity from a variety of activities under the securities and other financial services laws. *See, e.g.*, SEC Regulation D Rule 507; 17C.F.R. 230.508; 815 ILCS 5/4 F(2)(b)(iii). For that reason, firms try to avoid the entry of a final order or if the order is entered, obtain simultaneously an exemption from the disqualifying provisions under the securities and other financial services laws.

If an order is to be entered, in most cases the SEC, SRO or state will draft a proposed order with findings of fact and conclusions of law. In settling, it is advisable to neither admit nor deny the facts. The proposed findings of facts and conclusion of law in the order should be carefully scrutinized. Many times the findings of fact and conclusions of law in a proposed consent order far exceed what the respondent considers the true violative conduct. In such case, it is important to attempt to negotiate the language of the findings of fact and conclusions of law to eliminate fringe violations or acknowledged non-violations. Further, it is important that the findings of fact are not exaggerated, and most importantly, mitigating circumstances are included. Mitigating factors can be particularly helpful later if the firm is applying for registration in a new jurisdiction, and to avoid parallel state or SRO charges. See the next subsection.

3. Piling On

In any settlement, one must be aware of the possibility of "piling on" violations or proceedings. The SEC, SROs or states which have jurisdiction over an organization or individual may bring a parallel proceeding based on violations of their own rules for the same conduct. Most often, violative conduct will violate the laws and rules at the federal level, at the state level and with multiple SROs. Any one or all of these entities may bring a proceeding and seek sanctions and fines for the same conduct. The sanctions imposed by one regulator will not always be considered by another regulator in imposing its own sanctions.

The most concern arises where the business operates in all fifty states. If there is an SEC or SRO settlement, the states will, in many cases, bring parallel proceedings. When settling with one regulator, one should try to settle everything in one settlement. Unfortunately, often this may not be possible.

4. Sanctions

Sanctions are always part of an order. The mildest sanction is a censure. The SEC and states have the authority to:

a) bar permanently from the business or suspend for a period of time;

b) impose civil penalties;

c) enter cease and desist orders;

d) seek required restitution for victims; and

e) obtain injunctive relief.

See, e.g., Securities Exchange Act of 1934, §§ 15, 20, 20A and 21, 21A, 21B and 21C; ILCS 815 5/11. The self-regulatory organizations have similar powers with the exception of injunctive relief. The scope of sanctions generally are negotiated in connection with a settlement. Generally, the regulators often will trade time out of the business for fines and vice versa. However, in the recent past, regulators have shown an unwillingness to trade all time off for fines. Consequently, it is likely that some time off will be required.

Counsel for the respondent should be imaginative with respect to suggesting remedies other than statutory sanctions. Remedial undertakings are often suggested by counsel as part of a settlement. Although undertakings are not part of the statutory sanctions, counsel may offer undertakings as part of a settlement. For example, a firm may volunteer to have an outside third party review the firm's supervisory procedures, and make revisions. Another remedial undertaking is to establish a restitution fund administered by a third party.

Any undertaking which promotes future compliance with the securities laws is a possible remedy to offer in settlement discussions. For large and medium sized broker-dealers and investment advisors, the staff seems to be particularly amenable to these types of undertakings. Counsel should be proactive with the client in developing undertakings. Sometimes these undertakings can be quite expensive, but in most cases they are little more than good business practices that the business should have in place. Importantly, they will usually reduce the sanctions.

M. Adverse Publicity

In any investigation, adverse publicity is a concern, even though SEC investigations are almost always non-public. *See*, SEC Rules of Practice, Rule 203.5, 17 C.F.R. 203.5 The SEC generally will not comment as a matter of policy on any on-going investigation. Nevertheless, the press often finds out about investigations from third-party witnesses or talk in the trade.

If the SEC or a state must go to court to enforce a subpoena, then the proceedings will become public. Public disclosure is always a consideration in whether to resist a subpoena or subpoena duces tecum. If a third party resists a subpoena causing the SEC to go to court, public disclosure is also possible.

State and SRO investigations are usually private, but news may leak out. In some states, investigations are not handled with a great deal of confidentiality and leaks are a possibility. The firm should be prepared to respond to the press and any adverse publicity. The firm should have only one spokesperson, and employees should be cautioned not to comment to the press or other persons. It is generally wise to not comment except to say that the firm is cooperating with the SEC, SRO or state, provided such is true.

VI. Internal Investigations

Internal investigations are used in connection with various types of problems and for various purposes. If a firm detects possible questionable practices prior to a regulatory examination, many firms will conduct an internal investigation using independent outside counsel. Internal investigations may also be used parallel with an SEC or other regulatory investigation. In such cases, the firm may have independent counsel conduct an investigation without the knowledge of the regulator. In other cases, the firm will conduct the internal investigation with the knowledge and acquiescence of the regulator.

The purpose of the investigation is to uncover any questionable practices within the firm, and in most cases the independent investigator will also be retained to recommend possible changes in the company's procedures, possible termination or sanctioning of employees and possible restitution to customers and others.

Internal investigations should be conducted by counsel that generally has not represented the firm in the past and is completely independent. Counsel conducts the investigation on behalf of the firm with the cooperation of the firm. The firm makes available its employees and documents as requested by counsel and in some cases arranges for interviews or testimony by third parties. Counsel conducts interviews sometimes on the record, sometimes not, of employees and others, and where possible third party witnesses, customers or others. Often counsel is assisted by forensic accountants where there are accounting or operational issues.

Since counsel represents the company, company counsel must be careful when interviewing employees or officers to point out the potential conflicts, that information disclosed might be used as part of its report which may, under certain circumstances, be disclosed to regulatory authorities. *See*, Section VI.J above for further discussion. Counsel, particularly if the matter has not come to the attention of the SEC, should maintain a privilege with respect to the investigation so that it need not be turned over to regulators. The attorney-client privilege, the work product privilege and the self-evaluation privilege may be claimed. *See, e.g.*, Upjohn v. United States, 449 U.S. 383 (1981) (attorney-client); Hickman v. Taylor, 329 U.S. 495 (1947) (work product); In re Solomon Bros., 1992 WL 350762 (S.D.N.Y. 1992) (self-evaluation).

Whether or not a written report of the investigation should be prepared is a difficult question because the report may reveal violations. In some cases where the regulator was not

aware of the questionable practices or violations, the firm may consider presenting a written internal investigation report to the regulator. In such case, the company will argue that no sanctions should be imposed because the firm discovered the violations, imposed sanctions on the wayward employees and took all appropriate corrective action. In some cases, the regulator might take no action against the firm or senior officials, although it may take action against the actual perpetrators or violators.

Similarly, in connection with an internal investigation where the SEC has an on-going investigation, the internal report may be used for the same purpose. However, turning the report over to regulators must be carefully considered, because the report may be a road map to violations. The advantage of providing the report is that often the investigation and report may result in the regulatory organization imposing lesser or no penalties, particularly on senior officials who are not directly involved in the questionable activities.