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MIDWEST SECURITIES LAW INSTITUTE TRANSCRIPT, FALL 2014

BEGIN WELCOME, INTRODUCTION & SUMMARY OF EVENTS

Elliot A. Spoon
Good morning, everyone. My name is Elliot Spoon, and I am a professor at MSU Law and I want to welcome you to the 2014 edition of the Midwest Securities Law Institute. And to kick off this Institute today, I am very proud to introduce to you our Dean, Joan Howarth.

[Applause]

Dean Joan W. Howarth
Thank you. Thank you, Elliot. At MSU Law, one of the rituals of the Autumn season is the gathering that you are all a part of, and I know it's October and I know it's football season when I am surrounded by friends from the S.E.C. and from the leading law firms in Michigan and the Midwest. And we are here ready to spend a day talking about the cutting edge issues related to securities law. So, I really want to welcome you, as Elliot said. I want to thank Joe Spiegel, of course, our long-time partner in producing this event. And I also want to welcome Ray Henney to his role as the Co-Chair of this event. And I want to say one thing. And that is: it's a great opportunity for our students to be in the same room with all of you, and I hope that you will all take some time to have at least a short conversation at some point with one of the students who will be here with you all today. They are mainly from our Journal of Business and Securities Law, which means that they are very interested in the work that absolutely every one of you does. And they are also very interested in someday being in the positions that all of you occupy. And as everybody who is not asleep understands, this is a really challenging time for law students and for new attorneys coming into our profession. So, what you should know about absolutely everybody who's here is, not only are they talented – these are very talented students who are interested – but they are also investing in themselves and investing in our profession at a time when there are other folks who are turning away in droves. So I would just – I just want to share with you that the privilege for Elliot Spoon and Ben Edwards, who is also here, and me and all of us on our faculty here is to be inspired by the future of our profession every

day in our work, and I hope that some of that will also be part of what you get out of today as well as the expertise and the information and the community that you all have from being part of this event.

As I said, we are very proud to have this long-established – it's almost like a kind of a gathering of a tribe of people who have interests that not all that many in the rest of the world perhaps share. But we are very pleased to be able to give you an opportunity to be able to be together, to work together, to learn together, and to move forward to know more about what your work is and where the future is at the end of the day than you know now. And to have renewed some relationships with important colleagues and, potentially, new members of the profession as well. Elliot will, you know, those of you who this is not your first time know, Elliot is a very gracious host. All of us want to make sure – anybody from MSU Law who you see if you have any questions, if you need anything at any point while you are here, we want you to be as comfortable as possible and to really be able to get to what I hope is actually the joy of the work together that you have ahead of you today. So, thank you very much and welcome.

[Applause]

Elliot A. Spoon
Speaking of students, I would like two of our student leaders to come up and be recognized. Ashley and Mike, you can come on up.

Ashley [Byers] is the Editor-in-Chief of the Journal of Business and Securities Law, a journal that was begun within the last decade and the latest journal to be officially recognized by the Law School, and it has become a very prominent journal in a short period of time, being cited by courts across this country. Incidentally, any of you who are interested in publishing a piece about securities law, we would certainly be interested in talking to you about it. Mike Hinel is the president of the Business Law Society. And Mike is also one of many students in our school who are joint J.D./M.B.A. students. These days, in light of the job situation, which many of you are aware of and I know all too well, it is one of the strategies of students, of course to broaden their possible job opportunities by gathering additional expertise while they are in law school and, in this case, Mike made a decision to get an M.B.A. So we have many many [*sic*] students who are interested in this topic and these two student leaders have helped us a great deal in putting this Institute together, which required a lot of work and I would like to recognize them now.

[Applause]

And I want to second what Joan had said. I have to step back in front of the microphone because I'm reminded that we are recording this as we do every year. And if I'm not in front of the microphone, it will not pick up my golden words. There are, as the Dean noted, there are many students here and they will be in and out during the day. They are a little bit shy, even though we encourage them to interact with you. So I'm going to ask you, and particularly during the lunch hour, to take the initiative, those of you who are already lawyers, and talk to them. I think that they will benefit a great deal from even brief exchanges with you.

Now, without further ado and before we get to our first panel, I would like to introduce my Co-Chair for many years. This Institute has been at MSU for the last ten years, and for many years prior to that it was run by Joe Spiegel and I would like to introduce him now to you. Joe.

[Applause]

Joseph H. Spiegel
This is my last year as the Co-Chair. I have turned it over to Mr. Henney, who is going to do a wonderful wonderful [*sic*] job. I see out here people I have known for thirty years and this Institute has been going for about twenty-seven or twenty-eight. I know Mr. Hubbard first attended one of these Institutes in 1987. One of the traditions of this program is for me to make a small introduction to sort of set the tone for this program for this year. It will be up to Mr. Henney to continue on with this tradition.

This year's introduction contains a few F-bombs, but I think given the fact that over the last, unfortunately, two years there has been a lot of developments. As you are aware, we could not hold the program last year because the government shut down. Thank goodness the government has not shut down again. As you are also aware, there has been dramatic changes over the last two years. So we have to squeeze into this program two years of materials in one day and it's fairly intense. We are all aware of some of the high profile matters. And over the last twenty-five or thirty years, I've always wondered how to explain what a stockbroker does so I decided that I would show - if I can get this to go - what I consider to be a wonderful explanation of how stockbrokers work.

[Inaudible]

[Video clip from THE WOLF OF WALL STREET (Paramount Pictures 2013).]

[Laughter]

This is probably one of the best explanations of what stockbrokers do. Now, I know that Mr. Saretsky and Mr. Hubbard and Mr. Henney would take exception to that. And I understand because there is two sides to the story, but what you are going to hear today, both in the morning and the afternoon, is how we, as attorneys, and how the S.E.C. and how the State of Michigan, how do they deal with these sorts of issues. So, without further ado I am going to turn this over to Mr. Henney and welcome, Mr. Henney.

Raymond W. Henney
Thank you so much.

Joseph H. Spiegel
I am passing this torch to you.

END WELCOME, INTRODUCTION & SUMMARY OF EVENTS

BEGIN DEVELOPMENTS IN BROKER-DEALER AND INVESTMENT ADVISER REGULATION

Elliot Spoon
The first panel, of course, is the developments in broker dealer investment advisor regulation. With us today is Akrivi Mazarakis from the SEC, Kris Easter Guidroz from the SEC, Shane Hansen from Warner Norcross, and of course Ray Henney from Honnigman and Miller.

Ray Henney
For this panel, Shane Hansen, on my left, will be the person who will be sort of moderating, and we're very excited to have these two individuals from the SEC, who will give us some very practical and helpful insights as to the examination process and the priorities. Those of you who are

associated with, or advise, investment advisers or broker dealers will be particularly interested in what they have to say.

Shane Hansen
Well thank you Ray, and I'd like to echo the thanks to Kris and Akrivi for joining us this morning, traveling to East Lansing, and sharing with us some developments in their areas, and I'll turn it over to you if you like to kind of start out with the standard SEC disclaimer, and take it from there. You're welcome to either sit or stand, it's up to you, whichever you would like.

Akrivi Mazarakis
All right, I can stay here. Good morning everyone. I'm really happy to be here this morning with you. I have heard nothing but good things about this conference from colleagues at the SEC that have attended and presented here in years past, so I'm really excited to join you all today. The standard disclaimer that I should start off with is that the views that I'm going to be expressing here today and that Kris will be expressing here today as well, are our own views. They're not the views of the Commission, the Commissioners, or any of our colleagues at the Commission. I should also give you another disclaimer, which is that I am Greek and I use my hands a lot. So, you'll see those hands probably quite a bit during the next hour. I'll start off with a little bit of background about the Office of Compliance, Inspections, and Examinations. You'll also hear me refer to it as OCIE or the National Exam Program throughout the presentation. The national exam program or OCIE, has examiners all over the country. We have about 900 examiners located in D.C. and in the regional offices. We are a risk-based program. We conduct exams of various regulated entities, and we're broken up into different subgroups that reflect the entities that we examine. For example, the Office of Broker Dealer Exams examines broker dealers; the Office of Investment Adviser and Investment Company Exams examines investment advisers and investment companies; the Office of Market Oversight is responsible for examining FINRA and the exchanges, MSRB, and SIPC; and the Office of Clearance and Settlement, as you might imagine, examines clearing agencies and transfer agents. Next, I'll provide a few statistics. We are responsible for examining about 11,000 investment advisers, over 400 transfer agents, about 18 securities exchanges, and over 4,400 broker dealers. There are also about 1,000 Municipal Advisors and 7 registered

clearing agencies that OCIE is responsible for examining. Now, I'll turn it over to Kris.

Kris Easter Guidroz
Hi, so like Akrivi I'm really excited to be here this year. A lot of things have happened in the last two years, and just to give you a brief background about where I was at the SEC, I used to work in the exam program with Akrivi. I left for a couple years for private sector and just rejoined the Division of Investment Management. I've been there just 10 months, but I can give you some updates on what they have been doing. I work in IM's new office of Risks and Examinations, it's called REO for short, and they do a lot of outreach and oversight and monitoring, including something you may have heard about in the news; senior level engagement. Our director and some of the folks in REO coordinate with the exam program to reach out to boards and senior management of mutual funds, and investment advisors to talk to them about developments. The primary goal is just to kind of step back and take an overall look what is developing in the markets and in the asset management space, what we can do to inform policy within the division of Investment Management, and what kind of guidance might be necessary. So, we'll talk a little bit throughout the panel about the guidance that has come out. One thing that the division has been doing is issuing a lot of staff guidance on the website. It is publically available, and some of the feedback we've been getting is that firms do find it helpful.

Shane Hanson
Kris, a question along that line occurs to me, there's been some emphasis on analytics, and an analytical tools that the SEC has started to use, has that been part of REO's game plan?

Kris Easter Guidroz
Yes, our chair has spoken publically quite often about the need to enhance data and the way we use it across the SEC, and that effort has been coordinated among various offices and divisions including ours, the division of Investment Management and REO. We have a lot of great financial analysts in our group who are great with the data, and they work with OCIE and with DERA, which is the Division of Economic and Risk Analysis, to see how we can better use what we've got at the commission because we do have a lot of good information. It's just a question of making sure we can aggregate it, look at it, and think about it in the right way.

Shane Hanson
Actually, just a follow up to that occurs to me that when OC does exams, these days do you get data dumps, if you will, of basically trading information and that sort of thing?

Akrivi Mazarakis
Yes, depending on the exam, we could potentially look at trading activity. Within OCIE, there's the Quantitative Analysis Unit which created a new tool called the National Exam Analytics Tool. Examiners can dump a large amount of trading data into the National Exam Analytics Tool and use it to run a number of analyses. It's had a huge positive impact in terms of an efficient use of examiners' time in reviewing firms' trading activity. Using this tool, examiners can review millions of transactions in a fraction of the time that it would take if they were doing a manual review. It's one of the technological innovations OCIE has implemented to assist its examiners with reviewing trading activity that we may obtain during exams.

Shane Hanson
And part of that involves looking for exceptions, outliers; things that look odd.

Akrivi Mazarakis
We are a risk-based program and, therefore, yes, our examiners will look for conduct that appears to be out of the ordinary or an outlier in order to identify potential risk areas for targeting our resources and drilling down where we need to. Next, I'll discuss a couple of OCIE initiatives. The Presence Exam Initiative, like some of the other initiatives I'll be discussing today, seeks to blend examinations with outreach. For example, the Presence Exam Initiative focuses on exams of private fund advisors who have become registered with the Commission only within the few past years due to Dodd-Frank requirements. As of a few months ago, OCIE had initiated over 350 exams. The exams are roughly split between two types of private fund advisors -- private equity advisors and hedge fund advisors. OCIE's director, Drew Bowden, has actually talked about OCIE's findings under this initiative in several speeches and how successful it has been in informing the industry and our examiners.

Ray Henney

Some quick questions regarding the Presence Exams, there was a bit of fanfare when it was announced and some trepidation with respect to firms that had not been previously been registered who were now registered. Is there some deficiencies or common deficiencies and problems that you're seeing in the Presence Exams that practitioners should be particularly aware of?

Akrivi Mazarakis

As I mentioned, the exams are split about evenly between private equity and hedge funds. With private equity advisors, we found that in about half of the exams, by far the most common deficiency, was how private equity advisors were handling fees and expenses. For example, we have seen instances where private equity advisors were shifting fees away from the advisor to the portfolio companies or funds and not providing investors adequate disclosure. In some cases, one one fee structure had been disclosed at the beginning of the life of the fund, but then later on the advisor changed the fee structure without disclosing it to the investors. We've also seen advisors that charged the salaries of the advisor's CFO to the fund. We've seen advisors terminate employees, hire them back as consultants, and charge the fund or portfolio company for the consultants' salaries. It's a problem when some of these consultants looked, acted, and talked like they were employees of the advisor and many times worked exclusively for the advisor, n which case investors may not realize that they are paying for the consultants' services *a la carte*, in addition to the management fee paid to the advisor. In addition, many limited partnership agreements require that fees generated by an advisors employees or affiliates should offset the management fee the advisor collects.

Yet we've seen that these consultants' salaries rarely offset management fees despite how closely they resemble employees of the advisor. We also found that in about 20% of the cases there were deficiencies or material weaknesses with respect to valuation. Specifically, we found that advisors did not clearly disclose their procedures for valuation, whether it was a failure to disclose how the advisor would value illiquid securities, or a failure to disclose subsequent changes to valuation procedures. For hedge fund advisors, in about 30% of the firms we examined, we found several instances of back-tested performance numbers, portable performance numbers, benchmark comparisons, and past specific recommendations that frequently omitted disclosure that made the statements misleading. For example, some advisors had included in their pitch books for prospective and current investors information about specific recommendations the advisors had made. It turned out that the advisors had never actually invested in those, or carried out the recommendations.

Shane Hanson
Quick question along that line, sounds like when you're doing that kind of exam you are going pretty carefully through the private placement memorandum that has been used to sell the shares of the fund?

Akrivi Mazarakis
Sure. We are a risk-based program, which means we target certain higher-risk areas in these exams, including valuation, portfolio management, custody, and marketing. With respect to each of those areas, we review relevant documents including the private placement memorandum, and depending on what we find, if we see anything that peaks our interest in terms of a possible deficiency, then we drill down into that to gather additional information in order to assess whether there is a violation of the relevant laws or rules or whether there's a material weakness in internal controls.

Ray Henney
Are you finding any issues concerning unregistered individuals who are promoting or soliciting on behalf of these private funds?

Akrivi Mazarakis
You mean acting as unregistered broker dealers?

Ray Henney
Arguably engaging in conduct that should be registered. I think many of the practitioners here, in different ways have had calls about, can this person do this and can I pay him that, in all kinds of contexts, and so naturally one would wonder if in your presents exams, if you're seeing that kind of activity?

Akrivi Mazarakis
David Blass, as Chief Counsel to the Division of Trading and Markets, gave a speech last year that talked about this very thing. I think what it comes down to is a lot of private fund advisors not realizing exactly what kind of activities place them within the scope of acting as a broker. The SEC and SEC staff have taken the view that receipt of transaction-based compensation is the hallmark of being a broker. So, for example, if any payment is being made that is in any way tied to the size of the investment, including selling shares for the fund for example, it could bring one within the realm of acting as a broker and might require such persons to register as brokers. If you're soliciting or negotiating securities transactions, marketing securities or shares or interests in a private fund, or handling customer funds and securities you might be required to register as a broker-dealer under the securities laws. Education is part of that too, I think, because this is a new area for a lot of private fund advisors, and so I would encourage you to take a look at David Blass's speech which discusses the types of activities that could bring you into the realm of unregistered broker activity.

Shane Henson
Just a footnote, you can find for everyone's reference, speeches from SEC commissioners and directors and David Blass all on the SEC's website, they're organized fairly well and you can also do a search on the website to find those. And to add just a little color, the term that's commonly used is "finder." Someone who is funding investors, in this case for a fund, essentially the fund has not gone outside to hire a broker dealer, a third party that is registered to engage in that kind of activity; they are self-offering. But they have effectively internalized the broker dealer function by paying an internal team, transaction based comp, that puts them into the category of acting like a broker dealer would. One follow up, and I forgot to ask this is, and maybe Kris, on the REO examinations, they're coordinated with OC but they may be conducted solely by REO. Just a little color on that one, does a registrant know when they are being examined by OC, versus being examined by REO?

Kris Easter Guidroz
Yes, typically the REO staff would introduce themselves as staff in the Division of Investment Management and say what they are there to look at, whereas OCIE typically sends a letter saying that the Office of Compliance, Inspections, and Examinations is conducting an exam, so firms should be aware which team they are working with. REO has

stated publically that they will do exams on their own, but there is a lot of emphasis within the commission on coordination across building, and we typically call OCIE to see how we want to coordinate and vice versa, so there is a lot of coordination that takes place, even if the exam is being carried out by one office or the other.

Shane Henson
And REO, like OC, probably has a standard document request that you'll get to prepare for, or?

Kris Easter Guidroz
Well, we're a very young office as you know and we're still thinking through how we do certain things, so we'll have to see what I can publically say. And I do apologize, that's one difference from private sector and being at the government is you have to think about whether what you are saying has been made public before, so Akrivi and I had to do some looking into what has been publically announced by our Chair or Directors. We apologize if we're thinking through it but that's why. On the David Blass speech, I did want to add that something he advised firms to think about if they are an advisor that does there own placement, is do they have staff dedicated to that function, or do they serve other roles? So do you just have one person devoted to marketing, you know that might be something you want to think about, does that put you over the line to be a broker dealer? If you are a private equity fund advisor are you getting fees for investing in a portfolio company, and if you get those fees does that offset the fund's advisor fees? Because all of those structures may impact in one way or the other on whether the staff might consider a firm to be engaging in broker dealer activities without being registered. So those are just some additional thoughts that David put on the table, that folks may want to think about.

Shane Hanson
And along that line, that speech does point out that the SEC has a rule, essentially a safe harbor, you cannot violate it. It's 3A4-1, and for the law students in the group, what you will come to know if you haven't already, is the SEC has really weird numbers. But they track with a section of the statute, so 3A4-1 usually tracks to section 3, sub A, sub 4 of the rule, so it's actually a helpful tool as your are doing research for that.

Ray Henney

It might be helpful just to back up a moment on this question, because these questions come up quite often, in fact clients won't realize there's an issue here. For instance, someone is selling real estate and they put together a package that really is a security, and they have an individual who goes out and sells these units. He's an employee, so they don't think about that they may need to register. Maybe the security is exempt, but does he need to register because they pay him a commission, based upon how much money he raises? So, "John you've got great contacts and we want you to come aboard. See what you can do about raising funds for this particular program, you'll be our employee and you'll get X percent of the funds you raise." The commission will take the position that that's registered activity, is likely to take the position that that's registered activity, unless there's some exemption you can point to, and your client won't have any idea that they can't do that. So while we were talking about more exotic structures, for unregistered activity, there are very simple structures that the commission will see and then will see are violated. And come up all the time, in sort of the daily capital raising function.

Shane Henson
There's an SEC enforcement action against a fund and its officers called Ranieri Partners and if you Google that I think that R – A – I –N – I – E – R – I, or something close to that. It's a case where the SEC brought an enforcement action against a fund and its executive and then the finder that they were using to raise self fund interest but to basically raise capital for the fund.

Ray Henney
Never before examined initiative, care to comment on that?

Akrivi Mazarakis
The Never Before Examined Initiative focuses on advisors who have never been before examined. As you can see, we're very creative in how we name our initiatives. In particular the initiative focuses on advisors that have been registered for at least 3 years. In addition to examinations, we're holding a lot of regional meetings with advisors that have never been examined by the SEC before since they've been registered, and talking to them about the exam process, our exam priorities in the advisor space, where we see risks, and also hearing from them their concerns and answering any questions they have about the process. We think the initiative has been pretty successful, in terms of the

feedback we've received, including that the outreach efforts have demystified the exam process.

Ray Henney
When do you consider a never before examined firm? How about a firm who was registered with the state and is now registered with the SEC, would that firm qualify under this initiative?

Akrivi Mazarakis
Yes, if they've never been examined by the SEC since their registration, again we're focused on advisors that have been registered at least 3 years, but yeah, that would qualify.

Shane Hanson
The audience, background here, Congress changed the way investment advisors are registered, and so they cause what was essentially the great switch, so forcing a large number of SEC registrants to move to state registration. But then there are other who as they grow, become eligible for SEC registration, or required for SEC registration, so switch back. So you'd have someone who had, would state exams be any consideration, the fact they had been examined by states, even though not yet by the SEC?

Akrivi Mazarakis
No, the key factor is that the advisor has not been examined by the SEC yet.

Shane B. Hansen
OK, great. OK. Shall we move on to municipal advisors? This is an area that is pretty new for the SEC. Congress saw fit to require registration of municipal advisors. It started with a very broad definition of who are municipal advisors. There have been some tweaks along the way. Do you want to tell us a little bit about what the SEC, and maybe what some of the Municipal Securities Rule Making Board, the MSRB, is doing in this area?

Akrivi Mazarakis
I can tell you what we've been focusing on in terms of the exam program. To take a step back, the Commission did adopt final rules for registration of municipal advisors that became effective in July. In anticipation of that , OCIE launched an initiative that we announced a

couple months ago through which we'll be examining these newly registered municipal advisors. We are only focusing on the subset of municipal advisors that are not registered with FINRA. Again the idea here is that we are blending examinations with outreach. The exams will focus not only on municipal advisors' compliance with registration -- the registration rules go through in quite a bit of detail in terms of who needs to register, who doesn't, and what kind of activities would bring you within the realm of requiring registration – but also on other areas, such as municipal advisors' compliance with MSRB rules and SEC rules, including a focus on fair dealing, fiduciary duty standards, supervision, books and records, and training. The initiative and the exams will be taking place over the next two or three years, and I think ultimately the plan is to inform the Commission of our findings, and then perhaps publish a risk alert. We have published risk alerts on various areas where we've done examinations and we discuss related observations and findings, and highlight areas that we'd like firms that we've examined to consider. They are published on the SEC's public site- on the SEC.gov site. We also might talk about our findings in speeches to let the industry and practitioners know what we are finding. We aim to be transparent and hope that if municipal advisors have information about our findings at their disposal, they can review their own policies and procedures and their compliance programs and be proactive in terms of making any changes that need to be made before our examiners initiative examinations of them.

Shane B. Hansen

And just to echo one point there, the SEC does give a lot of guidance in speeches, and in releases. Rule making is very cumbersome, takes a long time and requires a lot of bandwidth, so you do get a lot of guidance out of those kinds of public statements and of course the enforcement proceedings that sometimes come out of them too. With the examination program, there sounds like, you're kind of divvying up the regulated audience by FINRA, examining those who are FINRA members. You're examining those who are not. What's the MSRB's role in all of this?

Akrivi Mazarakis

Let's take a step back. It doesn't mean that we won't be examining those municipal advisors that are also FINRA members. The initiative is merely focusing on just those municipal advisors who are not FINRA members. As far as the division in roles between FINRA, the MSRB, and the SEC, I think that is still being worked out. But we are all coordinating and, in fact, recently the SEC, FINRA, and the MSRB announced an outreach program during which newly registered municipal advisors would be able to talk about each regulator's priorities, , exam processes, and what areas each regulator views as risk areas.

Shane B. Hansen
Coming up soon, by the way- it's November 3rd, and it's nearby. It's in Chicago, so Google that or look on the SEC's website, because I think that will be well attended.

Akrivi Mazarakis
I hope so.

Shane B. Hansen
OK. Anything else on Muni's, or advisors, or should we move on?

Kris Easter Guidroz
Well I'm not sure if we'll get to it, I know we have custody on the list—

Shane B. Hansen
Yeah.

Kris Easter Guidroz
--but it's last on the list. We had a lot of topics today, but I wanted to mention that IM (Division of Investment Management) put out guidance for private fund advisors with respect to the custody rule because it is, as everyone knows, that rule is a little tricky as applied to private fund advisors. There are two guidance updates from the Division of Investment Management available on the public website. One is from August 2013, and one is, I think, June of this year. The June guidance talks about instances where one special purpose vehicle is set up by a fund or a fund group to invest in maybe one investment, or multiple investments. For example, one advisor may manage multiple funds and all of those funds may share an SPV that invests in certain investments and what the SEC said is that, in this type of instance, the advisor has a choice under the Custody Rule. In the case of the funds, the funds get subjected to an audit, so they qualify for the audit exception under the custody rule. The advisor can treat that special purpose vehicle as a separate client, in which case that SPV would have to go through its own audit under the Custody Rule, or the advisor would have to comply with all the rest of the custody rule elements, including a surprise exam.

Alternatively, the advisor can treat the SPV as an asset held by the funds, in which case those assets would just get audited when the auditor comes in to look at the fund. That I think is a big help to advisors when they're thinking about how to comply with the audit exception and the custody rule in connection with SPVs. So those are the alternatives under that. And the guidance also talks about escrow accounts and how to handle those for a private equity fund when they are selling a portfolio company that's also owned by someone who is not managed by the advisor. So it's a very helpful guidance piece if people want to check that one out.

Shane B. Hansen
Yeah. And that's on the Investment Management Website?

Kris Easter Guidroz
Public website, yes.

Shane B. Hansen
OK, good. OK, cyber security. This has been in the news. J.P. Morgan Chase, Target, Home Depot have all been hacking targets, and these days it's no longer thrill seeking college students like some of you guys out there who are techno-experts; organized crime, and petty criminals, too. It's kind of scary if you realize that someone, once they get a tidbit of information, can use that to leverage your identity. Forgot your password? Click here. It'll send it to the e-mail address that somebody else now has because they hacked e-mail addresses somewhere else. So, it's a little bit scary. Do you want to tell us a little bit about what the SEC has been doing on this? This is a hot topic.

Akrivi Mazarakis
Sure, I can talk about OCIE's cyber security initiative. We've initiated exams of over a hundred broker-dealers and investment advisors, and what we are focusing on is assessing their cyber security preparedness. This comes on the heels of the SEC's cyber security roundtable held earlier this year which included panelists from the relevant regulators, the White House, Treasury, the industry, lawyers and consultants, among others. As to OCIE's cyber security initiative, OCIE published on its public page on the sec.gov webiste a sample request letter and a risk alert. The sample request letter calls for documents and information that, in part, are meant to track the NIST standards, which stands for the National Institute of Standards and Technology. NIST is the leading industry group for putting together the standards, or best practices, in the cyber-security area. Our sample request letter tracks those standards in

some sense, but it also includes other areas that our examiners will be focusing on, including compliance with Regulation S-P and Regulation S-ID. The sample request letter calls for a wide variety of information, but it doesn't mean that every firm under examination as part of this initiative will get the exact same letter. We customize the letter based on the particular firm examined. Again in the effort to promote transparency, we have published the sample request letter to inform firms of the types of issues they should be thinking about, and assess their own compliance programs with respect to things like, "Do we have adequate policies and procedures to make sure that we can protect customer information?" and "Do we have rigorous IT controls?" among other things. Some other exam focus areas are governance and supervision of information technology systems, firms preparedness to respond to any cyber- security incidents, and firms' actual responses to cyber-security incidents.. Finally, examiners will also review how firms recover from any cyber-security incidents, that is, what are they doing to update their policies and procedures, train their employees, and to take those new risks that they've identified and address them into their compliance programs. We haven't published any findings yet, but we anticipate do so at some point, whether it is in the form of a risk alert, or in speeches.

Shane B. Hansen
Well and it ties into a couple of existing rules, one of which is Regulation S-P in the safeguarding rules. So firms are today subject to a safeguarding obligation if you're SEC registered, and there is a requirement that the firm have policies and procedures addressing administrative, technical, and physical safeguards to protect customer records and information. Does OC examine for that as part of the routine type exam, and maybe with a greater emphasis these days?

Akrivi Mazarakis
Regulation S-P is a component of the cyber-security initiative, but, yes, we've been examining for Regulation S-P compliance for years since the rules were implemented. Regulation S-P compliance is a potential area for examination in our exams. Since OCIE carries out a risk-based exam program, our examiners conduct a risk-assessment at the firm level to determine which areas to focus in on during the examination. If the examiners spot potential Regulation S-P compliance issues, then they will drill down into that and examine those issues further. I can talk a little bit about the problems our examiners have identified with Regulation S-P compliance?

Shane B. Hansen
Please.

Akrivi Mazarakis
The key phrase in Regulation S-P rules is "reasonably designed." There is no one-size-fits-all way of complying with Regulation S-P. Certain controls that might be reasonable for one firm might not be reasonable for another. In that regard, our examiners want to know whether examined firms are conducting their own risk assessment and not just adopting "off-the-shelf" policies and procedures that have not been customized for their particular businesses. Some of the questions we ask are: Are firms taking into account their business model, identifying the risks associated with that business model, and then implementing certain controls to address the risks that they've identified? And what do firms do if they find breaches in the security of their customers' information? How do they respond to it, do they take that incident and learn from it, and then update their policies and procedures to improve their internal controls? I'll run through a few examples of weaknesses in internal controls that our examiners have found. Please keep in mind, however, that some of the examples I'll mention involve underlying risks that may not be present at firms you counsel in which case there is no need for an internal control to address a non-existent risk. First, I'll talk about physical safeguards. We've seen inadequate procedures to address how firms are making sure that their hardcopy files are secure. Do they have a locked data file room? Do they lock up file cabinets? To the extent that firms maintain certain files in hard copy, they should make sure there are controls in place to address how those documents are stored. Next, I'll mention passwords. Our examiners have seen inadequate policies and procedures to address such things as the requirements for the strength of passwords that their employees use on their computers, or on any portable media devices like laptops or Blackberries. How often are employees required to change those passwords, and are the same standards applied to employees and, for example, contractors. We've seen some firms that may have different procedures for employees and for contractors, and the risks associated with each of these two groups is not necessarily different enough to merit different procedures. This concept applies to other areas of Regulation S-P compliance, beyond passwords.

Kris Easter Guidroz
Can I just add one thing maybe?

Akrivi Mazarakis
Yeah.

Kris Easter Guidroz
If it's an investment advisor firm, they also have to think about who at their firm is an access person for purposes of rules that apply under the Advisor's Act. And so if there information is, as ViVi said, left out in the open, then that broadens who at the firm has access to client confidential information- maybe about potential trades or recommendations, and therefore it would put those persons in the category of access persons for which the firm has to take additional steps to get that person's trading information, find out what they're doing. So there are different considerations about privacy than just Regulation SP.

Akrivi Mazarakis
Yes.

Shane B. Hansen
Sounds like we should all have clean desks. When we get back to the office start working on that.

Akrivi Mazarakis
Oh yeah I really need to work on that.

[Laughter]

Akrivi Mazarakis
I'll cover just a few other areas. Access rights. The key question here is does the firm have policies and procedures in place to make sure that, for example, access to internal databases and systems for employees that are no longer employed with the firm is being cut off. Also, is there a policy in place to address who will have access to what type of customer information based on each employee's specific job responsibilities, or does the firm simply grant access to whoever requests it. Where firms use a cloud to store customer information or where firms are contracting with third party service providers to store that information, our examiners have determined that some firms don't have policies and procedures in place to account for the risks associated with that practice. For example, where third-party service providers are involved, does a

firm's procedures take into account who owns the data, who is responsible for deleting or disposing of information when there's no longer a business use for it and how is such information deleted or disposed of. Training is also another area where our examiners have seen some deficiencies. Training is an important component of a strong compliance program. Some of the key questions we ask when it comes to training are whether a firm's employees are given adequate training to understand what their obligations are and provided with best practices to avoid compliance pitfalls, such as don't give away your password; and don't let other people logon to your computer or onto any databases that contain customer information. Overall, compliance with Regulation S-P requires identifying and addressing foreseeable risks, and when there's an actual breach of the security of customers' information, firms should update their compliance programs to address the breach. One common deficiency is that often firms don't incorporate lessons learned from prior breaches into their policies and procedures and don't implement controls to address the lessons learned from those prior breaches. Instead, examiners have seen firms fix the immediate problem, but do not update their internal controls accordingly.

Shane B. Hansen
Would you like to see in those policies something addressing due diligence, addressing a cloud vendor before they hire them and put their data out there?

Akrivi Mazarakis
Yeah, I think that would be reasonable, especially if it's a vendor who has relatively inexperienced in that area.

Shane B. Hansen
It crosses a number of different areas because you've got identity theft, you've got the Red Flag Rules, if I might just identify those: Reg. SID. This is an area where SEC registrants are supposed to have policies and procedures to flag identity theft, which might come from a breach of cyber security. Do you want to comment a little about what the SEC looks at in the OC exam process or compliance?

Akrivi Mazarakis
OCIE's cyber-security initiative includes examining for compliance with the SEC's Regulation S-ID or the Identity Theft Red Flags Rules which were adopted recently. However, this isn't a new topic for OCIE in the sense that, in the past, when examining firms claiming to comply with

the FTC's rules on identity theft red flags, our examiners have determined whether the firms are in fact complying with the FTC's rules. My understanding is that Regulation S-ID is largely similar to the FTC's rules on the same topic.

Raymond W. Henney
One area, with respect to the Regulation SP, has to do with the information a broker brings with him to a new firm. And, by way of background, I'll try to be as brief as possible. Ten years ago, three major warehouses staged what they call the protocol for recruiting brokers. Prior to that time, when a broker left a firm, they might take all the customer information with them. Account statements with social security numbers and all kinds of information. And obviously Regulation S-P says you can't do that. You cannot bring customer sensitive financial information outside into another employer. The protocol indicated that you could take a specific type of information: name, address, contact information, and what they called account type. They had an IRA account, or a trust account and so forth. And as long as you only took that, and indicated what you were taking to your former firm, then there would not be an effort on the part of the firm that you departed to try to enforce non-solicitation, or some sort of unfair practice or fiduciary duty claim. So that has been joined by many, many firms. There's literally a hundred firms that are now part of the protocol, but the protocol information arguably violates Regulation SP. It's noted that there has never been an enforcement action by the SEC for indicating that somebody who followed the protocol is in violation of that Regulation SP. And there was legislation—what was it three or four years ago?

Shane B. Hansen
Actually it was proposed amendments that would have essentially blessed the protocol's sharing of customer name and address contact information, which was never adopted.

Raymond W. Henney
Never adopted. Is there—I don't know how far you can comment on this, but when a firm has hired someone and followed a protocol, and you come knocking at the door looking at these particular issues on Regulation SP- what is the apprehension rate the client should have?

Kris Easter Guidroz

So actually we did go back through the staff guidance and frequently asked questions, such guidance on Reg. S-P, to see if they have publicly commented on the protocol. And we did not see any new information publicly available about the staff's views on the protocol, so I don't think there's much that we can add in that context. I know several years ago when I was in OCIE and working on the privacy laws a lot, one thing we heard from people in the industry is that reps might get customer prospective consent- without commenting on whether that works or not- and then they would disclose in their privacy notice, I guess, that a rep might take information when they go. But still, the obligations under the privacy laws do go to the firm, not the individual rep, so a firm has to sign on in a sense, because it is ultimately their regulatory obligation.

Shane B. Hansen
And just to add a little more color: although it's the firm's obligation, the reps are subject to it, so they will or can violate it themselves.

Raymond W. Henney
Frequently in these kinds of cases, rating cases and so forth, to the extent that there's lawsuits, the firm that—the losing firm if you will—the former firm will typically raise Regulation S-P violations, even though the protocol is followed or not followed, the strategy from the defending firms standpoint is to, number one say it's the protocol, there's never been an enforcement action, and there's never been an indication from the commission that the protocol does violate Regulation S-P even though, maybe technically it does. But the second issue is the obvious one. There's no cause of action for the former firm under Regulation S-P. That's the customer's private information. The statute and the rules only permit causes of action for the violation of their privacy. And the, I'll call it the losing firm, and there's court cases on this, don't have a cause of action with respect to the fact that a departing broker took the protocol information. So, with that maybe we should move on?

Shane Hanson
And with that, Joe, maybe with a little bit of liberty from starting late, can we go till about ten after?

Joseph Spiegel
Yes.

Shane Hanson

Ok. Great, sounds good. Well, why don't we move on down the list here? We talked about cyber security, and maybe pick up on the next item of engaging senior management?

Akrivi Mazarakis
Sure, the one thing I'd like to highlight about engaging senior management is that, this has been a part of our exams for a long time now. However, in the last couple years OCIE has increased its focus on engaging the board and senior officers in terms of speaking with senior management about their roles, assessing the tone at the top, understanding what senior management is doing in terms of enterprise risk management and how they are assessing and mitigating conflict of interest, and legal, compliance, and financial risks. So the idea is to make sure that senior management is engaged and that we are engaging in a dialogue with them about what they are seeing as the risks and priorities at their firm and sharing with them our concerns as well. I just wanted to mention that briefly that is something that we've been doing and increasing our focus on in recent years. I can move on if you'd like to the rest.

Shane Hanson
Yup. Sounds good.

Akrivi Mazarakis
As for industry outreach, we've talked a little bit about that in terms of the Presence Exam initiative and the Never Before Examined initiative, both of which include an outreach component. The other examination and outreach effort that I'd like to highlight is one you may have read about in the press. Our Fort Worth Regional Office sent staff to Houston, Texas for about a week during which they conducted exams of about thirty to thirty-five broker dealers and investment advisors. Simultaneously, examiners held educational seminars to which they invited investors, and, separately, organized forums to which they invited representatives from the industry, compliance professionals, attorneys, and consultants. The idea behind this initiative was to promote a dialogue and promote transparency by talking about what's on our minds, what OCIE's risk priorities are, and also hear from investors and the industry about their concerns. Other regional office exam programs anticipate carrying out similar initiatives in their respective regions. They might be coming to a town near you. The other thing I'd like to add is

something we touched upon already earlier today. For the last several years, OCIE has been publishing risk alerts to flag certain areas where we've seen weaker controls or deficiencies. The idea there again is to promote transparency to allow for firms that haven't been examined in these areas to take a second look at their compliance programs and be proactive about making any changes to beef up their programs in those areas. The topics range from social media to custody, for example. The full set of risk alerts can be found on the OCIE page on the SEC.gov site. Lastly, I'll mention briefly that, beginning in 2013, we started publishing our examination priorities on the same OCIE page on the SEC.gov site. Our fiscal year 2015 exam priorities are coming out early next year. The examination priorities are broken down not just with respect to what we are focusing on industry-wide, but also by registrant. Therefore, the publication will include areas that will be focusing on in our examinations of investment advisors, broker dealers, exchanges, FINRA, clearing agencies, and so on and so forth. Again, this is OCIE's effort to promote transparency. We are not in the business of playing, "Gotcha!" For the most part, I think people are trying to do the right thing. By putting out as much information as possible in terms of what we're seeing, we hope it will inform firms' compliance efforts and help them to re-assess and improve those programs.

Shane Hanson
Sounds good. We are running a little tight on time. Joe?

Audience Member
What about the overlap in red flag rules which apply to the large financial institutions?

Kris Easter Guidroz
The SEC and CFTC were both statutorily directed to model their rules after the Federal Trade Commission and the other financial regulatory institution's existing red flag rules. And, it is interesting the overlap that you are talking about, because an advisor, you know, may be subject to the CFTC's rules while one of the private funds that advisor manages may be subject to the Federal Trade Commission's. My understanding, although I don't regulate in this space, is that the CFPB is also involved in regulating privacy, and may in fact have dual jurisdiction in some instances with the Federal Trade Commission when it comes to the

privacy laws including the new identity theft rules and the privacy notice and safeguards rules.

Shane Henson
And just to footnote that - CFPB is the Consumer Financial Protection Bureau. That was created to fill a vacuum perceived by Congress that the banking agencies were not adequately representing consumers.

Ray Henney
An MSU Alum is the director of that department, Richard Cordray, from James Madison College.

Shane Henson
Very Good. Alright, with the time remaining should we flip on to the focus areas BDs - Broker Dealers - Investment Advisors, and Investment Companies?

Akrivi Mazarakis
I'm limited in what I can say here in terms of our 2015 exam priorities since they have not been published yet. I can tell share with you some of the core risk areas that we will continue to . . .

Shane Henson
You could announce them here, that'd be fine… [*laughter*]. Elliot would really appreciate it.

Akrivi Mazarakis
I think my desk would be cleaned for me. [*Laughter*]

Ray Henney
Elliot, that would be a great news release for you wouldn't it?

Akrivi Mazarakis
Well, I can talk about the core risk areas that we'll continue to look at in terms of broker dealers, which will include, among others, anti-money laundering and sales practices. For investment advisors, I think we'll continue to focus on custody as it goes to the core of the advisor–client relationship. Actually, speaking of custody, we published a risk alert a few years ago on what the common deficiencies our examiners found

with respect to custody. We're taking a second look at the common deficiencies identified in that alert, and doing exams again to see if we are seeing the same types of deficiencies years after we have published this risk alert. Our preliminary findings in these second round of custody-focused exams is that is that many of the same problems persist. Some of these common deficiencies include advisors not realizing they have custody and advisors not complying with the surprise exam requirement, among others.

Shane Henson
So, when you say they don't realize they have custody, it's often the case it's really constructive custody, that is to say I don't have the checkbook, I don't have the money in my hand. Do you want to comment on what constructive custody is, the notion?

Kris Easter Guidroz
Yes, so there were many instances of this mentioned in the OCIE risk alert and also in the SEC adopting release to custody rules, which were amended again, I think was it 2010. But essentially, if you are an advisor and one of your related persons acts as qualified custodian, or if you as the advisor serve as general partner to a fund, or in some other control relationship to the fund, where you have access to the money, then that puts you in a constructive custody situation. If one of your supervised IARs serves as a trustee for a client trust then that likely puts you into the position of having a constructive custody as the advisor. There are some other situations that we can talk about, but I think that the key here is even if you don't have the funds or securities, can you in any way access them? If you can do you have a right to pay expenses for the fund, do you have a right to, you know, send money for the client to pay a bill or something like that. Think about things like that, which would give you constructive access to client assets even though you do not have physical custody. And those are the things that the SEC represented create the opportunity for misuse by the advisor or its representatives of client's money or securities.

Ray Henney
An investment advisor for example that has one of its principals that owns a real estate deal and is the general partner of the real estate deal. Does that bring that entity, the investment advisor, into the custody rules? What happens?

Kris Easter Guidroz
That's an interesting question. The custody rule protects securities and money and not assets that are not securities. So, I guess that what the question would come down to is, "Is a client buying a security interest, a real estate venture, or are they holding a building, or land or land assets?" Those are some of the distinctions. Is that where you were getting at?

Ray Henney
Is that where the SEC is looking at?

Kris Easter Guidroz
I'm not sure what the current initiative is, but the adopting release talks to some of those distinctions and does clarify that the custody rule applies to money and securities and not to other types of assets.

Shane Hanson
Guys, we are kind of running out of time. Kris, I know you have got some notes, as they say on a certain television network, we'll give you the last word here. So, share with us what you would like.

Kris Easter Guidoz
Well, we had a lot of spectrum to cover here today. I don't think we've covered half of it, but there are some things that you may want to take a look at the SEC.gov public websites for both OCIE and IM. Alerts have come out as Akrivi mentioned in the area of social media. IM also put out guidance on social media which is quite helpful, addressing a lot of questions related to the use of testimonials in the social media sphere. The alert also clarifies a lot of past interpretive guidance by both the staff and the commission. The commission has been pretty consistent about application of its rules to the use of electronics, and how all the different rules apply as technology develops. So, think about it in the same way you do paper communications. FINRA passed new rules in February of 2013 that revamped their communications rules, and that also impact with social media and how it is used. You know, if it is interactive social media, different requirements apply. I think that FINRA may have issued guidance, I don't know that – maybe you can speak to that?

Shane Henson
Yup, there is guidance on FINRA's website.

Kris Easter Guidoz
Those are some of the areas to think about. There are a lot of developments in the social media space. I'm sure you've seen new developing case law on who owns the content. That is something for firms to think about because there have been different outcomes with respect to whether employees own their LinkedIn account contents- even if they have some information on there- or, if the firm owns it and whether an employee owns their hash tag on Twitter or whether the firm owns it. These are just things to think about. Some of the case law talks about whether a firm has procedures that state the employee's social media content is the firm's up front and give templates to the employee. A lot of developing things in the social media space. And then you had wanted to talk about pay to play?

Shane Henson
Yeah.

Kris Easter Guidoz
There's one case out now that interprets the SEC's Advisor's Act Rule on pay to play, it's TL Ventures.

Ray Henney
Could you explain what Pay to Play is?

Kris Easter Guidoz
Yes. Pay to play is basically a rule that says investment advisors cannot accept compensation from a public entity if they- the advisor or one of their representatives (covered persons as legally defined in the rule)- contributed over a threshold amount to a campaign of an official who can influence, basically, giving business to the advisor. TL Ventures is an interesting case to take a look at because the enforcement order says the underlying violation is that the advisor accepted compensation from public pension plans after they had contributed to a campaign over the threshold amount. But the interesting thing is they found no scienter here, no quid pro quo was required here. In the case, the pension plans had actually been investors in their private funds for a very long time. The payment wasn't to get the business, and it wasn't to retain the business because the funds were not open to new business. So it is an interesting case to look at.

And one thing I found interesting about TL Ventures and the companion case that came out is that I believe it may be the first enforcement case that speaks to advisors that appear to be operationally integrated, but each claim a separate exemption from SEC registration. The SEC said when it adopted the Dodd Frank amendments to the private fund advisor exemptions, "Hey, you know you need to think about how operationally integrated you are. We don't want you to evade registration by segregating your advisory activities such that you can rely on this one exemption for certain activities and then rely on that one for others." Well with respect to the TL Ventures case, one of the firms was a venture capital fund advisor and the other was another type of private fund advisor, relying on the two separate exemptions. If you integrated their operations the firms would not qualify for either exemption. The SEC orders spoke to the fact that the firms did not have procedures segregating their businesses. They had shared investment company committee people, shared managing directors, and shared personnel. In fact, the shared personnel did not even pay attention to which firm's email account they were using, and they would conduct business from both. So it is interesting from the perspective that it sheds more light on the statements and the adopting release as to when exemptions may not be honored by the SEC.

Shane Henson
Hmm. Excellent. We've probably run out of time.

Elliott Spoon
Shane, let's ask if there are any questions from the audience.

Shane Henson
Yup, we've got one right here in front.

Audience member
Great, um, just going back to Regulation S-P, and I guess this idea of protection; when I worked a deal, well I worked for a small investment advisor – obviously SEC registered - but who owns the client data, I mean vendors talk about what would turn your data back. It's clearly the client's data that you've aggregated…

Elliott Spoon
Can everyone hear the question?

Shane Henson
I'll try to repeat it.

Audience member
Who owns that client data, and then also have you come across any issues that dovetail with copyright laws, for example, compilations that firms create and claim they own the right in that particular compilation but that is client data?

Kris Easter Guidroz
I think that is an interesting question. We'd probably turn over to you guys because there's a lot of litigation there right now outside of the SEC context on this very issue isn't there?

Shane Henson
Yeah, it's a great question. It probably is a little outside of the regulatory context. What you have is client data, ok, but it is a question of who owns it. It may be "data" about a client, but it is actually the advisory firm or broker dealer that has acquired the data, holds the data in a particular form and content, and format. And I think there the question would often arise in your case when reps leave and they want to take the data with them. It really is the firm's data. It is not the representative's data. And it is clearly not the vendor's data in my view. It's the vendors simply processing and holding the data in the cloud. But it is something that is clearly the subject of every contract with a cloud vendor to make very clear who does own it or has rights to it, what they can and can't do with it. Copyright issues certainly do come into play with that. I'm not a copyright lawyer, so I'll definitely punt on that one. But, it is something that you can bring clarity to by drafting contracts with the vendors that describe it.

Ray Henney
And with respect to the customers too. For instance, regulation S-P to the extent that a firm has an open door policy with extra reps leaving, as a recruiting vehicle for instance, and they indicate you can go and come with the protocol, you can have the customer sign documentation that permits that activity that helps alleviate that concern. There are firms that - up front when they open up the account - indicate that you are going to give permission to the broker to take protocol information, if you will, when they open the account.

Shane Henson

Ok, there's another question back here? Jeff?

Audience member
In the context of the independent broker dealer whose got OSJ headquarters in East Lansing, MI and has independent reps scattered around the country who have customer information on their own personal computers, and the RR in Gnome Alaska leaves, what obligation does the headquarters OSJ have to make sure that the client data isn't walking away with the rep's personal computer? Is the representation during employment saying, "I won't take customer information with me?" Do you have to fly a swat team to Gnome, Alaska and say, "I want to see that computer and purge it," or whatever?

Shane Henson
You guys want to chime in? I'll throw in a comment too.

Kris Easter Guidroz
I would think you don't have to fly to Gnome, Alaska. Training, as Akrivi mentioned, is key. Have you trained them on what they need to do? And privacy procedures must be "reasonably designed" to protect customer data. I don't know about storing data on a personal computer- it may be reasonable depending on the firm, but maybe remote access is more reasonable – then the firm has control over the data. I don't know, I won't speak to that either way, I'll just throw out the question. But there are a lot of enforcement actions related to things like this that have come out of the SEC, including JP Turner being held liable for a rep leaving customer information in boxes on the curb when he moved. The information blew all over the city and JP Turner was never sure it recovered all of the records that had been in those boxes. So it is clear firms are liable, but what is reasonable depends on a firm's size and the extent of a firm's branch offices. And you know that what is reasonable changes from year to year. I would argue in my personal capacity that many more things may be reasonable now that were not necessarily reasonable three years ago just because we are now aware of more threats and more attacks and more opportunities that could take place. So, that's just something that I would throw out there.

Akrivi Mazarakis
Yeah, the only thing that I would add to that is that there is also a component of testing. Are the procedures you have in place working? So, you might have a procedure that you think is is reasonable, but are

you testing compliance with that procedure? If it is not working, what are you doing to tweak your controls to make sure that it works the next time?

Kris Easter Guidroz
And one issue with the rep having the data on their personal computer is how can the firm control whether the computer is login credential protected? Are there timeouts on it? Can anyone just, if the person leaves their laptop at an airport, could anyone just login and get to it? I think those are some things to think about that might go to what may be reasonable under the circumstances.

Shane Henson
Yeah, and I'll just add two closing thoughts. One is Ronald Reagan had a favorite phrase: Trust but verify. So, you really do, to be reasonable, have to have some way of verifying it. The other last thought would be that if the firm's privacy notice says that a representative may take the information, or truthfully keep the information, when they leave that will address the Reg S-P issue, but the firm will still want to be sure that from the cyber security standpoint that the information is adequately protected.

Kris Easter Guidroz
I think that all the studies show the most common mechanism still for attacks is either employee, or customers, just lack of care on accessing systems.

Shane Henson
Yeah, I would say the recent examples of "lightning in the cloud" being some movie stars whose photographs became public. The cloud vendor would say, "It wasn't our fault." They did not access it. It was somebody who had access to it through a password that someone was careless with that allowed them to get it. So it wasn't the vendor's fault. There's a fair amount of the finger pointing going on.

Elliot Spoon
On that note, about nude pictures on your phone, let's thank the panel for a very informative discussion. We are going to immediately set up our next panel.

END DEVELOPMENTS IN BROKER-DEALER AND INVESTMENT ADVISER REGULATION

BEGIN BROKER-DEALER ARBITRATION AND LITIGATION UPDATE

Moderator
We're going to get started. You can still eat and drink. We'll be a touch over lunch and if your stomach growls, it's okay. Over the last two years, there has been a tremendous amount of new developments in the arbitration area. We have a very very [sic] distinguished panel this year. John Hubbard has been practicing in this area for quite some time. Gary Saretsky has been practicing in this area for quite some time. And we have Felicia Fox from FINRA. Anthony Trogan primarily does claimants' work. In fact, when anybody ever calls his office, after they give them his name, he says "Have you been or are you affiliated with a broker-dealer?" And if the answer is "yes," he basically hangs the phone up. Ben Edwards runs the clinic that has been sponsored by the University. Elliot was very very [sic] instrumental in getting a very large grant from FINRA to establish this clinic for persons who have claims against broker-dealers. We're going to start with John Hubbard and he is going to talk about: Who's a customer?

John A. Hubbard
Thanks, Joe. Good morning, everyone. Joe's right. When I was a freshly minted attorney about twenty-seven years ago, I was working for Dickinson Wright in their litigation department; one of the first things they sent me to was the Midwest Securities Seminar. So, for those of you who are students, you're ahead of the game and maybe someday if you, you know, practice in this area, Ray Henney will knock on your door and ask you to present at some point. So, thank you for letting me speak to you this morning.

When does my topic, "Who is a Customer?," arise? What is a practical application of it? Let's pretend that I'm an attorney that's representing an investor. And the investor comes to me and he's got some losses and he says, "I want to sue the broker-dealer, or my broker to recover these losses." The first analysis I will make is – I've got several forums that I can pursue this in. I have court. I have private arbitration, you know, through American Arbitration Association, JAMS, or whatever. And then I have the opportunity to go to FINRA and [use] FINRA's arbitration because FINRA's members are required to arbitrate all disputes with a customer. The second thing I need to do is take a look at whether I have any agreements that will govern which forum I have to go to. If I have signed up an account with a broker-dealer, that broker-dealer account automatically requires me to litigate in FINRA. If I have another private agreement, it may require me to arbitrate in the American Arbitration Association. If I have no agreement, I have a choice of what I might want to do. I might want to go to FINRA based on my facts, based on my needs, based on my evaluation of the case, whether I think I might get knocked down in summary judgment in the courts and I can maybe plow my way through FINRA. So, I make a choice: do I want to go into court or do I want to go into FINRA?

If I want to go to FINRA, I have to be a customer. I have to be a customer of a member. And that's where my issue today arises. Am I a customer of a FINRA member? And FINRA has tried to define, at some point, through its notices – and there's some materials in your packet on this – who the customer is for purposes of going to FINRA in the absence of an agreement, a customer account agreement, that requires you to go to FINRA. And they, generally, throughout their notice talk about the relationship between my investor-individual and the broker or the broker-dealer and what is the nature of that relationship. Is it a casual relationship where I was at a cocktail party and I met a broker and the broker gave me a recommendation and I went out and followed that recommendation through Schwab or TD Ameritrade? Or did I meet with this broker at a restaurant and he gave me a recommendation and he sold me something based upon that recommendation? Maybe a private placement. Maybe it's a promissory note that he wanted me to enter into or purchase. Or is it more formal, where I go to his office and he provides me with recommendations and sits down with me and transacts with me there? Or is it investment advice that's being given in connection with a merger or an acquisition, and I'm getting advice and counsel in relation to that acquisition, that merger, or any of those other types of business transactions? What's the nature of the relationship? And what FINRA seems to focus on is: whether advice was actually given; who was it given by; and will that broker-dealer or broker receive compensation – that FINRA member receive compensation for that particular advice or recommendation?

Naturally, there was a lot of litigation that arose out of this. In your packets, you'll see "Questions and Answers" by FINRA. FINRA doesn't legislate. It has its rules. It tries to help interpret the rules, but it's not legislation and so a lot of litigation ensued. And the first kind of grouping of litigation, which is in the packet, was commonly known as the Morgan Keegan cases.

The Morgan Keegan cases are Morgan Keegan, which is a broker-dealer, issued some bonds that were purchased for investors through other broker-dealers, and the issuance of a bonds, it's a proprietary product of Morgan Keegan but it can be sold by different broker-dealers elsewhere. Well the investors wanted to sue Morgan Keegan, the broker-dealer, in FINRA, and there were a plethora of cases that came out of that which are highlighted here. But the end result was that based upon this transaction which is the Morgan Keegan bond being purchased elsewhere away from Morgan Keegan as a broker-dealer, but just the proprietary product, did not give it rights to pursue and was not a customer of Morgan Keegan the broker-dealer for purposes of FINRA litigation. And, so Morgan Keegan went to court, sought an injunction against continuing on in FINRA. That doesn't mean that you can't continue on in court, at that point in time. However, to the extent that the court, to determine that it was not a customer found that there wasn't a sufficient amount of relationship between Morgan Keegan, the broker-dealer, and the investor you are probable going to lose in court too, as a practical matter.

There were other cases that talked about how direct of a relationship, which I talked about a little earlier. How direct of a relationship is it? There are a number of cases where a broker is providing advice and services to, let's say, a corporation as it relates to its purchase of a hedge fund or investments in a hedge fund, but the shareholders who were damaged by that particular advice want to sue, in FINRA, the broker-dealer. What happens is, in that particular case the court found well, the relationship wasn't between the shareholders and the broker-dealer, the relationship was between a corporation and the broker-dealer so; therefore, there was no, there was an insufficient relationship to be a customer for purposes of FINRA litigation. And there was an injunction in that case. So, as an attorney, you have to analyze just how close this relationship is for you to want to pursue your case in FINRA. There is a particular line of cases that goes through, that talks about, [whether] the broker's conduct [is] sufficient to tie in the broker-dealer. In the line of cases, at least up until recently, what has been found is: yes. If the broker is selling you something or giving you advice and there is a direct relationship with the broker and he has sold you something, and he has received compensation, that's as if the corporation/the broker-dealer has received compensation, and that is sufficient for a relationship to pursue FINRA litigation.

There is also what is called selling away. For people who don't know what selling away is, it's a broker is associated with a broker-dealer, but he on the side sells something like a promissory note or a private placement memorandum and doesn't notify the broker dealer; he just sells it and pockets the money himself, or it is for his benefit. Or he is involved in the private placement as an officer or shareholder and receives money for that sale for the benefit of whatever that corporation that he sold was. And that is called selling away, because the broker dealer doesn't know about it.

There is a line of cases, so the defense to the broker dealer is well, you know, we didn't know about it, they weren't our customer, I don't know what this broker was out doing, they don't have an account with us, they don't have a relationship with us, and therefore they are not a customer and they shouldn't be in FINRA. What was found in most of the cases is that a customer of the broker is a customer of the broker dealer. Regardless of whether the broker dealer knows that this activity is going on. And the rationale for that is, because – or one of the rationales for that is, because the investor usually makes the claim of a direct lack of supervision over the broker against the broker dealer. That the broker-dealer should have known that there was this activity going on to the investor's detriment and because of that it is a sufficient relationship to get it in to FINRA and have a FINRA litigation.

So, after many many many [*sic*] years almost twelve, thirteen years of litigation, the Second Circuit recently has come out with what has been touted as a "bright line rule" for determining who is a customer for purposes of FINRA litigation. And that case, and I attached it to the materials is *Citigroup Global Markets v. Abbar*, [761 F.3d 268 (2d Cir. 2014),] it was decided August 1 of this year. It's very recent, and it is by the Second Circuit, and it will probably be adopted by most of the other circuits, I would imagine. And that case holds that a customer is one who while not a broker-dealer either purchased a good of service from a FINRA member or, underscore or, has an account with a FINRA member. And that's supposed to be the bright line rule.

This case arose – the Abbar family was businessmen that were dealing with Citigroup affiliates in the UK and in the United States, but not directly with Citigroup itself. And what the court determined was while you didn't have a direct relationship with Citigroup itself, you were just dealing with the affiliates. Citigroup although ultimately going to receive some benefit from its affiliates advice and payments made to its affiliates at this point in time, there is not a sufficient relationship to be able to pursue the case in FINRA against Citigroup. Now as I said it has been touted as making a clear bright line definition—I somewhat disagree. And I think there is going to be, continue to be litigation at least in the selling away cases because it doesn't define – it says "purchases a good or service from a FINRA member." Well a broker isn't a FINRA member, it's associated with a FINRA member and the FINRA members will go, "well they didn't purchase the good or service from me, therefore you can't litigate against me." I think there is going to be some litigation over that issue.

Part of that is because in the Citigroup case, although they were Citigroup employees and affiliates and the money was eventually going to Citigroup, the court found that they did not provide services to Abbar, and it was not sufficient because they did not purchase services directly from Citigroup, and they were not on account of or they were not accountable to Citigroup. So, those were employees that were actually providing advice similar to a broker being an employee providing advice, albeit not notifying its employer that it was doing so.

I also think there is going to be litigation over – let's say you have an account with a broker dealer. You've opened the account agreement, it provides that you are required to go to FINRA litigation, you then receive advice from your broker and you take that advice and you go over and buy stuff from TB Ameritrade or Schwab or you just exercise it on your own. So, the broker-dealer doesn't receive any compensation for it, the security is not purchased or sold through them, but you do have an account with them. So I think there is going to be some litigation as it relates to that because you have effectually gotten advice and you have an account with a FINRA member, which is one of the requirements. However, they are not being compensated and they don't even know you made the trade so I think there is going to be some litigation over that.

And third, it really doesn't address the issue of compensation that FINRA seems so focused on, which is the broker-dealer going to get any benefit out of this. I think that is a wrong analysis on just whether you are going to get any compensation. I think they have other duties to the particular investors other than "I only have a duty to you if I am going to make money off of you." So I think that is an incorrect focus, that will again be litigated over time so I am not sure that it is such a bright line rule as being advertised, but it is going to [you] know at least provide compensation for lawyers for time to come.

The second issue that Joe asked me to talk about kind of – it dovetails into who is a customer, but also who you are a customer of, in these particular cases. The first context and this comes up a lot and you will see this come up a lot. There is a bank, [the] bank has a securities affiliate you want to sue, you open an account with the bank where you put in your investment account you also put in your savings account, you also then open up a securities account with a securities affiliate. Your balance goes down significantly and you want to sue. And you want to sue the bank [that] is not a FINRA member and you want to sue their securities arm who is a FINRA member. The context that occurs is that the bank kind of gets to decide where it wants to be. It can kind of forum shop because it is not a FINRA member but if it would really like to be in FINRA it can draw itself into FINRA through its securities arm. If it doesn't want to be in FINRA and it wants to be in the courts then it says, "I am not a FINRA member, I am not bound by your jurisdiction, I am not in."

So, the bank has all the power in that particular regard as opposed to the investor and there was recently a Seventh Circuit case called *J.P. Morgan Chase Bank v. McDonald*[, 760 F.3d 646 (7th Cir. 2014)]. It's a July 2014 case where the bank did just that. The investor opened up a bank investment account and subsequently a brokerage account and it lost money. But it lost money primarily in the bank investment account. So the court – the bank sued to enjoin FINRA proceeding against its affiliate, its securities affiliate. The investor had only sued the securities member firm in FINRA and did not sue the bank at all. But the bank intervened, brought a court action, and received an injunction to stop the proceeding against its affiliate, which again the bank has all the power in that particular regard and the Seventh Circuit agreed with it. [It] said, "you are right the relationship is not really with your securities arm affiliate because most of the losses occurred in the investment account that was with the bank and the bank is not a member of FINRA."

I have experienced the opposite of that, where I sued the bank in court, didn't sue the securities arm of that, in fact it was J.P. Morgan Chase and the securities arm intervened into the federal court action and moved the bank and the securities affiliate into FINRA. And that was because the bank volunteered to go to FINRA on that particular note and the securities arm for some strategic reason wanted it all there as opposed to in federal court against the bank. So again, that is a unique issue where the bank has the power.

The second issue that arises is in connection with registered investment advisors. Registered investment advisors are not FINRA members. They are registered at the SEC at the state level, and FINRA doesn't have jurisdiction over them. What you will find in a lot of securities litigation is that there is a registered investment advisor that receives a power of attorney to run the account, but the investments have to be made through a broker-dealer. So, if there are losses in the account and you want to hold both the broker-dealer and the registered investment advisor liable – you want to sue them both and you want to sue them both in the same forum because that is efficient it would seem. Well, because the RIA doesn't have, is not a FINRA member, is not required to go to FINRA and usually has a separate agreement that sends it to some other forum it declines to participate in the FINRA action against the broker-dealer. What FINRA will do at that point in time is tell your investor attorney that it doesn't have jurisdiction over the RIA, but it will send out a letter to them and say, "hey you got sued, would you like to participate?" And in my experience 100% of them say no I would like to decline that and you know if they want to sue me, sue me under my agreement, my separate agreement, my separate forum and now you have an investor who may not have significant losses, significant to them certainly, but not sufficient losses to be able [and] now have to fight on two fronts. And I don't know if the SEC or FINRA is planning on doing anything but that seems to be a conundrum that is becoming more common as more brokers transition into RIA rules to kind of get out of the regulatory program that FINRA has and the SEC have. So, that is a topic coming up.

Another area where this arises is if there was a broker that was your broker, and your broker-dealer, and then you sustain losses; you sue them three, four, or five years later and they are not in business. The broker is either no longer registered, or is sitting on the sidelines; the broker-dealer has gone out of business and no longer registered and then FINRA has to decide whether it still has got jurisdiction over these particular brokers or broker-dealers based on this registration. I am assuming, based upon when the loss transactions occurred, and whether the broker was registered at that time or not, how long the broker has been not registered. For those of you that don't know, if a broker is not associated with a member for two years they lose all of their licenses. They become deregistered, and so FINRA loses jurisdiction over them after two years. However, their contract, it has been argued, that they have with the broker-dealer and with FINRA during the course of their broker time period should dictate that they are still subject to FINRA jurisdiction for the time period that they were in losses that occurred during when they were a broker with that broker-dealer. That is an issue that is somewhat out of the control of the attorney, and sort of left in the hands of FINRA to make that determination whether it still has jurisdiction or doesn't have jurisdiction. But again, if the broker wants to volunteer and sign a submission agreement and say, "sure I will come and participate in FINRA," – the other alternative is: [the] court [is] still available, [the] court [is] still available to sue the broker as long as the statute of limitations hasn't run. So, that is still available if you can't get it into FINRA. Those are just some of the different issues that are arising as it relates to who is a customer and if you are a customer, who is it that you are a customer of.

Moderator
John just to make one quick comment on variable annuities versus index annuities and the incident where you have a former broker or a broker who was a FINRA member and then becomes an insurance person: "Have you had any experience with trying to drag the insurance company into FINRA?"

John A. Hubbard
I have heard of that experience, but I have not had it personally. I have found that it is next to impossible unless they have volunteered to do so. There are special FINRA rules regarding insurance products and insurance sales, especially now that they're an insurance salesperson. It is nearly impossible, and in fact, it may just be easier to go to court anyway.

Moderator
Anybody have any questions for Mr. Hubbard? All right, Mr. Saretsky you are up.

Mr. Saretsky
I am.

Moderator: Mr. Saretsky is going to talk about motions.

Gary M. Saretsky
[Good] morning everyone. My name is Gary Saretsky. I'd like to begin my presentation with a personal note. This program has a rich tradition, and in truth Michigan's Security Law Bar has a long and rich tradition in part because it has been driven by two attorneys who really have been lions among all the other cubs and attorneys, among the attorneys practicing in this area. So, just on a personal note, I want to thank Joe Spiegel and I want to thank his good friend and sometimes partner, Tony Trogan, for all they've done over the years for all their contributions. They've not only added immensely to the educational process for all of us, but their occasional butt kicking of me and lawyers in my firm has made all of us better attorneys.

We're in an educational setting, which to me means there should be a spirit of intellectual freedom and the notion that people should able to speak freely. I interpreted that to mean that I can be and serve as a provocateur, and be a little mischievous today and try to stimulate some healthy discussion and debate and to try to make this program slightly more interactive. And so you'll notice that Mr. Spiegel began the presentation with a really exaggerated, negative view of the securities industry, which has made him a very which rich man I might add. Now the industry is comprised of well-intended professionals, but, like every industries, there are rotten apples occasionally.

[In] my office we do security defense work. So, we represent the industry, unlike Mr. Trogan or Mr. Spiegel who are more frequently representing investors or claimants. And in our office, we refer to representing the securities industry as doing God's work. So, I would point out to you that no industry, no industry, [*sic*] is as heavily regulated or polices itself better than the securities industry. I'm a lawyer, [I've] been practicing for thirty-four years, and I can tell you that for all the efforts of the Michigan State Bar and the attorney grievance commission, etc., lawyers are not nearly as heavily regulated as the securities industry – doctors aren't. So, while Matthew McCaughey's portal was interesting and exciting, the fact of the matter is that security professionals try very hard on a daily basis, just like the SEC, to get it right. But occasionally things do go wrong.

Now, in my packet of materials there [is] a handout, in the packet of material there is a hand out from us on motion practice, which is my assigned topic. There are many different types of motions that can and are filed in FIRA arbitrations. I've decided to concentrate my presentation on four types of motions: disqualification; discovery; dismissal; and expungement. And I've chosen these topics for a reason.

Disqualification refers to a motion to disqualify an arbitrator from sitting as an arbitrator in a case. And so you can image the exquisite irony that's presented by you as an attorney suggesting to an arbitrator that he or she is unfit in some way, shape or form because they're either biased, or prejudiced, or they have an interest in serving as an arbitrator and therefore they should be disqualified. It's so awkward that I thought it was a juicy topic to present.

The second topic is discovery. Discovery really is, in my mind, the guts of every case. You have a statement of the claim that is filed by a claimant, and you have an answer that is filed. And then frequently many months pass until you have a hearing. And in between those two events, the filing of the pleadings and the hearing, you have discovery. I wanted to present the subject today because arbitrators hate discovery motions. Everybody hates discovery motions. So I thought it [would] be a good idea to learn to love what we hate a little bit more.

The third topic I am going to present on are motions to dismiss. FINRA explicitly discourages the filing of motions to dismiss. And I am going to ask some of my fellow panelist to comment on motions to dismiss and their views on them.

And then finally, a subject near and dear to my friend, Tony Trogan's, heart, expungements, what he calls the clock of invisibility, and the notion that expungement which references the removal of a claim from a broker's record.

[Inaudible]

And so, let's start off with disqualification. A motion for disqualification has to be made with great hesitation because if you fail in your effort to disqualify an arbitrator you are left with that arbitrator deciding you and your client's faith. So, you better think long and hard before you seek to disqualify an arbitrator.

FINRA says all the right things in its pronouncements whether it's the FINRA arbitrator guide or in the rules that FINRA has promulgated. But the fact of the matter is, notwithstanding the fact that arbitrators are obligated in good faith to disclose anything that might create either an inability for them to be impartial, but something that might create an appearance of the lack of impartiality. And I think that FINRA got it right in its encouragement of arbitrators to make all the requisite disclosures. However, we live in the real world. Arbitrators are not judges. Judges don't work outside of their job as their judges. Arbitrators do. They have business and professional lives, and they have personal lives. And so, it's not infrequent that there will be situations, which create problems.

When there is a concern regarding the service of an arbitrator, a motion should be brought promptly and you need to articulate why that arbitrator is, in your view, unfit. Now, the important part is that arbitrators will be asked to decide, because they decide their own fitness as a preliminary matter. Whether they are – they feel that they would be appropriate arbitrators, can they be impartial, can they be neutral. The point is that arbitrators frequently believe that they can be impartial and neutral notwithstanding whatever the conflict might be. So, is the subjective test, the arbitrator's own personal view, what determine things? No, the answer is that the test is objective. Would a reasonable person believe that the arbitrator is impartial?

In the interest of time, I'm going to skip forward a little bit and present some study questions for us, and ask people on the panel to discuss these issues with me.

So, let's start with you Mr. Spiegel. Let's take the first question: Is an attorney [who] would regularly represent claimants an impartial arbitrator?

Joseph H. Spiegel
Sometimes. You have to go to the social media. It's a new world out there. When you have a panel of arbitrator you're going to look at what they do, who the panel is composed of, what the relationship between each of the individual arbitrators are and what they've done in the past. So, just because an attorney regularly represents a respondent or a claimant may not have the kind of impact you would normally think. It's idiosyncratic. It depends upon the case.

Gary M. Saretsky

Second question Tony, what do you think, what if that same attorney regularly represents claimants in prosecuting similar claims involving similar investments. Does that necessarily disqualify an arbitrator from service?

Anthony V. Trogen
Well, from the claimant standpoint probably not. Especially if that arbitrator happens to be Joe Spiegel or go on down the list. On the other hand, from a respondent's standpoint, I certainly can understand why there might be some concern. And I understand that – that's why I have not sat on a panel in, I don't know, 10-12 years. Because people associate me with claimants' grievances and they feel that I will, without thought, favor the claimants' presentations of the facts. In truth they are wrong. And the reason I know they're wrong is, like Mr. Speigel, I turn down ten cases for every one I take. I don't buy into the song and dance as easily as you may think.

On the other hand, when I see, when I see low hanging fruit I pick it. And in fact, I think for most claimants' attorneys who have the experience of picking and choosing, you would find the same approach. Convince a respondent's attorney that's true, I think would be almost impossible. It might be malpractice for the respondent's attorney to take that chance. However, reverse the position, if you have a respondent's attorney who routinely represents respondents and you know has represented respondents in a similar situation, can you trust him, or her? And –

Gary M. Saretsky
I thought you told me you loved me.

[Laughter]

Anthony V. Trogen
Gary, I am in a moment going to take a point of personal privilege, and I assure you right now I will not use it for the side of you.

Gary M. Saretsky
Let's get to the rub of the issue though. Because what if that same attorney is currently, not has in the past, but is currently prosecuting a similar claim against, you know, against another broker, another broker-dealer. Does the simultaneous service as an advocate in a matter in which that attorney has an interest in the outcome suggest to you that there

would be an inference of basis, or interest, or partiality in the, in the matter in which your shoes are pointed as an arbitrator?

Anthony V. Trogen
My point was that from a claimant's standpoint, not necessarily; from a respondent's standpoint, I would want to know about it and I would want to raise it. And I would expect that particular arbitrator in the exercise of some common sense, and in the desire to promote the universal respect for the conduct of arbitrators, which we absolutely have to have – we cannot have arbitrators out there that some people think are bent in some way, we just cannot have that – that the arbitrator would, would voluntarily withdraw. I think that strongly about it.

Gary M. Saretsky
We live and practice law in the real world; we have clients. So, how does an attorney, whether it's a claimant's attorney or respondent's attorney, how does an attorney explain to a client that they have on their panel a person who is currently prosecuting or defending a similar claim and it unsettles a client? The point that Tony makes is an excellent point. The arbitrator has an obligation to disclose and use good judgment, him or herself, about recusing or withdrawing under those circumstances.

Alright. Let's move on to discovery. Discovery really is the guts of every case. I am exactly certain, I am certain that it's exactly the same for claimant's lawyers as it is for respondent's lawyers. When the respondent's attorney receives that statement of claim, when it hits her or his desk and they read it and they first talk to the client, the broker, the broker firm, they say alright there's almost nothing in this statement of claim that is true. It seems contrived; it seems like a neat and pat story; it seems like, to be honest with you, the exactly same statement of claim that I've seen from this attorney twenty or thirty times before.

On the other side, claimants receive, claimants and claimants' counsel receive, answers from respondents' counsel that seem to say and cite the same authorities over and over again. And the story seems to be equally neat and pat: we didn't know the correct investment objectives; the correct box was checked on the new account form as to what the customer's investment objective was; that the customer indicated they were willing to take a modest amount of risk, etc.

So, all of us seem to hear the same thing. The point is that discovery is used to test the truthfulness of the statement of the claims allegations and the answer's assertions. And to address that, FIRA has wisely tried to streamline the discovery process through the process of document production lists.

Felicia would you like to, kind of, explain briefly what those production lists are and how they work?

Felicia Fox
Depending on the case there are certain lists that apply. So, documents need to be pre-produced, the discovery requests do not need to be automatically compounded. They list information, [it] just needs to be automatically exchanged. That does not preclude a party from requesting additional items that are not included on the list. But you do need to exchange the documents that are listed.

Gary M. Saretsky
So, to make things easy, FINRA rules build in documents which are presumptively discoverable in every case. And the goal of that effort was to minimize the discovery disputes. But still there are discovery disputes in most every case and a motion has to be filed. The single most important thing to know about bringing a discovery motion is that everybody hates them. Your client hates a discovery motion because it takes up a lot of time and energy and money fighting about stuff that people should cooperate on. FINRA's rules encourage the parties to cooperate in exchanging documents and information.

Beyond your client, the arbitrators justifiably hate discovery motions so the only practice pointer that I could offer is prepare a chart that summarizes what it is that you want, why it's important, and what the objection is to make life easier for your arbitrator. They're going to hate – everyone involved in the discovery dispute – they're going to hate them – the prehearing, which addresses it so by making the arbitrator's job a little easier. It'll help.

Felicia Fox
And Gary, let me also add that when you are filing a discovery motion, make sure you include the underlying disputed documents. Don't assume that the arbitrator has those.

Gary M. Saretsky
Ok, skipping forward to dismissal. FINRA's rules afford a party the right to move for the dismissal of claims. Sounds reasonable, doesn't it? It is. What might be subject to debate is FINRA advocating a policy position and saying that motions to dismiss are discouraged in arbitration. So, it can't be bad for FINRA business to allow motions to dismiss to be filed. So, the question becomes "why has FINRA expressly discouraged the filings of motions?" In court, motions to dismiss are favored, they dispose of meritless claims early on. They narrow the scope of issues that can be heard and argued in an arbitration. They can shorten a hearing, they can provide focus to that hearing and importantly save everyone time and money. So, the question becomes "why are motions to dismiss so discouraged by FINRA?"

Anyone want to take a crack at addressing that? I'm not going to put you on the spot Felicia but maybe one of the other panel members.

Joseph H. Spiegel
There is no appeal from an arbitration award. You can move to vacate, [but] it's virtually impossible. There are no depositions, there are no interrogatories for any practical purpose. And I think that FINRA's concern is everybody, and Tony I think would agree with me, is everybody should have their day in court. You want this customer to be able to tell his or her story to an objective independent panel and whatever happens, happens [*sic*]. Now, you'll notice that it's only dealing with motions to dismiss. I've never filed a motion for summary judgment in arbitration for a claimant because I know it's a useless, worthless type of motion. And I think that FINRA's concern is investor protection and market integrity and in order to further that process, they want the customer to feel they had a chance to say what was on their mind. Tony would you agree?

Anthony V. Trogan
Yes, and you make a very good point that you know we can, but never do. It really is something that only addresses a concern for respondents and it's intended to stop them for very good reasons. But Gary, you should tell them there are only three pre-closed proofs, there are only three things you can file.

Gary M. Saretsky

I'm going to do that, I'm going to do that. Thank you, but before doing that, I'm going to point out that motions to dismiss are so discouraged and disfavored that FINRA has implemented a rule which contravenes everything we know about the American legal system, which says that if you bring a motion and you lose, then you have to pay. Think about that… You're paying…

Anthony V. Trogan
Bad faith, [good] faith, you may have to pay if it…and then the other one is, you must pay if, what are the two standards?

Gary M. Saretsky
Well there are three grounds for motions to dismiss. One is where there's a settlement or release. So think about that, you've already received a settlement – you've already been part of a settlement agreement and obtained a release in the case, FINRA permits you to file a motion to dismiss to say hold it, this claim shouldn't be brought against me because I've already settled this, and my claimant – the investor has released this claim. That's the first circumstance in which a dismissal is expressly approved.

The second is where typically a broker hasn't been associated with the account in question, the securities, or the conduct. Those are the easy cases. The tougher case is when you have an eligibility issue. The FINRA rules contain a rule that is a threshold jurisdictional gatekeeper that says no claim shall be eligible for submission to arbitration under the code where six years have elapsed from the occurrence or event giving rise to the claim. Respondents will typically argue: lets look at the date of the investment, when was the investment purchased – that what's giving, that's the occurrence or event giving rise to the claim, the disputed investment, and therefore, that is the trigger for approval of the eligibility rule. Claimants take a different point of view. Someone on the panel want to articulate what that is? Ben, you want to jump in on here?

Benjamin P. Edwards
Sure. There are at least two circumstances where you may be able to use a different date. First, there are often continuing violations where you have a breach of fiduciary duty and the duty is breached again and again and again. Second, you may sometimes be able to use the damages date. After all, you may not be able to bring a claim until you have damages. Interpreting this as meaning that the occurrence or event giving rise to

the claim occurs before damages occur would make it very difficult for claimants to establish any claim in some circumstances.

Gary M. Saretsky
Right, that's a great explanation. So, the point is there are certain kinds of investments where there may be [an] ongoing relationship, either an ongoing relationship or duty post-purchase. So, for example, if you have a broker that recommends an investment and the customer makes that investment, and then the broker subsequently presents to the customer phony or fraudulent account statements in an attempt to lull the investor into a false sense of security that their account is doing well because the broker is misrepresenting the value of the investment or the status of the account. That would create a new violation within the six-year period.

Joseph H. Spiegel
You will see awards where there are pre-hearing dismissals but you have to look at them very carefully, they're very fact specific, there's something underlying the case that you don't know of, arbitration is private, there's no transparency, there's no record, there's no court proceeding that you would normally have. So, when you see, and if you look at awards regularly which we do, you'll see a few dismissals. But not a lot.

Gary M. Saretsky
Last topic, because I really monopolized and I apologized for that: expungement. Tony, this is an issue that's really near and dear to your heart. Can you explain to people what the expungement rule is and what your feelings are about it?

Anthony V. Trogan
Well, I don't even know if they still do this, but let's say you're a juvenile and you break into someone's garage and steal the beer out of the refrigerator out there and you get charged hard, [like] breaking and entering or something, instead of pilfering beer. If you stay clean, if that's you know the only time you did it, and there are extenuating circumstances like whatever –

Gary M. Saretsky
Somehow Tony, I think that this is a topic that you might have personally experienced at some point

Anthony V. Trogan
[Laughs] No no.

Joseph H. Spiegel
[Not that he'd] admit.

Anthony V. Trogan
But I've heard about these things, and let's say that you're convicted and they give you a chance since you were a kid, foolish and doing dumb things and so forth. As I recall, they use[d] to allow you to expunge that so you didn't have to carry it around the rest of your life because nobody looks at, well he broke into the neighbor's garage and took beer out of the refrigerator, they look at a felony. This is a felon. So, they let you wipe that off your record I think or they do it with driver's licenses too. Don't they?

Gary M. Saretsky
I don't know about either of those, Tony.

Anthony V. Trogan
Ok, well, let's just assume that something like that happens. And so what someone thought up was that brokers, who are adults in full possession of their faculties, fully aware of what they're doing, trained in the most heavily regulated industry in the world; when they do something wrong, they should be treated like the sixteen-year-old stealing beer. And we ought to be able to wipe that slate clean so that no one knows that he was found by arbitrators fifteen different times to have violated his clients' rights and his firm paid out four million dollars. That's all wiped off, that's why I call it the cloak of invisibility if you know about Harry Potter. Because it's an artificial device which cloaks the misconduct, and as with Harry Potter, from certain people but not everybody. The cloak doesn't work as to certain people. [Timothy] Massad can find out if that broker had some dings on his record, but I can't.

And I think it's just an awful awful [*sic*] device. And what makes it even worse is that for many years claimants' attorneys sold expungements as part of settlements. So, even the premise for the expungement that somehow nothing really bad happened that you know he was pilfering beer out of the neighbors, not a felony, not that he took a hammer and broke a window and – that it was somehow something less and claimant's attorneys – I remember the first one I sold and I got five grand for it and the case was all settled and my, well I can't say the name. And the defense attorney said "oh we want an expungement, we want an agreement to an expungement" and I said "sure, absolutely, five grand more ok." And it went on from there.

And I've never kept track but what awful awful [*sic*] circumstances when you've got an industry where almost nobody goes to jail, where if you do something bad and you're caught, write a check to the Attorney General of the State of New York and you go home to your wife and your kids. That's all you have to do, that now we're going to extend that to involve regular plaintiff sale brokers who are doing bad stuff, have been found to do bad stuff and they get their slate [wiped] too, so me as an investor, as a customer, there could be a guy out there with twenty-five hits on his record and I – maybe I don't want to deal with him because he has 25 hits.

Joseph H. Spiegel
This is an issue that has come up before the SEC, it's come up before FINRA. It is an issue that will be resolved I think through regulation in the future.

Anthony V. Trogan
It's Changing! It's Changing! I mean, you're still going to be able to sell your expungement, but you're not going to be prohibited as part of the contract of sale from showing up at the hearing where the panel makes the decision or the court decision where it's confirmed.

Joseph H. Spiegel
Correct, Felicia is going –

Anthony V. Trogan
Or writing letters or whatever that's way beyond me because I don't keep up on current things. But that's going to change because it's truly offensive. It's you know the rubber hits the road in arbitration and that's just a little too close. I mean you do things in the background that everybody doesn't see, but everybody sees that. It impacts everybody and it's too important not for it to be addressed and changed.

Joseph H. Spiegel

Ok, Gary do you have anything to say about expungement or are we done with it?

Gary M. Saretsky
I might have a different point of view about it but this might not be the time or place to express that, Felicia?

Joseph H. Spiegel
Felicia Fox is going to follow up now.

Felicia Fox
Good afternoon everybody, good morning everybody, time change. I'm going to talk about four significant rule changes within the FINRA forum. And today, like the SEC folks, I just want to say that any opinions being expressed are my own and not necessarily those of FINRA or my FINRA colleagues. So, with that in mind, let's talk about four recent developments in FINRA in the arbitration program. I'm going to talk about today's panel composition, personal confidential information, amendments to the discovery guide, and hot off the press, the increase in the arbitrator honoraria, especially as a primer to Tony over there who doesn't keep up on current events.

So, in September 2013, the SEC approved amendments to Rule 12403 of the customer code to simplify the arbitrator panel selection process in customer cases with three arbitrators. Under the amended rule, all customer cases have the same panel composition method. A customer no longer needs to elect the panel selection method, and that was referred to as the customer option rule. So, under the amended rule, parties will receive three lists of arbitrators, one with 10 public names, one with 10 share person names, and one with 10 non-public names. The parties may strike 4 arbitrators from the list of 10 public names and 10 share person names. If a party wants an all-public panel, any party can strike all of the arbitrators on the non-public list. If a party wants to have a non-public arbitrator on their panel, they can limit their strikes, however limiting strikes does not guarantee that there will be a non-public arbitrator on the list. FINRA won't appoint a non-public arbitrator if either individually or collectively all of the non-public names have been stricken, or if there are remaining names, but those folks are unable or unwilling to serve for any reason. So, as the panel selection rule developed, we've been tracking awards reached by all public and majority public panels. In November 2012, we started posting the results on the website regarding the customer option rule, and these are the results so far:

So in November, I'm sorry in 2013, investors prevailed 43% of the time in cases decided by all public panels. And 44% of the time in cases decided by majority public panels. Through July of this year, investors have prevailed 45% of the time in cases decided by all public panels and 42% of the time in cases decided by majority public panels. Another recent rule change protects personal confidential information, otherwise referred to as PCI.

This summer, the commission approved an amendment to the codes of arbitration procedure to provide that any document filed by parties that contains social security numbers, taxpayer identification numbers, or financial account numbers needs to be redacted to include only the last four digits. And these amendments apply only to documents filed with FINRA, they don't apply to documents that are exchanged among the parties and they don't apply to documents presented to the panel directly at the hearing on the merits. The rule also doesn't apply to simplified arbitration cases. So, here's a best practice tip for you, make sure you are redacting your documents because if you don't, it's going to delay your filing.

Another recent rule change impacts the discovery guide. Now the discovery guide provides general guidance on electronic discovery, product cases, and it clarifies the provisions relating to affirmations. And this became effective in December of 2013. Specifically, the amendment modifies the introduction to the discovery guide, and includes guidelines for the arbitrators to consider when deciding disputes regarding the form of electronic discovery. Production needs to be reasonably usable. The introduction also adds guidance on product cases to explain that the document production lists don't provide all of the documents that the parties generally want in a product case. And thirdly, the introduction clarifies that a party may request an affirmation when an opposing party only provides partial production. Also, the amendment encourages arbitrators to consider the totality of the circumstances, including cost and burden when they're resolving discovery disputes. The amendments do not impact the document production lists.

And, finally, I'm gonna spend the majority of my time on the latest rule that just passed this week, on the 3rd, and this regards the change to increase the arbitrator honoraria. So, honoraria payments to arbitrators have not increased for, anybody have an idea for how long? It's been fifteen years. So, the amendments increase the honoraria for the arbitrator's receipt for serving as arbitrators in hearing sessions for serving as chairpersons, for deciding contested subpoenas, and also for serving in simplified arbitration cases.

To fund the increase in the additional honoraria to the arbitrators, the SEC approved amendments to the Code that increase certain arbitration fees. Included in those increased fees are arbitration filing fees, member surcharges and process fees, as well as hearing session fees. The new honoraria will apply to new arbitration cases filed on or after the effective date of the rule.

So, by way of background, honoraria are the fees that arbitrators receive for participating in the arbitration process and for making decisions in the FINRA forum. Again, this is the first increase since 1999. And the increase is needed to help retain arbitrators, and attract quality arbitrators who have the skills necessary to manage the arbitration cases and is essential for FINRA to meet its regulatory objective of protecting the investing public. To fund the honoraria increases, FINRA has amended the codes to increase the member surcharges and process fees for claims over $250,000. The filing fees and hearing session fees are increased for claims of more than $500,000. In addition, the amendments increase surcharges, process fees, filing fees, and hearing fees for nonmonetary, or sometimes referred to as unspecified, claims.

So, as I mentioned earlier, there are four types of honoraria that are increased with the rule changes. First of all, there is an increase to hearing session payments. Under the amended rule, the arbitrators will receive $300 a hearing session. This is an increase from [the] $200 that they currently receive. So, under the amendments, arbitrators will generally receive $600/day, which is a 50% increase.

Joseph Spiegel
Felicia, could I interrupt you?

Felicia Fox
Sure.

Joseph Spiegel
Can law students apply to be arbitrators?

Felicia Fox

They can apply, but they're going to have to wait a few years until they have some experience under their belts. I believe we're looking at a minimum of five years of employment before serving as an arbitrator. Chairpersons also receive an additional honoraria in addition to that $300 that it will be a session. So, currently chairpersons receive an extra $75 for a hearing session per day. Under the rule change, they'll receive $125 per hearing session day. Doesn't matter how many sessions are included in that day, could be one, could be three, it's still going to be $125, that part doesn't change. And, there's also an increase in the hearing session for the honoraria for contested subpoena motions. Currently, it's $200. With the amendment, it'll be $250. That means that parties will be paying $250 for contested subpoena motions.

There is a limit per case, so it would be one arbitrator, each arbitrator per case, so it's a $750 limit for the parties. Before, it was $600. So it doesn't matter how many contested subpoena motions they decide, they max out at $750. Also, for simplified cases, the honoraria have increased. That one has gone, simplified cases, let me start with that. Simplified cases are cases where arbitrators decide the case based solely on the pleadings, and those are for claims of $50,000 or less when the customer does not request a hearing. Currently, arbitrators receive $125 for that. And with the amendment, they'll receive $350.

In order to fund the increased honoraria, certain fees have increased. So, first of all, certain member fees have increased. To begin with, the Code provides that a surcharge is going to be assessed to all members based on the claim amount in any case when they're brought in, whether its through a claim, a counterclaim, or a third party claim. And FINRA has amended the rules to increase those surcharges for all claims over $250. The surcharge only applies to member firms, and it's not something that can be reallocated to an investor.

Similarly, for member firms, they also pay process fees. Currently, all firms have to pay process fees for cases of $25,000 or more at certain milestones in the case. So, specifically, the prehearing process fee comes in at the time when the list of arbitrators are provided to the parties, and then hearing process fees come in at the time that the dates and location is provided to the parties. Under the amended rules, the member process fees will increase at claims of $250,000 and over that.

Significantly, this is a bigger difference, the prehearing and hearing process fee, which are currently two different fees, will become one. So, there will be one process fee and that will be assessed at the time that the lists are provided to the parties. Like the surcharge, the process fees cannot be allocated to an investor.

Next, we come to fees that affect both members and investors. These are mainly filing fees. So, under the Code, a customer, associated person, a member, a non-member, anybody who files a claim has to pay a filing fee to initiate the arbitration. The filing fee is composed of two parts. There's a refundable part and a nonrefundable part. And, the rule increases affect the filing fees for claims over $500,000. Most of the increases come in the refundable part of the filing fee.

Lastly, there is an increase to hearing session fees. A hearing session is any meeting between the parties and the arbitrators that includes prehearing sessions, injunctive sessions, and hearing sessions. A hearing session can be held by either one or three arbitrators, and the amended rules increase the hearing session fees for claims involving disputes more than $500,000. For hearing sessions with one arbitrator, those fees will not change, but for hearing sessions with three arbitrators, those will change. And arbitrators will allocate all those hearing sessions to the parties in the arbitration.

The last change I want to note concerns unspecified, or monetary, or nonmonetary claims. So, each of the fee categories that I talked about has a certain fee for unspecified claims. And, the amendment increases the surcharge, the process fee, the filing fee, and the hearing session fee for those unspecified claims.

Joseph Spiegel
Felicia, can you get waivers for these fees if the person provides certain information?

Felicia Fox
Yes. When filing a claim a party can ask for a fee waiver. They need to substantiate that with documentation, but those are presented to the director, who will make those decisions. Those can be waived, deferred. Just remember, if they're deferred, you want to ask the panel to permanently waive those when you're at the hearing.

Joseph Spiegel

Discussion: Midwest Securities Law Institute Transcript, Fall 2014

Okay.

Felicia Fox
And the fee charts by the way are in your materials.

Joseph Spiegel
Thank you, Felicia. Felicia will be available after for questions, after because we're running short on time. Ben and Tony have a point, quick point-counterpoint on the issue of arbitration. Yes, just very short, we only have a couple of minutes left.

Elliot Spoon
You have ten minutes left.

Joseph Spiegel
Yes, ten minutes left but we're gonna have some questions I'm sure.

Anthony V. Trogan
Now, before we do that, personal privilege?

Joseph Spiegel
Personal privilege granted.

Anthony V. Trogan
When Ben got his job, he moved into town. Somebody gave him my name along with a couple of others and he called me up. And I took the call, I don't know why. I did. Since then, I've had the privilege of working with Ben, and the clinic, and the kids, and the school, and the clinic. Mediation, mock arbitration, working on panel picks, just talking to 'em. I'm honored and privileged for having been exposed to that and the experience.

Ben needs two things. One he needs cases. He doesn't need cases that you don't want because they're lousy cases. He needs cases, which maybe are too small for you to handle for his students to work [on]. If you've got those cases, send them over. Number two, he needs your advice from time to time. And you should feel honored and privileged if you have a skill or an experience or an expertise that would cause him to call you and say, what about "X," or have you got anything on "Y"? Or gosh, I don't know what to do about this, or could you come up and talk to some students some afternoon?

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Take the call. Take the call; you will be rewarded. You will help the profession. You'll help the school. You'll help the industry. And I swear to God, you'll help yourself. You will be invigorated and excited. And you'll feel better about yourself after one of these experiences. You might even wanna call him. [Chuckling.] Someday when you're sittin' in your office and it's three o'clock and your sugar is low and you don't have anything else to do. Call him up. Ben, what can I do for ya? You will, as I feel, and I'm not an easy nut to crack. I feel great about what little I've done, and I look forward to the next experience.

Moderator
Alright, let's do your point-counterpoint. Are you in favor of arbitration or against arbitration, Mr. Trogan?

Anthony V. Trogan
My, first of all, don't do away with arbitration. For the simple reason that it opens the door for so many people because of it's efficiency and its low cost of prosecution compared to in court. My practice is not exclusively in arbitration, and I bring cases in court, but it takes a lot more to do it in court. A lot more time, a lot more money, a lot more will. And, if we didn't have the arbitration forum, we would have a major problem with pent up demand for a forum, which would allow us to do what we do in arbitration. It's necessary. It's good. It was crammed down the investor's throat. And it turned out to be very tasty for them overall.

Moderator
Mr. Edwards, this is counterintuitive. Are you in favor of arbitration or are you against mandatory arbitration?

Benjamin Edwards
I'm in favor of arbitration, but against mandatory arbitration.

Moderator
Tell the group why.

Benjamin Edwards
Investors did not choose mandatory arbitration. There are significant concerns about the FINRA arbitration process and whether it is fair to investors. And while FINRA does a huge amount to make arbitration

fair, and is incredibly responsive, these concerns remain. The best fix may simply be to give investors choices.

Investor choice has a long history. This is something that Congress has endorsed as a possibility. In 2010 in Dodd-Frank in Section 921, Congress granted the SEC the power to make investor arbitration voluntary, instead of mandatory or compulsory. Despite having authority, the SEC has not yet acted. In its defense, it has had a lot of other things to deal with. Because of that, there are multiple bills pending in Congress, pushing to make arbitration voluntary. And so, I speak today in favor of the Investor Choice Act which was introduced by Representative Keith Ellison. This Act would give investors the ability to choose whether to go to arbitration or whether to go to court.

A broad coalition supports investor choice. The idea has been endorsed by the North American Securities' Administrators Association, which is the organization the state securities regulatory bodies, Americans for Financial Reform, The Consumer Federation of America, and the Public Investor Arbitration Bar Association of Attorneys, a voluntary bar association of attorneys who represent claimants. People want choices for a variety of reasons. A study released earlier this week raised concerns about diversity and the FINRA arbitration panels. It found that the average age of a FINRA arbitrator is sixty-nine. 80% of FINRA arbitrators are male. Forty percent of the arbitrator pool is over seventy. Seventeen percent are over eighty. To be clear, older arbitrators bring a lot of wisdom and experience to the panels. Yet this distribution doesn't reflect the diversity of the investing public or the general population. For reasons that remain unclear, FINRA also does not release racial demographic statistics.

Because of these and other concerns, many people have begun to push to make arbitration voluntary. For perspective on the broader mood, I want to read to you very an email from Diane Nygaard, who is a former President of the Public Investors Arbitration Bar Association. "Having just settled a case in which two of the arbitrators were dead, and a replacement arbitrator failed to disclose his son is a broker, I am in the camp favoring voluntary arbitration. I would much prefer to file lawsuits for my [churning] cases, for elderly widows. With every bull markets comes [churning] cases. Juries understand and will award large damages claims, including punitives to the victims. Our clients should have a choice. If they choose arbitration, they should receive a fair process."

And FINRA is, I want again to emphasize, incredibly responsive to investor concerns. It does much more than any other arbitration forum. No other arbitration forum vets its arbitrators, has the same kind of background check process. It does much more than any other forum. Still, giving customers the ability to choose whether they wanted to stay in FINRA arbitration or go to court would let them vote with their feet on whether or not its fair.

Moderator
Thank You, Ben. Gary, I, before we break, you did some statistical analysis ad hoc on expungement. You want to tell the group what you found?

Gary Saretsky
Yeah, notwithstanding the fact that expungement is subject to criticism. You heard much of the criticism from Tony. The fact of the matter is that arbitrators ultimately decide whether expungement should be recommended and is appropriate. So, there are safeguards built in for that. And statistically, just looking at the last three months of arbitration awards in which expungement was requested; in approximately two-thirds of the time, 66%, expungement is granted. So, Felicia, you and I had discussed what, before looking at what the statistics really were, what our impressions were. As a representative of FINRA, you thought that expungement was granted in less than half the times. So, your thoughts about the expungement process?

Felicia Fox
I think arbitrators are paying much closer attention to the documents that are produced. They are looking at more documents. They're looking at settlements. And they're not granting nearly as often as they have been in the past. So, expungement is an extraordinary measure, and arbitrators recognize that, and that's being reflected in the decisions that are coming out.

END BROKER-DEALER ARBITRATION AND LITIGATION UPDATE

BEGIN SEC ENFORCEMENT UPDATE

Elliot Spoon

Alright folks, if you could take your seats. We're going to start our next panel. [Audience chatter] So, we're running a little bit late. We're going to catch up during the lunch hour and there will be a great lunch available as soon as this panel is over. But this is going to be a great panel. Richard Zuckerman from Honigman Miller is surrounded by the SEC. Both Midwest and west coast. John Birkenheier from the Chicago office. David Van Havermaat from the L.A. office. And they have a very, very [*sic*] interesting presentation, so I'll turn it over to them.

Anonymous Speaker
Mr. Zuckerman has a tether by the way.

Richard Zuckerman
Right. It's from the law firm. *[Audience laughter]* Ok. Well, good morning. This panel has traditionally focused on – not knowing how to work the microphone – issues relating to enforcement, and we have picked some areas to discuss with you today. They're kind of disconnected but they're a combination of things that seem to happen a lot, and a combination of things that are relatively new or projected to be things the SEC will pursue. Unless my colleagues think otherwise, we welcome questions in the middle of our discussion. It livens things up and there's no need to save questions for the end because the topics are kind of discreet in any event. So, if you have some questions or some comments or you need some clarification of our muddled presentation, please feel free to ask. The first thing we're going to discuss are admissions in settlement agreements with the SEC. And this is, I say reasonably known, to me reasonably could be the last seven years but perhaps either John or David could set out what used to be the norm when it came to the factual basis in SEC settlements and what the, I'll call them the defendant, what the putative defendant had to agree to do or not do, and how that may have morphed somewhat into this issue of admissions.

David Van Havermaat
Thanks. I do have to give the standard SEC disclosure that both my and John's comments reflect only our views and not the views of the commission, the division of enforcement, or of the staff. Getting to that substantive question, some background on the Commission's policy regarding admissions in settlements. For as long as we can remember, the Commission's policy had been to include in perhaps literally every settlement a "no admit or deny" provision, which meant that if you

settled with the Commission, you were not required to admit to any of the findings or any of the facts in the settlement process. By the same token, you were not permitted thereafter to go out on the courthouse steps or in a press release say, "I didn't do it" or "the facts aren't exactly right" or something like that. Uniformly, it was the case that the "no admit nor deny" language was included in all Commission settlements, except for perhapd an isolated instance where the Commission might have won a trial and won on appeal.

That changed in 2012 when the realization came to the Commission that it was inconsistent that in many of our cases, because we had more and more criminal involvement, we would have matters where defendants had pled guilty or had been convicted of securities or wire fraud charges that were similar to what we were bringing, yet we were allowing them to settle without admitting liability. And to remedy that inconsistency, the first change in the policy was in 2012 and it was limited to those circumstances of a parallel criminal matter.

That changed more dramatically last year when the Chair announced a new policy that would require admissions in some cases. And in doing that, Chair White identified four categories of cases in which admissions might be appropriate. The categories she identified are cases where you have a large number of harmed investors or conduct was otherwise egregious; cases where the conduct posed a significant risk to the investors or market; cases where an admission might help investors in determining whether to do business with a particular entity or individual in the future; and other cases where having a recital of the facts and an admission to the facts would send an important message to the market.

Now, reciting those categories of cases probably doesn't give you a whole lot of guidance. What's egregious conduct in a case? I know there have been various panels throughout the year that have probably raised more questions than they've answered. And I fear that's partly the case here because I think the way to get the guidance on what the Commission is doing here is just to look at the cases in which we require admissions. I think you can fairly say they fit within those categories. For example, there was a case involving blue sheet trading data, which really constricted the Commission's ability to investigate matters. And I think it can be fairly said that that posed a risk to the market. There are other cases where, there was a case involving internal control breakdowns that lead to financial reports being faulty. So, the difficulty is, here, trying to figure out what, going forward, is what cases are going to require admissions. I think it's safe to say that the policy is – the majority of cases are still going to be on a "no admit or deny" basis, but you need to be aware that this policy out there. And again, the best way to see which way the wind is blowing is to review the cases going forward in which the Commission does require admissions.

Richard Zuckerman
Well, just to follow up on a couple of things. One, there's a reg that says, you can't go out on a stoop after you say "no admit nor deny" and say "No, I just settled with the SEC to get them off my back." Because that could violate the agreement you signed with the SEC. Whether or not the requirement to admit is a problem or not, probably depends, if you're a lawyer or you're going to be a lawyer, on whether you're representing the entity or a person. And then, whether or not the requirement to admit comes before or after a criminal case. If you're representing an individual who's been charged and who has been convicted or plead, the Latin phrase for admitting something to the SEC is *who cares*. [Audience laughter] Because you're –

John Birkenheier
What's that translate into in English?

[Audience laughter]

Richard Zuckerman
It translates into *who cares*? Because the criminal conviction will collaterally estop you. Whatever collateral consequences arise from being convicted, and there by either, well, de facto, admitting what you did, they exist, and you might as well settle with the SEC and admit to what you've already been convicted of because you've been convicted of it.

If you represent someone who is under a parallel investigation, you may be fortunate not to get into the conundrum of whether you have to admit something to the SEC to settle with them because what does that do to the criminal investigation because, and these guys can speak to it, maybe but not under all circumstances, the SEC will defer to the criminal case. They will put their investigation on the shelf if the same transaction is being investigated criminally. And so, you don't have to decide what you have to do with the SEC in advance of worrying about whether your admission would carry over into the criminal case in some respect. There's a lot of boxes here.

So, if you represent a company who has an individual who's admitted, that can, if the company is under criminal investigation under the laws of corporate criminal culpability, admissions or convictions of individuals run up stream and the company is criminally culpable for the acts of its employees done within the course and scope of their duties. And so it could be a great concern to the company as to whether or not an individual admits something if the company too is under some form of investigation or enforcement proceeding. There's probably some other permutations but if you guys want to hop in on whether or not the SEC defers if there's a parallel investigation and any further enhancement of when you might want to have somebody admit to something other than when they've just heard.

John Birkenheier
Well, I don't….

Richard Zuckerman
I told these guys I wouldn't sandbag them but I might.

John Birkenheier
We were expecting that, we just don't know what. No, the SEC won't defer its investigation when there's a parallel criminal investigation. The SEC represents different aspects of the public interest than the Justice Department, and we seek and obtain different types of relief. So, that's not going to happen. Once an indictment is issued, if we have a pending parallel civil case, sometimes the Justice Department will seek to stay our case to prevent discovery in the civil action from spilling over and having an impact on the criminal case. But that's really a different question than what you asked. But it is related.

And in another related aspect, and this will set up a question I'm going to ask you, when a defendant enters into a plea agreement with the prosecutors and at the same time settles with the SEC, or if sequentially they're convicted and then they have to resolve the SEC action, the Commission will often forgo monetary relief against that defendant if the purposes for the monetary relief are unnecessary. For example, if a defendant has been sentenced to prison, there often is no point in securing a penalty in the civil case. And likewise, if there's restitution ordered in a criminal case that goes to the benefit of the same pool of victims for the same violations, the Commission will usually forgo disgorgement. But that brings the question for you, which is, in trying to negotiate a deal, if you're thinking about settling with the SEC, would you also then consider entering into a plea agreement with the prosecution and making a lot of these spillover effects running both ways go away?

Richard Zuckerman
That kind of depends on how bad the facts are. If you are representing an individual that has the bad fortune, good for you as a lawyer, to be subject to a parallel investigation, you always want to have a global resolution. And that's just *ipso facto* automatically, you don't want to – if you can do it. Now not all agencies of the government will settle civil and criminal with you if those agencies have either dual enforcement responsibilities or, even if they don't, there's some form of civil investigation by an agency that does have civil enforcement responsibilities. And you will probably want to settle with the criminal people first because that, from the point of view of a client, is the greatest exposure. If you can reduce the case to just writing a check, most clients will be very happy about it, they don't look too kindly on going away for a certain period of time.

If you settle with the government in a plea, you're going to, in most instances, [go] for what are called nolo pleas or Alfred pleas, you are going to wind up admitting facts and then you can sit down and, you know, do whatever you want with the SEC because the consequences of the admission are, they're already there. You know the SEC is someone that you sit down and settle with, if you can, and admit because you have already agreed to plea to the same facts; and it's more efficient to dispose of a case that way.

So, let me ask you a question, since you say you don't defer to a criminal case, if you, if you were brought into a case first or you discover a case or the civil, or somehow or another comes to your attention and are pursuing it, and you see that it ought to be referred, when do you refer it? Do you refer it when you are done? Do you refer it as soon as you notice that there is potential criminal culpability? And if you refer it to the DOJ, do you defer at that time?

John Birkenheier
Can we answer that question?

David Van Havermaat
Well I think that…

Richard Zuckerman
Sure.

[Audience laughter]

John Birkenheier
I was looking past you, yeah…

David Van Havermaat
That really depends on the facts of the case. My experience is that it will be a lot of times an ongoing dialogue between us and criminal authorities. There will be, once we find out about, for example, a significant insider trading matter we have, [we] will contact an AUSA and the AUSAs often will tell us, "sounds great," "what are your plans?" "you are taking some testimony of this guy?" There will be that dialogue, but a lot of times there is not really a focus on behalf of the criminal authorities until we have developed more that we're able to provide for them and a lot of times it will be at the end of our matter. I've certainly had occasions where our office will work up, for example, an insider trading case, bring it and then two years later the criminal authorities will bring their action. Again, no slight to the criminal authorities because they have tons of cases on their plate; it's just, I think what Richard said is desirable, but I think in a lot of instances, it's just not practical because even though we have parallel investigations, many times we are not going to be on the same track.

John Birkenheier
And I would add too that we, the Exchange Act contains a provision which explicitly encourages the SEC to share information with and make referrals to the Department of Justice. And under our rules, we're not allowed to tell you whether we have done that, or when we have done it in a particular case. So if you're representing someone and are concerned that we have, you should just assume, I mean the safest course for you is to assume that we have referred the matter to justice.

Richard Zuckerman
Well if an FBI agent shows up and you get a grand jury subpoena, you know, they still won't tell you who referred it, but you kind of get a hint

on, under those circumstances. Any questions about this kind of thing? We're trying to give you some background as to policy, procedure, rules, and also, you know, what a lawyer has to think about if he gets a client involved in this kind of maelstrom.

Audience Member
At what level in the Commission is the decision made to require admissions? The district director? Does it have to go to the Commission itself?

David Van Havermaat
That has to go to the Commission.

John Birkenheier
Negotiating is done by the senior management of the Division of Enforcement. But the Commission would ultimately have to approve the settlement, any settlement involving an admission.

David Van Havermaat
And on those lines, one other thing that's important to note here is the Commission has identified these areas where admissions are, could be appropriate; there are other facts at play obviously. If we have a case where we would otherwise get 100 million dollars that we could return to investors next week and litigating it to get an admission is going to take twenty-four months – that that plays into it. And you know you also have the issue of the staff resources, the Commission is serious about the admissions, but there are other factors that can impact that decision.

Richard Zuckerman
If I crystallize what was just said, I guess you can buy the SEC off for $100 million.

[Audience laughter]

Audience Member
Richard, I have a question, along the lines of what you have just been talking about with respect to certain pronouncements by the Commission and sort of a perception among the defense bar that the Commission is demanding higher fines than it has in the past. I don't know if either one of you, David or John, can comment on whether or not there is a policy or focus on the SEC to require higher fines in resolving a matter?

David Van Havermaat
Yeah, there's no policy certainly. I can tell you that the Commission has taken more aggressive stances in the past few years which I think has led to higher penalties. But the one thing that I think gets lost in that sometimes, I know the literature is all about the penalties, the Commission is not just focused on that. The Commission is also very heavily focused and in many instances I think it's fair to say it's even more important to the Commission the issue of what prophylactic measures are going to be put in place. With the penalties, I think it's a fair perception to say they are trending upward, but there are often cases where the dollar amount isn't the issue. The issue is how long is this guy going to be out of the industry, is he going to have a permanent bar or a time limited bar. So, I think that's more a focus of just a more aggressive Commission as a whole.

Audience Member
Following up on that, Richard, and David, and John, is it your perception that in the last few years, a higher percentage of your cases are going to trial than maybe they had in the past because of the more aggressive approach the Commission has, either because of admissions or fines?

John Birkenheier
Last year we had more cases go to trial, in this last fiscal year, than we had in the immediate previous years. I'm not sure how that number compares over a long period of time. I wouldn't read too much in to a single year. And I would also say, in response to your question that to the extent we've begun demanding more recently in settlements, I think that would take a few years to work its way into trial numbers. And I'm not sure that we're going to see that level of trials continue. So, it's, that's a very hard question to answer I think.

David Van Havermaat
I think that's all correct. I think it's also related to the aggressive nature, going back to the prior issue. I think the numbers that I had seen were something like we had thirteen more trials in fiscal fourteen then we had in fiscal 2013. More than half of those were insider trading matters. I think the numbers were, in 2013 we had zero trials on insider trading cases, and we had seven in 2014. And I think we are having more cases go to trial, but not solely because of the admissions policy or higher penalties. I think we're just taking a lot more difficult cases too and I think that leads to more cases going to trial.

Audience Member
How many cases have there been in the last twelve months where there has been an admission of liability and no criminal case? If you know? I mean is it dozens? Is it one? Is it two? In other words, when someone admits liability and there's no criminal case as Mr. Zuckerman has pointed out, how many of those, if you know?

John Birkenheier
There haven't been that many stand alone admissions at all.

Audience Member
So, it's rare?

John Birkenheier
Yeah and whatever number there have been, it's only been in the last let's say eighteen to twenty-four months, so it's still probably too early to even say whether or not there would be criminal action although I think some of those cases don't appear on their face to be likely to involve criminal charges.

Richard Zuckerman
So, let's see if we can get some comments here on this. So the SEC is getting tougher okay? So what?

John Birkenheier
There's that Latin again.

[Audience laughter]

Richard Zuckerman
But all is not, if your client, institutional or individual, is, in your judgment, only going to be subject to the SEC's enforcement mechanism and it's a guess, but you don't think the DOJ is going to show up or it isn't on the scene right now. And leaving aside for a moment the economics of the institution or individual, maybe it's not such a bad idea to go to trial because in a trial there's discovery, there's a jury, and even if your client looses, the penalty is imposed by the judge. And there are, do you guys have any sense as to whether or not cases that go to trial, the judges for whatever reason don't look at the case as horrible as the SEC might?

John Birkenheier
Yeah, I think, actually I think one of the later panels is going to touch on that. And…

Richard Zuckerman
Well I'm not coming back for that.

John Birkenheier
Yeah, I know. It's important to comment though that there's been a lot of focus on some of the trial outcomes over the last twelve to eighteen months and most of that focus has been based on either partial statistics, for example, focusing only on jury trials and not on bench trials or administrative proceedings. I wouldn't read too much into that.

The Commission tends to win about eighty to eighty-five percent of the time. And that has been pretty stable as long as I've been with the Commission. There are some results that came in or results that came in right at the end of the fiscal year. I don't have those yet but I expect that we're going to be pretty close to that again this year.

So when making the calculus about whether you're likely to win or not, I think that still remains a steep hill for the defendant. And, also, by looking at trials, you only look at really a very small fraction of the litigation load or results of the SEC. About two thirds of our cases, of course, settle when they're brought so we're only talking about maybe 200 cases a year on average that actually are litigated. And the vast majority of them, I would guess out of 200, probably about 180 never go to trial because we either succeed in obtaining acceptable settlements out of the defendant during the course of litigation or because we win on summary judgment. And I say because *we* win on summary judgment, we don't lose very often in my experience on dispositive motives ourselves. So, the outcome calculus is still, like I said, a big challenge for the defense.

Richard Zuckerman
So, let me refine that a little bit and just pose another suggestion or hypothetical. So, you represent a client that can't settle with the SEC because the SEC is being too difficult. You don't really want to go to trial, but you almost have no choice because maybe you wind up better, maybe not, but that's a function of the judge that's assigned. So, you cause the SEC to file, and they sue you and you get assigned randomly to

a judge, and voilá, if you're familiar with the district and you know the psyche of the judges, you wind up with a judge that you know is not only lenient in criminal sentencing, but, you know, generally just gets muddled when it gets to very complicated financial type cases. But, you don't want to sit there for six months while the SEC proves the case because it's expensive so as soon as you get to the judge you go in and admit liability. Have you seen that? Do you want to see that?

David Van Havermaat
That would be great. We, I haven't seen it.

John Birkenheier
I haven't seen it either really.

Richard Zuckerman
Well that, if you're thinking about how do you pyramid your client in the best position, if you can't settle with the SEC, he, she or it doesn't want to spend a fortune sitting through a real long trial, you get assigned a sympathetic judge, you know, like any case you can walk in and walk in the middle of a criminal case and plead guilty because for whatever reason you certainly should be able to get out in front of the judge after, you know, after the case commences and say, "You know, we sat here like a day and a half and we're willing to admit to the allegations in SEC's complaint." You know, and then you go through the process of imposing a penalty. A judge might actually like it that you saved them six months worth of trial time too. That's a soft consideration if you're going to adopt this strategy soon. If anybody thinks it has any merit.

John Birkenheier
You know, you got in a little wrinkle the last way that you articulated it. We do settle quite frequently after we file and under an arrangement in which the defendant consents to the entry of an injunction, generally without admitting or denying the allegations, with the kicker that they agree not to challenge any of our factual allegations for purposes of a motion that we will bring to have the disgorgement and penalty set. So we make the motion. Maybe there is some discovery, and then we make the motion, but the defendant can't challenge or deny any of the facts in the complaint. And the judge, under the terms of this order which the judge enters, is bound to find the facts as alleged in the complaint are true. So, the only question really is whether those facts justify the imposition of disgorgement and a penalty and then how much.

Richard Zuckerman
So here's the $64 question. Was the client, are the clients who do that better than they were in the pre-filing stage where you say, "I want, you know, that's what I want, that's what I want." Okay, sue me. And then now after the suit's filed the judge is assigned, both sides know what the judge's prerogatives and foibles are because you guys are going to talk to the US attorney's office about what the judge is like and you say okay, let's settle. Is the settlement better than what he could have gotten pre-filing? And do you keep track of that kind of stuff?

David Van Havermaat
And that's just so, depends so specifically on the facts of the case.

Richard Zuckerman
I thought you were going to say it was so despicable. *[Laughs]*

David Van Havermaat
You know, the one thing that that does, I think, lead into a little bit is the Commission's cooperation program, which I know we were going to touch on later. But that is significant in that realm in that if you have a situation where your client is actively, you or client, is actively assisting the Commission, if they are the first in the door with some information, going through and unwinding transactions and things like that, it is relevant to the Commission how cooperative you've been. I think that's fair to say whether or not there is a cooperation agreement. Obviously if a cooperation agreement is put in place that formalizes it, but that is a factor that is not insignificant in determining the relief.

John Birkenheier
Yeah there are advantages to a defendant doing that. Cost is a factor. Time might be a factor. But you would also give up, you'd make it a lot harder for the staff to agree to negotiate the amount of disgorgement. If there are any issues about disgorgement, any reasonable ways that you can say it should be a lower amount or a higher amount I think that's off the table if you go this route. We will seek the highest amount that we can justify. And if you're looking for a waiver or payment plan or anything like that, I think those would be off the table, too.

Audience Member
Where does the money go? I think that that is something that the consuming public isn't aware of?

John Birkenheier
Well generally, our preference is that any money that we collect be distributed back to victims of the fraud. And whether we can do that depends on, we have the legal authority, we can ask the court who has legal authority to do that. It depends on how much money we collect, depends on how many victims there are, depends on whether the victims can be identified. I mean, for example, on an insider trading case, it's virtually impossible regardless of the exchange or market to identify exactly who bought or sold with the person in charge. And sometimes, there isn't enough money collected, but our preference is that all money, including penalties, be distributed to the victims of the crime.

Audience Member
But the SEC money, the Steve Kohn money? Where did that go?

John Birkenheier
That I don't know.

Richard Zuckerman
They probably couldn't comment on that anyway. Those cases are still…

Audience Member
No, I think the penalty has been imposed.

Richard Zuckerman
Well, I was going to hop over to cooperation, but let me just ask a question on restitution. It's not like a victim shows up at the SEC's front door and says give me a check, I'm a victim. Isn't there a bureaucratic procedure that victims have to go through in order to obtain entitlement to the money even though they're identified as victims?

John Birkenheier
Yes. But it's not, when you say bureaucratic, there will be a claims process, and usually if, depending on the size of the case, if it's a large enough case, we'll hire a claims agent or claims administrator.

David Van Havermaat
Or have the receiver do it.

John Birkenheier

Or if there's a receiver, have the receiver do it. But, there will be a claims process and then a distribution.

Audience Member
Would the SEC ever challenge the enforceability of applying insurance coverage as being against public policy to reimburse a company for a claim, or would it depend on whether the money from the insurance coverage is going to fund disgorgement to investors versus pay penalties?

Richard Zuckerman
You aren't talking about challenging lawyer's fees covered by insurance? [Laughs] Just want to make sure, you know.

John Birkenheier
You scared him there. Generally, I think, David correct me if I'm wrong here, but generally with regard to disgorgement, we do not try to stand in the way of that. But penalties, we will oppose penalties being paid for either by an employer or by an insurer.

David Van Havermaat
I think that's a standard provision, yeah, in our consents as well. Yeah.

Richard Zuckerman
Well it's unlikely that an insurance company is going to pay a penalty imposed by virtue of fraud. So, there would have to be some kind of other penalty in the nature of a speeding ticket, that still would be contrary to public policy to have, you know, your bad deeds insured otherwise we'd all go out and do bad deeds, well some of us.

Do you want to talk a little bit about, since we sort of segued, we go back and forth, we're not tied to anything in particular as you can tell, do you want to talk a little bit, either one of you, about the SEC's cooperation program and what it is, and the elements of it, and you know how you might try to take benefit of it, and that kind of stuff?

[Audience laughter]

Richard Zuckerman
Oh thank you, Ray, you're doing a good job.

Raymond H. Henney

Anything that I can do for you, Richard.

David Van Havermaat
The cooperation program is fairly new. It began in 2010. And, prior to that, again there were allowances made for defendants that, depending on their level of cooperation, that could impact a final judgment against them. This is a more formalized process. It really derives from the criminal model and the various benefits depend on the level of cooperation, the nature of the case, the importance to the Commission, and can range from anything from no charges being brought to a reduction in the sanctions.

And, the tools that we have are, generally the first step is having a proffer agreement, whether it's through the attorney, through the defendant, we need to get a sense as to what the person wanting cooperation credit knows, how truthful is he, how forthcoming is he, how timely is the information that we're supposed to be getting. And so we'll go through the proffer and at that point determine whether a cooperation agreement is appropriate. And that has to be approved by the office heads or the director of the division actually. And that is really the first level of cooperation which basically says, "Look, I'm going to prospectively help you guys, help you the Commission, and what I get in return for that is a promise that assuming I meet my end of the bargain that you will recommend to the Commission that that be taken into consideration. There are no promises given, you don't know what you will be getting or not getting, but I can tell you that as the staff we do take that seriously. That's an encouragement for people to come in and provide us information, to give us help, and so it is important to us.

The next steps would be, in examples of gold star level cooperation, the potential for deferred prosecution agreement or a non-prosecution agreement. Again, those are going to have to be matters where the level of cooperation is significant, and significant is probably not a strong enough word; it has to be at a very high level. The things that the Commission looks at in determining what is appropriate is the nature and the value of the cooperation, you know, are you the first one in the door giving this information? How much are you helping? Is this a one-time phone call or are you sitting down for days on end walking the Commission staff through unwinding complicated transactions? As an entity are you providing summaries of witness interviews that you did?

One thorny area here is if there's privileged information that's not part of the cooperation program and there is no requirement that to be given cooperation credit that privilege needs to be waived. But as a whole the cooperation has to be something special;the keys here are, is this something that we, the Commission, may otherwise not have discovered, or did it save us substantial resources? If it's something that we're going to find out anyhow you're probably not going to get a whole lot of cooperation credit for it.

Richard Zuckerman
So let me ask a couple of questions, because this opens up another wide area and I'll try to keep it more focused. Each agency of the government has different cooperation programs and requirements. Dave just talked about, you know, if you're in early you get the best deal. Do you have any rule, like for example, the Antitrust Division has that it's only the first in that gets the deal. So, if you're the second in, and you're in an antitrust case you're kind of out to lunch.

David Van Havermaat
In terms of cooperation, no. It's a factor if you're the first one in the door. It's, I guess the corollary to that is if it's something that we don't know about and you come in the door and tell us, that, I think, would be a significant factor as well. But it really depends on all those factors. You can be second in the door but if you are, you know, otherwise fulfilling all of the requirements it will be considered. You have, I think you're at somewhat of a disadvantage if you're second, third, fourth, twentieth in the door. You probably won't get as significant a credit, but you still have the potential to do so.

Richard Zuckerman
So, you also mentioned, or used the phraseology, non-prosecution agreement, deferred prosecution agreement. So, I want to focus on the word "prosecution." These agreements, non-prosecution agreements and deferred prosecution agreements, are things lawyers try to get for clients. They're kind of paper probation to some degree. Deferred prosecution agreement means you admit but if you're a good person or good company for a certain period of time, then it goes away and that's the end of it. Something like, you know, drunk driving and taken under advisement for six months. A non-prosecution agreement is simply we're not going, that's the end of the case, in simple terminology, but you don't really agree that they will not be criminally prosecuted?

David Van Havermaat
We can never do that.

Richard Zuckerman
Right. So, what do you do if somebody wants to have a global resolution because, you know, there is the possibility of the DOJ lurking out there?

David Van Havermaat
Well, I mean, if they're lurking out there I, again obviously it depends on whether your client knows of their existence and their investigation or not.

Richard Zuckerman
Would you tell them?

David Van Havermaat
No.

Richard Zuckerman
Well, if I'm sitting across the table from you and we're negotiating a settlement, I'm going to say, you know, "Did you guys refer this? Is anybody at your doorstep? Have they given anybody information?"

David Van Havermaat
As a general rule we don't, but in terms of settlements that does change.

Richard Zuckerman
Okay.

David Van Havermaat
And, typically, what we try and do is, we don't go out and unilaterally tell defendants that we're aware of a criminal investigation of them. We generally, will work with criminal authorities if we're aware of them to try and convince them to do so. But I think at the end of the day that if we're not able to get that disclosure, that could potentially hold up the settlement.

Richard Zuckerman

That's just if you're going to settle with the SEC and you have a real "no-good-nik" you should ask a lot of questions about what else might be out there, because the worst thing to do with a client is to go high-five at lunch after you settle with the SEC and two days later he's arrested. He's going to think there's something wrong with you as a lawyer.

David Van Havermaat
More or less.

Richard Zuckerman
Is there anything else we should talk about with regard to cooperation? What about the means of cooperation? Other than, I mean, you want debriefings? Documents? They don't want, they won't demand privilege waiver from an entity that's conducted an internal investigation because of the big policy about, there was a big stink about this in litigation on the criminal side, about we're not going to do a deal with you unless you waive privilege, and that created a fire storm so now all the agencies say, "We're not going to," you know, "You don't have to waive privilege and give us anything, but you know you're going to do a lot better if you do." Is there anything, do you require people to go out and meet with other people that you're, wear a wire? Let's put it in simple terms.

David Van Havermaat
Yeah, unfortunately we don't have the people out there wearing a wire.

Richard Zuckerman
That's good to know.

David Van Havermaat
We do, one of the factors for cooperation is, if you encourage or authorize, if you're a supervisor, if you authorize your subordinates to come in and essentially, if they're better positioned to provide us the assistance than you are, that's a factor as well. I think the best way, again, a lot of this is you have to see what the Commission does and just sort of follow that.

The two, I think, biggest developments in the cooperation agreement arena, in the last year or eighteen months, one is a FCPA violation that resulted in a non-prosecution agreement. The other was an insider trading prosecution that, with respect to one "tipper," resulted in an NPA. And I don't think that that's just random that it happened that way, it's because of the nature of those cases. You think about FCPA, very document intensive. You many times need to get documents translated, you need summaries from witnesses overseas, and so by providing assistance in that matter, in an FCPA matter, I think that showcases how your clients can come in and really provide greatly beneficial assistance to us.

The insider trading matter, again, historically, insider trading cases have been very difficult for us to bring. You know, we many times rely on circumstantial evidence, and juries will sometimes balk at circumstantial evidence. They'll want the wiretap or they'll want the video of the bag of cash being transferred, things like that. So having a physical body that can come in and, at least, tell part of the story is important, and I think the reflection of the NPA in that context is the result of the nature of that being very significant to us because it helps us prove our case.

Richard Zuckerman
Just as in, you mentioned, insider trading case and the difficulty in obtaining a verdict. Is that because of the absence of what's called a "plus factor," and you're just trying the case on telephone records and somebody's brother happens to be the insider?

David Van Havermaat
It can be.

Richard Zuckerman
You want to maybe explain what plus factors are?

David Van Havermaat
Yeah, the…

Richard Zuckerman
This is a test.

David Van Havermaat
Yeah, just a little bit of the background on the insider trading, you know, the courts have universally held that circumstantial evidence can be used to prove an insider trading case. And the need for the plus factor, depends what jurisdiction you're in too.

Richard Zuckerman
Yeah it does.

David Van Havermaat
For whatever reason that the jurisdictions that seem to have the biggest bodies of insider trading case law, or at least significant bodies, are Northern District of Illinois and Northern District of California. And essentially there needs to be more than the, more than the appearance of insider trading having been conducted. You can have a case where you've got very suspicious trades that took place, fifteen minutes before an acquisition was announced by someone that probably had inside information. The jurisdictions treat that differently in terms of what more do you need to prove. Do you need, for example, can a Fifth Amendment assertion be a plus factor? Things like that. The thought is that it would require something more.

Audience Member
Like a Doctor Gilman?

Richard Zuckerman
Well, the way it comes up is you have a relative as an insider, and you, the supposed, alleged, hypothetical, but obviously innocent to be, is buying stock or selling stock right before some form of material public announcement. And all the SEC has is your relationship with the insider and some phone calls. But, they can't prove much from the phone calls because, if it's a relative, you call each other all the time anyway. So, and that's, you know, that's the circumstantial case other than an admission because they'll try to take statements, they'll look around to see the trading history of these people.

And even if you have a guy that's never traded before; trading history is important to the SEC and insider trading cases. But even if you have someone that's never traded before, if there's a reason to call the insider and these trades are made and this guy shows up and he has some file with some papers about some industry and he denies ever talking to the insider, you know, that may be a kind of case where there are no plus factors, at least not from my point of view. Those are the kind of cases the SEC might have more difficulty with.

David Van Havermaat
Yeah, I think that's right. I think courts do recognize though, I'm trying to remember the exact language that I think appears in a bunch of cases, which is something like, in an insider trading matter there are two parties and neither one of them generally talks, so that's why you have to rely on

the, on other sources to prove your case. But, so, the plus factor is an issue. I don't think, it doesn't have to be a big plus factor I think is the bottom line.

Richard Zuckerman
But with this kind of confusion that you can wrought as a lawyer, this is why, in these kinds of cases, you want a jury not a bench trial, because a judge will hammer you like that. Even the ones that aren't that tough. They don't like insider trading cases all that much.

Anonymous Speaker
Richard, you have until five to.

Richard Zuckerman
Do you want to talk about 20(b)?

David Van Havermaat
Well actually, what I was going to say is relating to one of your other comments. You're sort of through the, the threat here has been do you settle with the Commission or do you take your chances with a judge and jury? The reality is that a lot of times you don't have a jury. A lot of times you, we're bringing our cases through administrative proceedings.

Richard Zuckerman
I've never met a defendant that wants to exercise their speedy trial rights. [Laughter] We were going to talk a little about 20(b).

John Birkenheier
20(b).

Richard Zuckerman
Right. Do you want to explain what 20(b) is?

John Birkenheier
The Exchange Act has a provision, section 20(b), which says that it's illegal for anybody to do indirectly through others something that they could not legally do themselves. And this is a provision, I guess it's maybe a broader observation about the way we all practice law in different fields too and a span of fields, but it's a provision that basically nobody has paid much attention to since it was passed in 1934. There are only a handful of cases. But it's a provision that the SEC is going to start

looking to employ more often, in cases, especially in cases involving large organizations. You can think of maybe market manipulations or cases where there is a question under *Janus* whether someone is or is not the maker of a statement, a more senior person rather than a more junior person.

Richard Zuckerman
Does everyone know what *Janus* is?

David Van Havermaat
Maybe you want to explain that, John.

John Birkenheier
Yeah. The Supreme Court, in a private action involving *Janus*, and I forget the rest of the name of the company, but it was…

Richard Zuckerman
Its J-A-N-I-S, not J-A-N-I-C-E.

All
U-S, U-S, U-S.

John Birkenheier
Limited liability under section 10(b) and 10(b)(5), liability for a false statement that is disseminated to the public, to the person who's the maker of the statement, so the person who signs it, the person who controls its content, the person who controls its release to the public. And when you think about a press release or financial statements, you can see that that draws a smaller, a relatively smaller circle of people who have potential liability than was the case prior to the Supreme Court decision. Under section 20(b), to some degree, that circle gets expanded again because the people who are acting through others can be held liable.

Richard Zuckerman
The Supreme Court kind of said that the person who really does the speaking is the person who is liable for the false statement. And so what do you have in a very simple, rough example: If you have a bunch of high level people who put together a bunch of false statements but the press release is issued by a PR person, whose only job is to issue statements and doesn't have anything to do and has no knowledge of, that everything he or she is talking about is a bunch of, well its inaccurate at a minimum; and the question is, how do you get around

Janus? And so what the SEC is going to try to do is use 20(b) to get around *Janus*.

John Birkenheier
And like I said too, is that I think it would apply in other cases, such as market manipulations situations, where you've got one person in sort of a kingpin role coordinating, say fraudulent trades, wash trades, or match trades, or whatever, but not really engaging in any of those transactions him or herself.

Richard Zuckerman
And then there's, okay, and what about 20(a)?

David Van Havermaat
20(a) is control person, you know, it's really a different animal. That requires an underlying violation. The difference between 20(a) and 20(b)is that 20(b) does not require an underlying violation. Whereas, control person or aiding and abetting would require, for example, in the context that you have of someone that's out there, for example, drafting a false press release and you have someone that's actually issuing the press release that may not have a level assigned for us to bring a case, we might have a problem with control person because we don't have an underlying violation. Whereas with 20(b), again, that's a way of circumventing that.

The other thing I think that's worth noting is that the *Janus* applies primarily to section 10(b) of the Exchange Act, so we still have other tools. There's 17(a) of the Exchange Act, which is the complementary anti-fraud provision, where the *Janus* analysis may be different. But 10(b) is really our bread and butter. So, it is important that we are able bring cases involving anti-fraud violations.

John Birkenheier
You know, I would think that 20(a) is especially valuable in the financial reporting field where higher level executives of a corporation – they can't violate, say the reporting provisions under section 13, because only the issuer can violate those. But a control person, as long as they, the law varies from circuit to circuit; the Second Circuit has a very strict standard, they actually have to…

Richard Zuckerman

John, let me interrupt. Could you explain what section 13 is, because I think the point your making is very good, but without knowing exactly what section 13 is.

John Birkenheier
In the Exchange Act, Section 13 is the section that requires periodic reporting by publicly traded companies and there are several related, there are a lot of subsections and a lot of rules under that. But, basically it's the provision that requires a 10-K to be filed every year and 10-Qs to be filed every quarter and books and records to be maintained. So, if you focus on the books and records for example, the CEO and the treasurer of a large company will have very, well they'll have no hands-on involvement in entries being made in the company's books. And they probably won't have any direct personal involvement in circumvention of the company's internal controls. They'll give orders to other people for example, or like in…

Richard Zuckerman
Like in a law firm.

John Birkenheier
Like in a law firm, there you go. Why can't somebody improve this revenue situation that we're facing this year? [Laughter] But, if they're in charge, if somebody's in charge of the organization, they can be held liable for the actions of the organization and the people under their control. They can raise affirmative defenses, which are basically good faith defenses, but 20(a) is a very good enforcement tool for trying to hold senior people accountable for the activities of the organization that they are managing.

Richard Zuckerman
When we were discussing 20(a) and 20(b), I gave an opinion, which I'd give anyway, regardless. The chair is a former U.S. attorney in New York and if you read 20(b) and you think about what the SEC seems to want to do with it, they're going to try to make that a conspiracy statute like 371 under Title 18 where you can just bring everybody into it instead of being focused in on only the person who made the false statement to the public. It's not a bad idea, you know, it would probably generate a lot more cases. But there will be a lot of litigation over it because, as John said, it hasn't been used much, if at all, since 1934 or

33. But if you read it, you can see that you can really run with that statute.

Unknown Speaker
There is a recent example of 20(a), and just what you're setting John, the Delphi, the CFO of Delphi, the Commission was successful in its trial of the former CFO of Delphi under 20(a). The decision was about three years ago.

Richard Zuckerman
If you want to see 20(a) and 20(b) at work fairly recently, there's a case in the Third Circuit called [*SEC v. J.W. Barclay & Co.*, 442 F.3d 834 (3d Cir. 2006)]. And if you go read *Barclay*, it'll lay out much better than we have been talking. You know, 20(a), 20(b), where they apply, how they apply, and the history of 20(b) not being utilized all that much. It's a pretty insightful case. Is there any questions for the last three and a half minutes? Somebody say something. Other than Joe.

Audience Member
Cooperation and whistle-blowing, what's the relationship between them?

David Van Havermaat
There is a significant overlap. The whistleblower provision, just a bit of a background, is fairly new. It provides that if a whistleblower comes in and provides original information that leads to a successful enforcement action and the recovery is a million dollars or more, that whistleblower can recover in the range of 10–30% of what is collected. There are many restrictions. You would be sorry to hear that generally counsel for defendants are not eligible. [Laughter]

There are even some exceptions to that exception though.
But there is significant overlap between cooperation and whistle-blowing. Both reward first in the door. The whistleblower provision, in fact, requires you to be first in the door. If you're second in, you're not entitled to a share of any proceeds. They look at the same factors, for the most part. Is the case that you're either providing cooperation or that you've given whistleblower information on, is it a significant case? Is it a priority to the Commission? Do you have a large number of harmed investors? Is it something that's ongoing, that by you coming in and blowing the whistle and/or cooperating, you're saving investors from tens of millions of dollars in losses?

So, there's a lot of overlap there. Both of those are a function of trying to, I think that Dodd-Frank recognizes that the monetary incentive to come in and divulge what you know to the Commission is not a bad thing if it results in us being able to take proactive action and avoid a massive Ponzi scheme and avoid an Enron situation and things like that. It's fairly new but I think just within the last couple of months or week, there was the largest ever whistleblower award, which I believe was thirty…

John Birkenheier
Thirty million, yeah.

Richard Zuckerman
Well, I think they overlap maybe in terms of how you effectuate the cooperation and how you effectuate the whistle-blowing. But, to me, and there guys can correct me if the SEC takes a different view, but someone cooperating is under the gun and I doubt that person can be a whistleblower about his own actions and get a reward for turning himself in. So, the process might be the same, but I think you have different characters in each bucket.

David Van Havermaat
I think as a general rule, that's right. I don't think there's an express prohibition of if you have some involvement in a matter that you are blowing the whistle on that you can't receive funds. I think that is a significant factor though, to the commission, in terms of whether they would authorize an award in that situation. It's not outside the realm of possibility; it would be incredibly difficult to do.

Richard Zuckerman
And I think we are talking about similarity of how to effectuate, rather than the same person being both. That would seem kind of peculiar.

END SEC ENFORCEMENT UPDATE

BEGIN (SPECIAL PRESENTATION AND) SECURITIES "TRANSACTIONAL" HOT TOPICS

Dean Spoon

Alright, welcome back folks. I hope you had an enjoyable lunch. We have two panels remaining—two very important panels. One is on the transactional side of securities issues, and the other on the State of Michigan enforcement issues. They're both critical to practitioners. But before we being with this next panel, I would like to ask Ray Henne to come up and make a special presentation.

Ray Henne
Well thank you Elliot. We think, Elliot and I think, it is important to acknowledge Joe Spiegel and what he has done for more than twenty years with respect to getting this particular presentation off the ground many years ago, and continuing to do so, Joe can you up for a moment here? So, Joe, I… [applause] we have known each other for a long time Joe.

Joe Spiegel
Long time, long time.

Ray Henne
In fact, I remember our first discussion. Do you remember it?

Joe Spiegel
Uh, no.

Ray Henne
And you'll know why I remember it and he doesn't. So I was a young lawyer representing a Broker/Dealer, who you had sued in the NESD arbitration. And I had called you up to get an extension and so forth . . . and then you yelled at me! That my client…how could my client defend this. How could I possibly want to defend it? And it ended with something that has never happened to me since—a lawyer screaming at me that he was going to make an ethical referral and have me disbarred. Now, I remember that because that has happened since then. But he doesn't remember because how many of us in this room have had that call? [laughter]. Now, having said that, the wonderful part about Joe and his energy in doing this is too much of our profession is business—we have the business of law now. And you young students who are graduating, you are graduating into an environment unfortunately that has too much to do with business, and much less about being a profession. And what Joe brought in getting us together is education—yes, very important; very important to further our place, and our

knowledge, and have regulators come and speak to us—all that is extremely important. But what was more important to me was the collegiality and the professionalism. We come together as professionals. And these opportunities are becoming more and more rare. And so, for you younger people, this kind of energy in this room, this kind of closeness of the securities Bar, I hope that you'll embrace it, and it will be something that you will be able to take in whatever line of work, whatever area of the law you practice, as Joe would do, after he would yell and scream at you. The next day he's buying you coffee and Danish, and it never happened. And it's because he recognizes the importance of the profession and treating each other as professionals. So, Joe, I've got a plaque for you that Elliot was kind enough to arrange for. So you can put it up in your library. It says: "Michigan State University College of Law, Joe Spiegel, In appreciation for more than twenty years of hard work and creativity as the guiding light of the Midwest Securities Law Institute, October 10, 2014."

Joe Spiegel
Thank you very, very much!

Elliot Spoon
Thank you Ray, and congratulations Joe! I got a subpoena from Joe [laughter] while we were working on putting this program together, so there you go! Our next panel is the Securities Transactional Hot Topics, and we have three prominent securities practitioners: Marty Dunne from Morrison & Foerster, Mark Metz from Dykema Gossett, or Dykema I guess, and Pete Sugar from Jaffe Raitt. And I'm going to turn it over to the panel.

Pete Sugar[1]

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[1] Peter Sugar is a partner in the Southfield and Ann Arbor offices of Jaffe Raitt Heuer & Weiss. He is a member of the Firm's Securities Regulation, Acquisitions and Divestitures,Emerging Business, and Corporate Practice Groups, specializing in securities regulation, corporate finance, and mergers and acquisitions.
Peter represents clients in both private and public securities offerings, exchange offers, refinancings, private debt, mez and equity placements, as well as public companies in all aspects of 1933 Act, 1934 Act and Sarbanes-Oxley compliance matters. He represents directors of public corporations individually and in their capacities as members of Audit Committees, Disclosure Committees and other Special Committees. He has an active practice in the acquisition and disposition of businesses and has led M & A teams in multiple sales of venture-backed businesses that have become finalists and winners of Crain's Business Deal of the Year awards. Peter is also involved in all aspects of the formation, financing and governance of businesses, including equity, debt and hybrid

So "Hot Topics in Transactional Law" . . . we're going to start with a topic that is hot for mostly all the heat that it is generating when it comes to how much light has been cast on actual transactional practice, we may have a few doubts, but the topic is "Crowd Funding." And so, you've been hearing a lot about it if you're been awake—if you've seen newspapers, if you watch TV—people talk about it. The definition is impossible to constrain. We'll try to give you some sense as securities lawyers of what we think about when the term is used. And certainly from a regulatory standpoint, what we are concerned about, what our clients should be concerned about. The materials are very robust, Mark has made available materials, they're on the Morrison & Foerster website, as well as our website, so we're going to try to stay away from some of the technical detail and really try to give you a sense of, or at least our sense, of what is developing in the marketplace, what you're going to encounter in practice, what you may want to think about when talking to clients. To get there, I have to go through a couple of things, but I promise to be brief. So just interrupt any time. So, what are we talking about…generically, I think crowd funding has come to mean obtaining capital through the use of the internet, whether it's websites, whether it's social media websites, and there are some distinctions depending on who is operating them. And it is getting capital, and I use capital with a small "c," typically from a lot of small, individual contributions—so small, individual contributions, and a lot of them. And I think that's what we think of.

Martin Dunn[2]

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capitalization transactions. Peter has assisted several businesses in financing their start-up all the way through IPO.
He earned his Bachelor's degree from Wayne State University and is a cum laude graduate from Wayne State University Law School, where he served as articles and managing editor of the Wayne Law Review.

[2] Martin Dunn is a Corporate Finance partner based in Morrison & Foerster's Washington, D.C. office. Prior to his career in private law, Mr. Dunn spent 20 years at the U.S. Securities and Exchange Commission, having served as Chief Counsel, Deputy Director and Acting Director of the SEC's Division of Corporation Finance, as a highly respected counselor to public companies. Mr. Dunn "*is an immensely respected regulatory expert… He provides high-end securities counseling on regulatory compliance and transactional matters.*" as noted in *Chambers USA* 2013.
Fortune 500 clients turn to Mr. Dunn for his skillful counsel on critical issues they face. He offers a unique insider's perspective and clients admire his ability to apply practical guidance to situations that they face every day. He provides guidance on corporate governance and securities laws to newly formed publicly traded companies as well as to established ones. Mr. Dunn counsels companies through the public offering process, including compliance with the SEC requirements and responses to SEC comments.

Yea, I would say that, it has become almost a brand, you know? Just like every fund has to be an "activist fund," you know? Every time you raise capital and you aren't registering it you have to call it "crowd funding." You know, "crowd funding" originally was the PBS approach of "give me twenty bucks, and you get a tote bag." So, you didn't have a security involved because there was no expectation of profit, and that was kind of fine everything went along. And then people thought, "well, I'd kind of like some money back," and so you came up with different ways to crowd fund. And, virtually every call I get that does not involve an initial public offering is somebody saying they want to do crowd funding. And so it is broken into…you've got interstate crowd funding, which we'll talk about, you've got Reg. A crowd funding, 506(b) crowd funding—it used to be called just interstate offerings, 506(b), 506(c), and Reg. A, you know? But now you have to throw "crowd funding" around it. I would also point out that one third of those calls because my firm is mainly a California firm is some form of the "weed" industry. These days, that's quite popular these days—and it is becoming an industry, all the way from testing it, to growing it, to selling the lights and everything else . . .

In his role with the SEC, Mr. Dunn supervised the Corporation Finance Division's Offices of Chief Counsel, Chief Accountant, Mergers and Acquisitions, International Corporate Finance, Rulemaking, Small Business and Enforcement Liaison. He oversaw many of the SEC's most significant initiatives on disclosure, governance and capital-raising, including reforming the securities offering process, updating Rule 144, implementing the Sarbanes-Oxley Act, adopting the plain English requirements for prospectuses, implementing electronic proxy delivery, and easing exempt and registered capital formation for small businesses.
Mr. Dunn is top ranked by *Chambers USA* in the area of Securities Regulation: Advisory and is a recommended lawyer by *Legal 500 USA* for Capital Markets in Debt Offerings, Equity Offerings and High-Yield Offerings. During his career at the SEC, he was the recipient of numerous awards, such as the SEC Capital Markets Award, SEC Regulatory Award, SEC Law and Policy Award, SEC Chairman's Award for Excellence, and the Federal Bar Association's Philip A. Loomis, Jr. Award.
Mr. Dunn is frequently sought after to speak, write and comment on securities law topics. He is co-editor of the widely read newsletter, *The Corporate Counsel* a premier publication in the field. He is on the Executive Committee of the Northwestern University School of Law's Securities Regulation Institute, a past Chair of the Northwestern University School of Law's Ray Garrett Jr. Corporate and Securities Law Institute, and the University of Texas School of Law's Conference on Securities Regulation and Corporate Law, and has been on the faculty of the ALI CLE's Regulation D and Private Placements Conference for more than 20 years. Mr. Dunn also speaks frequently as a member of the faculty of the Practicing Law Institute.
Mr. Dunn is Co-Chair of the NASDAQ Listing and Hearing Review Counsel and he has been an adjunct professor at Georgetown University Law Center and the University of Maryland School of Law.

Pete Sugar
Are you on the "testing" side? *[laughter]*

Martin Dunn
This is being recorded, so, no. But really, the "crowd funding" thing it's fascinating to me. To me, like Pete has said, it really is unregistered, generally solicited sales, in some fashion, whether you're going to call it interstate, whether you're going to call it Reg. A, or whether you're going to call it 506(c). That's what I see it as.

Mark Metz[3]
And sales of securities, as opposed to what you see on KickStart today, and some of the other internet portals, where you can go on and do as Marty said, which was pay twenty bucks, or fifty bucks and get a watch, or get a tote bag or whatever.

Martin Dunn
One of my favorites is Zach Braff, the guy who was on Scrubs, did crowd funding to fund a movie and he raised five million dollars. And the movie actually sold at one of these festivals that he made money off of it, like millions of dollars. And everyone who pitched it started saying, "Hey we want some of that money back," and he said, "No, I told you, you weren't getting any back." And everybody was very upset about it, and all the securities lawyers in the room were like, "well he can't give it back, otherwise he violated the securities laws when he raised it, cause he sold a security." So, I just, you know my kids didn't think it was interesting either, but I found it fascinating. So, there you go.

Pete Sugar

[3] Mr. Metz provides general corporate and securities representation for many of Dykema's publicly-held corporate clients in areas such as securities law compliance, defensive planning, directors' duties, periodic reporting, disclosure, responsibilities of corporate insiders, stock-based benefit plans, insider trading rules and Board committee representation. A frequent speaker and writer on securities law topics, he has extensive experience in public and private securities offerings, acquisitions and dispositions of public and private companies, subsidiaries and divisions and private debt transactions, including single and multi-bank credit facilities and institutional private placements. Mr. Metz is a member of the firm's Public Company subgroup, advising clients on various corporate governance and compliance issues and monitoring related legal developments. Mr. Metz also provides representation and guidance to insurance companies and other privately owned businesses on governance, corporate and securities issues. Mr. Metz joined Dykema in 1986.

So thank Howie, right? What we're talking about now is really the question of the expectation of a return, efforts of others, I won't get too deep into arcane language, but as Marty and Mark point out, that is the focal point. And so we want to talk about really three types of initiatives that really carry this broad band that Marty has described. That there is some activity and they're worthy of note, and they're worthy of, well—to the extent anything is worthy of "hot" in the question of securities law topics, we think these are worthy of some discussion. So the first topic, no specific order here—this has to do more with chronologic order than anything else—but April 2012, those of you that are recent graduates, or, again, have been paying attention, Congress and the President, prior to that date signed the JOBS Act into law. And there are two titles, Title II and Title III that had in them Congress' version of crowd funding types of initiatives.

Peter Sugar

Again, broad-based offerings. An exemption, rather than registration. And I'll take one second to remind everybody that when we think of broad-based securities distributions, historically, we think of registered offerings. If you're going to use general solicitation, if you are going to use advertising, you can't do so without some kind of regulatory regime to protect against fraud. So, this is huge, right. This is a big step out of something that has been happening for 80 years, from a regulatory standpoint. So, those statutory provisions got passed and—we will talk a little bit about where they stand—maybe, start with the Title III activity, the crowdfunding. So, this Jobs Act crowdfunding—we are going to be very, very careful and Marty gave you the background—not to confuse this with a Kickstarter campaign. This is an expectation of return. An expectation of profits. Efforts of others. A security. An interest in the promoter's business, whether it is a note that qualifies as a security, a share, or some other claim on that enterprise. That has to be the trait for us to engage this particular aspect of crowdfunding. Two and a half years after passage [of the Jobs Act], the SEC promulgated rules. They struggled with it. They had a lot of input. State regulators were very, very concerned about fraud. This is a new regime. They finally cobbled together some proposed rules. I will just highlight real quickly some of the aspects of these. This is a bullet point list. Limits on the amount invested were one of the safeguards that they wanted to put forth. They wanted to disqualify certain issuers. We will talk more about that in the rest of the panel. Prohibitions on resales for some period of time. This is taking the risk. So for one year is the general default rule. Some specified disclosures. They felt that maybe an investor on the internet is entitled to some information about the business prospect that they are going to invest in. And some requirement of financials. These are all very controversial—you will see—and why it took so long, I think, to get them out.

Martin Dunn
You know, it was funny when Title III came up in the original Jobs act, all of these protections that are built-in were not there. In the week before it got adopted, one of the senators dropped in an entire act as Title III. I actually think they spent more time on the title of it because the acronym is actually crowdfund. Like they found all these words that spelled out crowdfund. And I think they spent most of their time on that. Because, by the time it was finished, there is a $1 million limit every year that you can raise under this. And the investor protection concerns that came up by the end are such that between requirement for financials, only sold through a portal, ongoing reporting, the cost of raising a million dollars became—to my mind—ridiculous. So, while it is nice that there is a Jobs Act crowdfunding and the SEC wrote the rules exactly the way the statute required. They didn't go above and beyond. They didn't do anything. They just put in what Congress told them to put in. They haven't adopted it yet because in Washington these days, it is tough to adopt anything, which we will talk about in a second. But really, I think everybody is not that excited about Jobs Act crowdfunding. I think at the end of the day, the statute itself collapsed under it's own weight.

Mark A. Metz
And just to give you a sense—if you want to look at it visually—in the packet there is a couple things that we included. One is a PowerPoint and the other is an article. Both of them have the same chart in them. I think it is page three and four of the article if you want to take a look. Its got the three things that Pete is going to talk about here briefly. Its got those three—sort of laid out—if you want to see generally what the requirements are. Just the high points at least.

Peter Sugar
Just to touch on Marty's point about this portal. You know, there is two ways to conduct this in accordance with the statute. One is through a portal that has to be registered with an SRO, the self-regulatory organization that monitors the activities of people who are intermediaries. There is only one right now, which is FINRA. FINRA is pretty robust and is used to regulating broker-dealers. The second

category is a registered broker-dealer. So, what is happening is you have got Congress saying wow, you got this $6 billion industry. Small "c" crowdfunding, not equity crowdfunding, right. $6 billion they expect to be raised through this methodology in 2014. Not done with the year yet so we will see how that goes. That includes Kickstarter, it includes social kinds of programs and they're talking about trying to open up to create jobs, right. Capital formation. Meanwhile, when they start bumping up against the countervailing concerns regarding expanding fraud, they start to go to traditional kinds of restraints. So, registration is one of them with an oversight body and it is creating a lot of problems. People don't necessarily want to go into that. I haven't seen, by the way—I'd be curious from you guys—I haven't seen significant broker-dealer websites that are doing anything like crowdfunding.

Martin Dunn
I've done a couple of reg A's that I will give you a brief history about to give you an idea of the challenges you have here. Broker-dealers are not interested because there is not much of a secondary market here. There is not a lot of money to be made. That is why people want to use the web and go out directly. I had a client who wanted to—really interesting idea—wanted to buy a building in D.C. and he puts a huge question mark on the front of his building that says "what do you want me to be?" and the neighbors vote on it. Then, after he decides what it is going to be, he does a reg A and he offers it to the neighbors. That way he can generally solicit under regulation A. The good part about that—and he is a very thoughtful guy—he raises a little bit of money but he raises a lot of money through private offerings, but you get the neighbors involved and interested in what it is. To him, he feels that the social capital is almost as important as what he raises there because he wants the business to succeed. But in order to do that, in order to generally solicit the way we wanted to, we had to use regulation A, which was the only thing available to us two and a half years ago when we started this little industry. We had to do regulation A then because we didn't have what we are going to talk about today. So, the way regulation A works is you can only raise up to $5 million and you have got to register with each state in which you are offering. So, if you are going to do that in D.C., that involves Maryland and Virginia. On each of our deals, we spent much more time with the states than we did with the feds because even though the feds review the regulation A, we did two rounds of comments and we were done. Each state had a different thing that hung them up and it cost a good deal of money to do it. We thought it was worth it because of what we were trying to create. But, in order to do it where you have

also got to go through each state—again, going back to my cost of capital point when we were talking about small offerings—it is too much money. That is why the new things, crowdfunding under the Jobs Act 506(c) that we are going to be talking about in a few minutes with [the interstate], I think are all good ideas because in every one of them, it doesn’t have that duplication and hopefully the cost is better, so that should be one of our goals as we go through this.

Peter Sugar
The deal I'm thinking of is about a $850,000 offering.

Martin Dunn
We didn't raise that much. We were trying. We didn't raise that much in the reg A.

Peter Sugar
The legal fees were listed at 115 and they had to be 350 or 450.

Martin Dunn
The reality of it is it cost them a lot of money to raise not very much capital. I will also say—this is the honest truth—the very first comment we got from the states was "give us a Howie analysis as to why this is a security." And I answered by saying "if you are telling me it is not, we can make this a very brief conversation." So, they backed off of that.

Peter Sugar
If you can get the SEC to agree, right. That's a big, quick overview of what we're calling Jobs Act crowdfunding. Let me just say—a little bit cumulatively to the comments that you've heard—this thing is stuck. There is 605 pages of suggested regulations that are out there. They've been commented on. State regulators are very concerned about how do they prevent fraud. There are different views on this. If you want another opinion—I usually can't help myself—you know, the internet is here. Social media is here. People are raising money and some are violating securities law and doing so already, expecting them not to is probably wishful thinking. So, it may be worthwhile for regulators to actually step in here. The idea of low-cost of capital or lower cost of capital in our current regime is not something that we ought to just throw away and Congress has mandated, asked for it. So, we will see how the politics go but that is where we are, I think. Anything to add on. It is sort of a choice of last resort right now.

Martin Dunn
I would agree with that.

Mark A. Metz
I assume we are going to be talking here in a minute about sort of the pros and cons of some of these and I think there is going to be more about all of that. So, keep on laying the groundwork.

Peter Sugar
Okay, perfect. The next is a subcategory of what is the largest private capital resource methodology under U.S. law today, which is accredited investor private capital formation and so, accredited investor only. Now, there is a lot of deals done where there are some non-accrediteds involved. But, the vast majority of the volume of capital formation that is exempt from registration, is being done under Rules 505 and 506 and primarily under 506.

Peter Sugar
So for those of you familiar with Regulation D[4], if you have accredited investor-only kinds of financings, if you qualify the investor's reasonable belief under 506(b) before 506(c) and 502(c) are really the requirements for those of you who are as close to as geeky as we are about section numbers. Those transactions are what you're going to find in practice. If a business proposition is worthwhile, you will raise capital primarily through a private offering, or a public offering, if it's at that stage. The regulatory initiative under Title III of the Jobs Act[5] was to create what essentially is now known as a "crowd funding" exemption for accredited investors only. And I won't bore you with, because you've probably heard it last year and the last five years, how accredited investor- only offerings have been conducted where they've all been subject to the limitations of Rule 502(c).

Martin Dunn
General solicitation.

Peter Sugar
No general solicitation, no advertising. Okay. Now there's a new rule, it's 506(c), and it says if you'd like to use general solicitation- and this

[4] 17 C.F.R. §§ 230.500-.508 (2012).
[5] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

became law, again, September 23rd of 2013- if you'd like to use general solicitation go ahead. But we're going to impose a little bit of a requirement. Instead of having a reasonable belief that you're dealing with accrediteds only, you have to verify, you have to take reasonable steps, if you want the rule language, to verify that in fact you're dealing only with accredited investors – the thought being there should be some higher standard to make certain that you're not going out with a broad solicitation and taking people in who aren't qualified, can't fend for themselves.

Mark A. Metz
So just to clarify, you could put an ad in the newspaper that says we're selling shares of our common stock and if you're interested call this 800 number. As long as you sell only to accredited investors and as long as you take, as Pete said, reasonable steps to verify that they are accredited investors and you reasonably believe that they are accredited when you sign them up, Rule 506(c) says that's okay, we're good. The rub is what are reasonable steps to verify and that's what's still being fleshed out.

Martin Dunn
And on the reasonable steps to verify. So if you look at, so we're more than a year into 506(c), I really thought 506(c) was going to just absolutely change the world of how everything got done and you were going to see ads in the paper and people were going to do 506(c)s instead of (b)s. And really, if you look at the forms that need to get filed with regard to these offerings you can track the information – it's still like 90% is still the no general solicitation, the old way. Why? Well because a lot of the folks who are selling to accrediteds are big enough that they have relationships with these folks already, and they don't need to use the papers to find people, they don't need to fly a blimp outside the window to find people. And the people who are trying to do general solicitation are looking for smaller fish and so it hasn't really fit yet as to how that works.

The other problem with why it hasn't worked is, and I include myself in this category, is lawyers. We saw the phrase "reasonable steps to verify" and immediately spun ourselves into a frenzy. Oh my god, what does that mean, that's different, I don't know what that means. And the SEC came out and said it's principles-based. And I wrote rules for twenty years at the SEC, and everybody came to me and said "write me a principles-based rule. I want a principles-based rule, I know what to do." And as soon as I wrote a principles-based rule, they said, "give me a safe harbor because I need certainty." So your there. So the reasonable steps to verify thing came out and the SEC said here's how you figure out what are reasonable steps. And it really was the reasonable belief kind of thing, which was how long have you known them, who are they, stuff that you would think was common sense and all the lawyers said "I want a safe harbor." And so the SEC said alright, we're going to leave the principles out but here are four things that if you absolutely do, you're certain you do it. Look at their IRS forms, you get a third party to do it, stuff like this. And so now all the lawyers are asking questions about which IRS forms, how long do they have to be. And so they've got them spun into this little thing, and the SEC keeps trying to say look at the principles, look to this. But I think the lawyers have made it harder than it has to be and when you listen to the folks from the SEC speak, they're like don't get carried away here. But I just think lawyers' basic risk-averseness, I don't even know if that's a word, their absence of enjoying riskiness [laughter], is absolutely slowing down 506(c); and also the nature of the market. So I think (b) is going to win.

Mark A. Metz
At the end of the day, you still have the choice not to sell to somebody you can't verify. Or if it takes too much time and effort and cost to reasonably verify Investor A, and you have ten other investors, you just have to make a decision of how much you want to raise and so forth. But I agree with you, I think lawyers are spinning themselves into a frenzy trying to worry about this when practically I think there are ways to work those issues out in the course of the offering and get to where you need to get. And there are so many advantages, sorry I'm stealing our thunder for later, but so many advantages to 506(c) over any of those other methodologies, especially if you're a smaller company without a lot of relationships, it just makes sense.

Peter Sugar
So I have a slightly different take on this. But it resonates from the same principle, which is practicality. We talked about the lower cost of raising capital, which I think if you give Congress credit for anything, which I do reluctantly, that is a legitimate motivation for trying to loosen this up. That, plus the reality we have. That, social networks, we have the Internet. People are using these devices. Why not use them to disseminate information about opportunities. The practicality here, I think, and I agree with Marty, I think for a long time at least (b), the old accredited investor-only offerings, the way we've been doing them. We

only have to reasonably believe that they're accredited will dominate because deals that are good deals typically don't have difficulty accessing the market and even if the issuer doesn't have the relationships, intermediaries do. And they go to intermediaries and if the intermediary says there is a high likelihood of success in selling this and I'm comfortable with the business proposition, it's a reasonable risk reward playoff, that intermediary will get involved and they have relationships and they have access. And this will come up again when we talk about [MILE Act] kinds of initiatives and state law initiatives. So we think that good business propositions are still going to get done the old way. We'll see, having said that, I'm optimistic that the legal issue that we've talked about, the lawyers issue, of verification is a red herring. Okay, so that's that one.

Marty, I wanted you to jump in and Mark, not to preclude you at all, to invite you. The IAC supported changes yesterday. This is the SEC's Investor Advisory Committee, and they've done a few things on recommendations on accredited investors and I think you should be aware of them.

Martin Dunn
Congress asked the SEC to look at the definition of accredited investor because accredited investor has, with the one change that came out of Dodd-Frank[6], which is you don't count your house as far as your net worth, it's been the exact same test since 1982. And when it was adopted in 1982, and it said annual income of $200 thousand and net worth of $1 million, that was a small, small part of the world. It's still a pretty darn small part of the world but it's nothing compared to what it was thirty-something years ago. And it's never been ratcheted up. And what came out of Dodd-Frank was a request to look at it. And people have talked about the dollar part but one of the things that they keep talking about as a way to change it is to look more at someone's financial sophistication and have some other test for who is accredited, not just how much money did you inherit or how long have you sat on something while it turned into money and that suddenly makes you smart, you know. And so they bounce these ideas around all the time and I really think there was a four-year test put out by Dodd-Frank, which the SEC has already missed. To butch, they haven't hit a single deadline under Dodd Frank or the Jobs Act so that's not to …..

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

Mark A. Metz
That's because you're not there anymore.

Martin Dunn
Yeah right, that's the reason, yeah. Because I sped everything right through when I was there. [Laughter]. Although I will admit, Allen Beller and I were responsible for 18 such rulemakings- we did them all on time. Didn't miss one deadline on that. But that's mainly Allen, not me.

Peter Sugar
Beautiful rules, too.

Martin Dunn
Some were written in iambic pentameter actually. [Laughter]. But so I think you're going to see some movement on accredited investors, be it a dollar amount, or this notion of sophistication and some other way to test it is really starting to get a good bit of traction, they've discussed it yesterday at the committee meeting. And so that'll be an interesting one to see.

One of the difficulties with this is one of the tests was done that said if you just raise the million dollars to like 1.2, or 1.5 or some amount for inflation over some recent period, that it would cut the pool of U.S. investors available from 9% of the country to 7%. And if you take that in relative terms, you're losing a quarter, you know 20-25%, of your potential investors.

And so the business community's never going to like that. And so that's the hard part, we're changing the definition of accredited investor as it necessarily seems like it would shrink the pool. And that is always going to get pushed back because if you're talking about jobs and raising money and everything else, shrinking the pool of potential investors doesn't sound good. And so that is the conflict and why they always butt up against each other and never do anything on accredited investor. Every year when I was there I would go to the small business guys and go "we gotta raise this, this is silly." And they would be like, "you want that fallout?" And I would be like "nah, I've got other stuff that I'm doing wrong." So we wouldn't do that. So I don't know if that will happen, but again they've been directed to do something. So keep an eye on that.

Peter Sugar
Just so you're aware, watch the space. Mark, one other thing to jump in on if you will is, we now have 506(d), and this is not just applicable to 506(c), general solicitation offerings, it's now applicable to all Reg. D offerings, 506 offerings, and we didn't have this before, these are the bad boy prohibitions. Do you want to just highlight your thoughts on this?

Mark A. Metz
Well, yeah, it's real simple for me. This whole scheme boils down to a policy of who do we feel that we don't need to protect as far as investors and the policy [decision has been] made; we're not going to worry about people who are financially sophisticated, credited investors. How we define that is still up in the air. And, in a realm where there's not SEC review of a disclosure document with things in black and white and there's not a set of underwriters out there that are looking out for the purchasers, in a sense, what kinds of people should we allow, what kinds of companies should we allow to sell securities in that environment? Well, you can't allow people who are fraud-based people: people who've been convicted of fraud, people who've been convicted of a number of different things in new 506(d), which I think is very similar to the regime that…

Peter Sugar
Sixty-two and yeah.

Mark A. Metz
…that has been around forever. So, to me it makes sense that those things would apply, especially when you're talking about a realm where there's no SEC oversight and we're basically allowing companies to go advertise widely, bring in investors, sell to people who are people that we don't feel like we need to protect, and what else can we do to make sure that there's not a bunch of Ponzi schemes out there? Well, here's one: let's not let the bad guys participate in this scheme.

Martin Dunn
And yeah, I know we want to get to interstate next, but an interesting bit of history on why the bad actor part is in 506(d), and it is funny. Thirty years ago, they were called "bad boy" provisions; now they're bad actor provisions, but when 506 was originally adopted, when reg D was adopted, it didn't have bad actor provisions in it because it's a private

placement exemption and there's nothing in Section 4(2), now 4(a)(2), that says "and you can't be a bad actor." It simply says it's not a public offering. And so the SEC said, "No, this is a private exemption; we're not going to include bad actor provisions in it." Besides, it has to go through blue sky and each state has a bad actor provision, and so it's going to get caught anyhow. Nineteen ninety-eight, unintended consequences, Congress passes the Securities Markets Improvement Act that basically preempts states from regulating 506 offerings. And so all of the sudden, the bad actor part goes away. And so now you have no regulation at the states, free at the SEC just with the form D, and no bad actor provision in it at all. And you immediately started seeing some 506 abuses, a number of them in Texas, actually. I think it makes perfect sense that it's in there. Sure there's a little bit of how do we get up to speed and figure out how to document things, but I think everybody agrees it should be there. I have no problem with that.

Peter Sugar
I just have one question. People sitting around at the SEC and they're looking at 506(c) and saying, "Alright, we're going to open it up to general solicitation, but we don't want these bad actors. Oh, by the way, maybe we don't want them in any kind of exempt offering." Is that how it sort of went?

Martin Dunn
Well, I mean look at where it is. Well first off, the provision was in the Jobs Act so they had to do something…

Peter Sugar
Right.

Martin Dunn
…But they had been talking about adding it to all the exemptions for, gosh, I mean before I left, and that's been almost ten years. That's been a discussion ever since the late '90s. I think it was just an opportunity to do it. It doesn't make any sense to have a bad actor in (c) and not (d); I mean, that just doesn't make any sense.

Peter Sugar
Okay, so the practical takeaway here is you're working on a private offering, you're trying to fit it into Reg D, 506, you have to pay attention to some kind of diligence mechanism to assure that nobody involved in the offering—and you need to look at this rule because it goes through

the issuer or it goes through the affiliates, it goes through any participant, really, in the offering process—and you need to protect your client if your client is the issuer. In trying to assure that, they've done everything they can do to determine that there isn't somebody on the scene because the exemption goes away, and we all know that when the exemption goes away, it violates Section 5 and you've got a real problem, a real liability.

Let me touch on the third category, and we all sort of figured we'd go a little over on this subject because it is the transactional activity that's hot. So, forgive me for taking a little longer. I want to start by referencing the MILE[7] Act. We're all sitting here in Michigan; I think this is a little bit ironic because 90-some years ago, you know, the farmers in the Midwest, to protect themselves against, you know, you bad guys from the east…

Martin Dunn
He's actually pointing at me. [Laughter]

Peter Sugar
Well I know you're a Midwesterner.

Martin Dunn
I'm not even close to 90 years old. [Laughter]

Mark A. Metz
Marty and I don't remember back that far.

Peter Sugar
I remember. You know, passed these laws protecting themselves from these guys coming out and selling them nothing but the blue sky. The original source of regulation of securities offerings emanated from these state laws. Now we have this initiative, which to me, you know, strikes an irony. We have state legislatures stepping up and saying "federal government can't get their act together, the SEC can't get their act together, we can't get crowd funding, we're going to do crowd funding." Essentially, the framework for these provisions, MILE, which is the Michigan Act, which is the first, but there are 14 states either through legislation—I haven't taken an update on the count, but I think it's about 14—either through legislation or through rulemaking have created an ability to do internet offerings, going back to our original

[7] Michigan Invests Locally Exemption.

thought, coupled with the federal intrastate exemption, provided by Section 3(a)(11) of the 33 Act and rule 147 promulgated under there. The statutes are interesting just anecdotally; they do wonderful things. For the geeks, if you learned 3(a)(11) and 147 you know that the statute and the rule, but the statute primarily governs offers rather than focusing on sales and that is significant because if your offers have to be within a state, they have to be made to residents of that state, and when you couple that with social media or internet-based communications: Houston, we have a problem. You know, how do you control this? How do you keep it from going out of state? Well, what the legislature said was if it goes out of state, it's not an offer; it can't be accepted. That's a question of state law; it's contract law. Tongue in cheek, Marty's confirmed for me that this hasn't resonated yet at the [SEC]…

Martin Dunn
And will not. [Laughter]

Peter Sugar
But that's the way the statute's written. Getting back from that peculiarity, the idea is that if you have truly a local kind of offering and the SEC has been helpful—Marty's going to speak to it and Mark is in a second—in terms of identifying how mechanically you might want to approach this and take some care so that offers don't flow out of the state, which so far sound helpful. Limited offerings, Michigan's statute is a $10,000 cap, which is a sizeable investment for these kinds of things. If they're local, the one success, you can go to the local state website, which is a local portal, who has done two deals now: one was the brewery deal, and then another one which is similar…

Mark A. Metz
Is it debt or equity? I didn't hear about the second…

Peter Sugar
They're both debt deals, so there's some question about whether they're even securities, but I think they presumed they were. Tecumseh Brewing was the first deal. Up to a million dollars if you have limited financials, two million if you have audited. You can look at the details. These things are floating around. If you have truly local deals with local investors and if it's not significant enough or solid enough that you think you can go to an intermediary and you have an issue—or whose relationships, friends and family are tapped out—right, this may be something to look at and we're going to have to watch this space.

Martin Dunn
The challenge you have, as I said, though, is that there's always been this [interpretation] under 3(a)(11) the SEC has that's very confusing that says yes, you can do general solicitation under 3(a)(11); there's no limitation there, but you still have to comply with 3(a)(11). And everybody's like, well what does that mean? Well, it basically means I can fly a blimp out because nobody outside of the state can see it. So that's general solicitation, but I'm not offering outside the state. But, it always created a problem with the internet because if I'm on the internet, you know, I don't know how the tubes work and all, but apparently everybody sees it, which we're learning. So, the SEC has always said the internet is incompatible with 3(a)(11). Then the states saw that, because crowd funding under the Jobs Act, the states are preempted, 506 the states are preempted from regulating, so the states said, "Why don't we find a way to do crowd funding that's within our regulatory regime instead of us aced out." So that's where we come up with these things and they're encouraging folks to use the internet and people would call me and say this must mean the SEC is okay with this. I actually mentioned this to folks at the SEC and their first reaction was "we didn't even know about it." So that was good that I talked to them. So they've actually come out with a couple of interpretations, one which is very, very good, which says yes, you can generally solicit, 3(a)(11) is not incompatible with the web so long as you put disclaimers and restrictions making clear it's only an offer in the state. I thought that was a huge interpretation that came out a few months ago. It's going to permit these things to work and people not violate the federal securities laws by trying to use an intrastate exemption at the state level. So that's a great interpretation. Two or three days ago, they came out with another interpretation that says you can use social media, you can do everything under 3(a)(11), and one way to do it is to limit the IP addresses that you send it to. I've spoken to a couple of CTOs and they're like that's not possible; they don't know how the internet works, right? So this thing sounds really good and I guess theoretically it's good, but practically, look at the first one.

Peter Sugar
Isn't the theory that it sends out a signal and the signal comes back and it says I'm calling from Michigan?

Marty

I think that would be the theory, I don't think that's the reality. But, actually the federal interpretation of the first one is very very useful.

Peter Sugar
Does that mean then Marty, that a company could use its own website? Because practically speaking, I'm not sure how you could put enough disclaimers and limitation on access and that sort of thing to make a company's own website compliant with that CDI.

Marty
I think a company's own website has always been a challenge for offering securities. It creates a lot of problems, one from an anti-fraud perspective, and two from a jurisdictional means perspective. Once you are offering on your own website everything on there is part of the offer. So I've just always thought that that was a bad idea. I always thought some kind of password protected or using someone else to do it or a specific website is the only way to do it. Otherwise, there are just too many problems.

Peter Sugar
There are two related topics, just to mention quickly because we are going to move on to other hot topics. One has to do with after-market trading. All of these rules and limitations, limit re-sales. Whether you are looking at federal statutory exemptions, state exemptions, rules, Reg D, etc. There's some limitations on re-sales and there have been developments in the re-sale markets, including some substantial markets taking on private company trading. So you want to keep an eye on this, you have to mesh it with the restrictions obviously. The reason I bring it up here, under the state initiatives the state has mentioned as well, that despite the re-sale limitations, they are laying the groundwork for state based exchanges. And I think that is a big word for what they are talking about, I think they are talking about something like the old portal before the new portal. Where you have got some place you can go and bid and ask within the exemptions and trade. That's a big issue, liquidity is a big issue. For security offerings, it has an economic effect on the appeal of an offering. Whether someone wants to make an investment, typically don't want to make it for thirty years and not have any exit capability.

Mark Metz

So the bottom line really is, on all these sort of crowd funding exemptions, that if you are advising a client as to which road to go down. It is going to depend in large degree on your circumstances and how much you want to raise, but if you want to raise more than a million or two dollars, you are really left with the Reg A plus that Marty talked about, which has its own set of issues. Or going to the tried and true 506(b) placement with no general solicitation if you have an intermediary who has contacts, or if you have your own contacts. Or looking at 506(c) and following that and taking on whatever risk there is in trying to figure out how to take steps that reasonably verify accredited investor status of all your purchasers. And from where I sit, 506(c) at least in theory is far superior to any of those other alternatives because of the lack of conditions and hoops that you have to jump through to get there. Before we leave this, does anybody else have anything to add to that? I think that's where we end up.

I want to talk briefly about something that happened just last month that will affect those who advise public companies or who are interested in public companies' insiders, and that is a couple of press releases from the SEC announcing enforcement actions under Section 16. There were about twenty-nine public company officers, directors, major shareholders and another seven public companies that were on the other side of these enforcement actions by the SEC. Unlike most prior enforcement actions in the area of Section 16 reporting requirements, this related only to filing and disclosure issues. So there were no insider trading issues involved with this where the failure to report trades was just a tack-on to the insider trading violations. This was pure filing, and in some cases, pure disclosure when it came to the companies. And just to back up a step, for those of you who are little new to this area, Section 16 is forms 3, 4, 5 reports that are filed by directors, executive officers, and ten percent shareholders of a public company. And then section 13 filings, there are two different schedules, one is a 13(d) schedule, the other is called a 13(g), the (g) is the shorter of the two. They come out of the Williams Act, from thirty or forty years ago, which requires five percent owners to report their ownership. It was part of the same act that brought in the tender offer rules and so forth. The idea was to give public information about large shareholders and build-up of share ownership, so that the market could take that information into account when deciding whether to buy or sell. So, the SEC came out with these enforcement actions, which was rather surprising because they have not done much in the area of enforcement especially in the 13(d) and (g) area. But, also, very sporadically over the last ten to fifteen years in the area of forms 3, 4, 5. So this was pretty interesting and important for people who are advising public companies. The SEC enforcement staff said that they used quantitative data services and software to identify these insiders as repeat offenders with high rates of filing delinquencies. That means they are putting computers to use now to identify who is not filing on time.

Peter Sugar
No, they are using the NSA. *[laughter]*

Mark Metz
Or the NSA. Violations included late and unfiled forms, including companies failure to report late filings in their proxy statement and 10-K under S-K item 405. If you do any public company representation, you know exactly what I am talking about, it's right at the end of every proxy statement. Based on all the filing forms 3, 4, 5, we've reviewed since the beginning of last year, the only ones that are late are the ones that we list, or there haven't been any late ones.

Peter Sugar
And it requires it to be detailed. It requires it to say, she didn't file it, she was twelve days late. He didn't file it and it really says, some were detailed, some were late.

Mark Metz
Right. The violations also included, and this is the first time I have ever heard of this being brought by the SEC. Company negligence in helping insiders file reports on time, when they had undertaken to provide that assistance. It is not exactly a novel approach, because it is actually back in the adopting release, in the new Section 16 rules if I remember correctly, from fifteen years ago or so. Where the SEC hinted that this could someday come up, but to my knowledge it hadn't come up, since before September of this year. There was even one enforcement action that was brought against an institutional investor who failed to switch from a 13(g) the short form to a 13(d) the long form when there ownership got above twenty percent. Failed to catch that little nuance in the rules and they got hit too. All but one of these parties settled with the SEC, and they ended up with cease-and-desist orders and penalties that totaled for the whole group of thirty-six or so, penalties that totaled more than three million dollars. That got my attention, that's a lot of money. For the individuals, the penalties went anywhere from twenty-five thousand on the low end to one hundred seventy-five on the top end, but

that was sort of an outlier. An average was about sixty-five to seventy thousand dollars against individuals who had failed to file reports. For the seven public companies who were hit for failure to help their insiders after they had sort of assumed that role, failed to help them and negligently contributed to the failure to file on time, their penalties were either seventy-five grand or one hundred fifty grand, except for one outlier.

Now the outlier public company, and these guys got called out in their own press release. A company called Advanced Cell Technology and its CEO Gary Rabin, they were called out and it was stated that they defrauded investors for failing to disclose numerous transactions by Mr. Rabin. And the company got hit with a three hundred seventy-five thousand dollar penalty and a cease-and-desist order. Rabin got hit with one hundred seventy-five thousand dollar penalty for failure to file these little one page two-sided forms. A lot of them actually. The enforcement releases make a point of stating that the violations don't require any particular state of mind, no scienter involved here. Inadvertence or ignorance of the filing rules is no defense. Individuals can't rely on a defense that the company didn't help me properly, although the company sometimes gets nailed too. Or that someone else, their broker, their lawyer, is responsible for their failure. A few of the releases even make a point of stating that the incorrect information required by item 405, which is that little paragraph that Marty and I were talking about, that constituted materially misleading information because it didn't list all of the late filings by that company's insiders. The company violators were cited for undertaking to assist and then being negligent in discharging that responsibility, as I said, as well as the false disclosures under item 405. Some observations, one other thing that I was going to just mention. Some of the enforcement actions note that the respondents' remedial actions were taken into account as part of determining how much the penalty would be, and that was almost universal if I remember correctly. So that means that these folks still got penalized, to the degree that I mentioned, even though they had gone in and taken steps to fix the problem, fix their procedures or whatever it was internally that had caused these late filings. So some observations, and you guys jump in here. So some observations, and you guys jump in here.

Peter Sugar

I don't want to cut off Marty's time, but, you know, this is like a speeding ticket, right. I mean Section 16 is a law. This is a provision in the exchange act, particularly 16(b), which, you know, takes back short-swing profits, that is an *in terrorem* statute. We don't know whether you are inside trading; we don't know whether your trading is a secondary information point to the market about what you think, because maybe you sold because you bought a new house. We don't know any of that, but this is so dangerous that we want you to report. And so one take on this is look, you know, you have to do this—it's the rules. You've got a legal department or outside lawyers who are telling you all these protocols. You have to follow if you don't do it, right whether or not there's harm.

Martin Dunn
The first thing that I would observe is that I think it's hysterical that Mark forgot his glasses and can't actually read what is on the paper there. It is the tiniest little print; he's got no chance. *[Laughter]*

Mark Metz
That's what happens when you get old.

Martin Dunn
It's interesting. So when 405 got adopted now, geez, 20 years ago or so ago, there was some "say you have to do it" but there was no check on it. And there was no company check on it and so the studies that the economists did proved that, like, the compliance rate was like 16%. It was ridiculously low 20-25 years ago. And item 405 shot that up. And I think we reached the point where item 405, people would kind of stop worrying about it so it had stopped having that impact act upon compliance and that's why I think they brought these cases. Chair White, Mary Jo White, has given us a few speeches, where she refers to the broken window policy that she is applying now, which is the Guillani approach to cleaning up New York, which is take care of the little stuff 'cause then it doesn't look as bad. People see you are doing the little stuff; they'll do the big stuff too. So I think all that goes into this is the little stuff but that is the law. People need to comply with it and if you look at every settlement, they say, saying 'I asked my company to do it' and company is saying, 'We didn't'—Yes, ma'am,

Audience Member
So is the presumption that none of them, I remember reading the article, but I can't remember….

Martin Dunn

The way this works, the way 405 says it, it has to be a known error. So all the company is required to do under 405 is read all the threes, fours, and fives. They're not required to question further. So while that may be the question that everybody asks, the 405 requirement goes to known. And they make a point of saying the only thing you have to do is what 405 says. Because I don't think they wanted to create a huge cost. They just want people to do what they were supposed to do. So while it is still in there and I think people use that to help with compliance, they made a point in all the settlements of saying, they lay out the legal framework and make a point of the known failures and you don't have to look beyond the known, which I thought was a very good thing. These were easy, yeah, they used qualitative stuff, but if you file something six months later, that says 'I made the trade six months ago', and there's a four day filing period, You can figure that out and then for companies they would write things and say 'nobody was late' and the SEC pulled up the Form 4 and, like, everybody was late [Laughter] so everybody was just—These were easy cases to bring, but I think it's to have the effect of reinvigorating 405 disclosures, so I think that's the takeaway for everybody, is remember that it's there and do it.

Mark Metz

If you were around 10 or 15 years ago, like a lot of us were when the Section 16 rules changed, and this was a big deal and a lot of us went around and were helping companies put compliance programs in place and taking this very seriously. Well, we should again because another one of these could come out next week and you don't want your name on it. So take the process seriously. Make sure there is somebody inside your company who knows about section 16 that knows, who is responsible for getting the stuff filed. Make sure there's a procedure in place for getting information from the individuals to the person who is responsible and that that person, if they don't know all there is to know about section 16, at least knows what questions to ask when they call outside counsel on the phone. Uh, some of the enforcements were brought based on some very arcane pieces of the rule. For example, one company got hit for not filing restricted stock unit grants on time. Well that was because they were performance based grants, and they didn't have to be reported until the performance conditions had been satisfied, which was not when the grant happened but was a year later or two years later, and it slipped under the rug. It's an easy one to miss. Another company and its insider got hit for not realizing that the company controller who, I guess, was the chief accounting officer needed to file a Form 3, even though he technically wasn't an executive officer, or considered an executive officer, of the company. He missed a whole bunch of filings; both the company and the individual got hit. So take the stuff seriously, make sure you have good competent people, make sure you have a procedure in place. I think it works best if you can dovetail it with an insider trading policy where you're finding out ahead of time that there are transactions coming, and it gives you a chance to figure out what the reporting is supposed to be if there is any reporting at all that is required. Any other observations to make on that?

Martin Dunn
The only thing I would add is a lot of companies' insiders now have Rule 10(b)(5)(1) trading plans, which provide you a break from insider trading, when you entered into the plan, you didn't have any material information that trades were made under the plan you could be as conflicted as you need to be because it's just operating by operation by the plan. Everyone of those that I work on has a provision on the back, to be sure that the broker who does it is working with the company to inform them about the Forms 4 as they go along. Most companies in fact will have a particular broker or two because they want to have a relationship with them where they do these and so make sure you work it into those trading plans that executives have. I know we're late, so I just want to finish on it.

Mark A Metz
I just bought you five minutes.

Martin Dunn
No, no, no, it's fine. *[Laughter]*

Mark Metz
Ok, if you want to spend five on the shareholder proposal piece--

Martin Dunn
Sure, we'll just go very quickly over shareholders' proposals. Another part of being a public company is the shareholder proposal rule, Rule 14a8, which says that any shareholder, who for a year has held, and this is one of my favorites standards, either 2000 dollars or 1% of the voting stock. I can't imagine where 1% is going to be less than the 2,000 dollars. Ok, so that could be there. And so really pretty much any

shareholder who has held stock for a year can send in a proposal and the company has to include it in the proxy unless either procedurally or substantively, the rule allows you to exclude it. This is a big deal; we're coming up on proxy season. I think the most important thing to note is it's become a routine for the S&P 500 to get 12, 15, 18 proposals in a year. But when you talk to smaller companies and the Russell 3,000 companies, they're like, 'yeah, I haven't gotten a proposal in 10 years', that's changing. The CALPER, CALSTERS, all the public pension funds, they have kind of worn themselves out on the S&P 500 and they have accomplished a lot of what they want--declassification of the board, majority voting for directors, all they're you know, Chevedden is getting his action by written consent, special meetings, and you go through the litany of corporate government proposals and they have kind of worn themselves out on the Fortune 500, the S&P 500, and so they are reaching out to a much broader category of companies. And the interesting thing is that the smaller companies who have escaped this for a long time, their governance is not inline with what these pension funds are after, so these proposals are pretty easily raised. If you look at the numbers, less than 10%— just under 10 % of the S&P proposals each get a majority vote. But if you look at the Russell 3,000 it is up closer to 20%, so the smaller companies who have kind of been in a different corporate governance world and not under the microscope are starting to see these. The other big trend from last year is there are many, many more proposals but many, many more of them are withdrawn. And the reason for that is especially at the larger companies, which still get the lion's share of these, they have really set up engagement programs with their largest investors so now when you get a shareholder proposal the initial reaction isn't to call one of us and say, 'Oh my God, can I get it out? Do I actually have to waste two pages of my proxy; I can't believe I have to do this'—Rather, it's 'let's call them and see what they want'. Because they have been talking to these investors all year and its an easier conversation. It's less confrontational than it used to be.

And so you are seeing a lot more withdrawals, a lot of engagement, a lot of working on—I think it is a good trend. I think ultimately it saves everybody some money and a lot of time. The last trend I will note is if you look over the last 15 years more than 10% of all proposals have been brought by one guy. A guy named John Chevedden from California who has a group of people who own $2,000 worth of stock in just about every company; they've given him authority to raise proposals on their behalf and he just bounces around. I've written probably 1,000 letters with

John's name on them when I was with the SEC and he doesn't withdraw, he gets angry, he does all these things—and so people keep saying, well, this is a problem. Because it is a waste of money and it is absolutely is. You know, that's the way it goes.

Mark Metz
Tens of thousands of dollars, probably—

Martin Dunn
Are you kidding? I think there were like 75 letters last year on his filings. No letter cost lest than $10 grand. So he's costing millions of dollars of a year—

Mark Metz
As well as taxpayers' money, from all the people—

Martin Dunn
The people at the SEC have to review those letters. Although every year he did stop by the building to say hi [Laughter]. I don't know why he did that.

Peter Sugar
And toilet paper the trees outside *[Laughter]*

Martin Dunn
So there was a big push in the last two years to say that this proposal by proxy—this proxy other people were giving him wasn't a valid way to do it cause he is not the shareholder. And this gets into the debate about, well, companies are allowed to have counsel, why can't a shareholder have a representative who's more sophisticated or counsel, and so I think there is a good bit of fairness to that. And 5 or 6 companies have sued John, to say he wasn't the proponent, we don't have to include this because the SEC has done nothing on this topic. It's too thorny for them. They're going to tick somebody off no matter what; I don't blame them for that. So people have gone to the courts. The first one was *Apache* and the court said you are right, he didn't own the stock—this isn't right. Two cases followed that, I think KBR and one other, where the court was like—and in each case John wrote a letter and said, 'If you don't include it I promise not to sue you, and I promise not to raise it at the meeting.' So then he went to the court and said, 'see, there's no case or controversy', something about the Constitution or something, I don't—[Laughter] So he did that and those two courts agreed with *Apache*, that

he couldn't. Interestingly the next three courts—Chipotle, EMC, Omnicom—said 'no, no', 'cause what the company said is, 'that's not good enough' because the SEC could still sue us; other shareholders could sue us, so him saying he won't sue us doesn't eliminate the case or controversy. First three courts agreed with that. The last three courts basically said 'the chance of anybody else suing is so slight we're going to say no. So they disagreed with the companies. But at the same time it's a Pyrrhic victory for John because he already promised not to run it, so the companies got what they wanted, which it wasn't included. But now the question is way up in the air. The commission won't do anything, every public company is pretty much just throwing their hands up and goes, this is a terrible issue, but there's nothing we can do about it.

END (SPECIAL PRESENTATION AND) SECURITIES "TRANSACTIONAL" HOT TOPICS

BEGIN STATE OF MICHIGAN INVESTIGATIONS AND ENFORCEMENT

Elliot Spoon
Alright folks we are going to start our last panel, if you could take your seats please. Our last, but certainly not least, panel of the day is dealing with the State of Michigan Investigations and Enforcements. And on this panel we are very fortunate to have MSU College of Law Alum, Lindsay DeRosia.

Lindsay DeRosia
I will note when I was in law school I took Professor's Spoon's Securities Regulation class. And he was a kind Professor that would tell us ahead of time which class we were going to get called on, and my assigned class was Regulation D, so I studied it diligently.

Elliot Spoon
So that should be some sort of recommendation for the rest of you. We also have Rocky Pozza, from Miller Canfield and Mark Kowalsky, from Jaffe Raitt. And I will now turn it over to the panel.

Clarence L. "Rocky" Pozza Jr.

Lindsay first question if you are in a matter before the state, if you wear a little green and white "S," will that help you?

Lindsay DeRosia
Absolutely, you wouldn't be in a matter.

Clarence L. Pozza Jr.
Well good afternoon everyone, I have the privilege of actually presenting both Lindsay and Mark today, and from Lindsay, we'll hear a little about the re-organization of Securities Regulation in Michigan. But then we are going to go beyond that, she's going to review the types of matters that the State is seeing commonly, and provide a lot of very useful information to all us on State Enforcement cases. I think for those of us who practice in the area this should be very, very good, and her materials are very good. Mark is a long time outstanding practitioner, highly experienced. He's got a powerful set of slides with not only useful information, but some statistics that I think will counter what many of us view, and actually have counseled clients on, about going to hearings and the likely results. I think these slides will open some eyes. Now, I'm going to digress just a little bit because it is late in the day, but you're all here it's a Friday, and a beautiful weekend. About three weeks ago, I had the privilege of attending a four-day set of meetings in London, and in thinking about today and thinking about what I did in London, there was a very strong connection. We talked about today during an entire day securities regulation rule of law in a very specific area, the American capital markets - best in the world - and really based upon rule of law and that's what we've been talking about all day. In London, the theme of these set of meetings was rule of law and Magna Carta. Next year is the eight hundredth anniversary, and two things really stood out from this meeting in London. The first was that our British friends really like us, because we took their system and we actually, as their break away colonist country, we embodied it in a written constitution. And what impressed me was how important that was to the British. That we really did it; we took what they started and went way beyond. So when we think about today with securities regulation, I think well this is another example of America taking an area and really doing a great job with the rule of law. The second thing in this meeting, Justice Breyer - Steven Breyer – spoke, and he was absolutely brilliant and at the end of his hour he was talking about all kinds of things but you can see it was leading to a conclusion - world events what's going on in the Mid East, what's going on in the Ukraine, etc. Justice Breyer looked out at everything body, and there were about 2,000 people there and he said, "You know

it's actually very simple, either people and nations stand on the side of the rule of law or they don't." And he then left, he got a standing ovation. So, what we're doing is really talking about rule of law in a specific industry that's so critical to success capital formation. So, enough of my digressing, Lindsay you want to come up and kick us off, or from right there?

Lindsay DeRosia

Okay, that will work! As any good regulator of course I would like to say that opinions expressed are my own and not necessarily those of the Department or its' staff. I recognize a lot of faces here, I recognize a lot of names, so I'm sure you have dealt with security regulations in Michigan with some fashion. There has been pretty significant shift in the structure of it in the past couple of years. Previously we were with part of the Office of Financial Insurance Regulation with the insurance department, and about two years ago now by, governor's order, we were transferred into what is now known as the Bureau of Commercial - I'm drawing a blank now - Corporations Securities and Commercial Licensing. I was trying to think of Commercial Industry Services. So we are now in that bureau and so the Securities division which was once one unit within OFIR has now been broken up into different divisions within that Bureau. So, what I wanted to do initially was just to go through who you may be working with whether you're doing a Licensing application, whether you're doing a notice filing within that bureau because that has changed. So an outline of the bureau generally, our bureau director is Al Schefke, and our bureau deputy director is Ann Baker and they're both in the audience today. As I said before the functions of securities division have been realigned within that bureau, and I'll expound on that a little bit. So the Licensing Division, the director of that division is Andrew Brisbo, and this is going to be where if you're dealing with a registration of a broker dealer or a broker dealer agent, investment advisor, and investment advisor representative. They are also handling the notice filings of mutual funds and the form-D filings. Kim Breitmeyer who is in the audience as well is the head of Regulatory Compliance Division. What that division does is they work kind of in between the Enforcement Division and the Office of Attorney General. So any order drafting that's s that unit should coordinate compliance conferences, hearing requests, monitoring on-going compliance initiatives, as well as Freedom of Information Act requests, and Kim is back in the red.

Another departure was previously the examination and investigative function was combined into one, so an examiner may also conduct investigations. The examination function has been brought into the audit division, which Tim Teague is the director of, and Linda Cena is the manager of, and so this unit would be doing the routine examination of investment advisors and broker dealers. They also handle the securities product registration, if you happen to be involved in living care facilities, the registration of those facilities as well. Barrington Carr is my director of the Enforcement Division, and he is in the back as well. What the Enforcement Division does is, it receives complaints and conducts investigations under the Uniform Securities Act, and determines if administrative action needs to be initiated. Complaint sources that our bureau receives, a lot from consumers, a lot from other regulatory agencies, Securities Exchange Commission, FINRA[8], CFDC, a variety of organizations could refer matters to us, as well as internal referrals. A licensing staff member may note unregistered activity that could get referred to the investigation unit.

Clarence L. Pozza Jr.
Lindsay - and I should have asked or indicated that everybody asked questions as we go - FINRA, SEC can you help us with what might get sent
to you versus FINRA hanging onto it or the SEC.

Lindsay DeRosia
Sure, a lot consumers may know the name FINRA they may see the FINRA arbitration in their documents, and so a lot of times they will initially complain to FINRA. This even includes when there may be an investment advisor arrangement, so FINRA a lot of times may not have jurisdiction over the particular party or their firm might refer it to our agency as well as the SEC; the SEC maybe something smaller, if complaint it is primarily just in Michigan, they may sometimes defer those matters to our agency, or we could work jointly with them as well. Some of the common complaint types we get, majority of the complaints that I see, are unlicensed people, unlicensed individuals that are conducting unregistered offerings so that is a large portion of what we look at is people who are not in the industry. We do get complaints from people in the industry as well though. So a lot of what we're looking at is the sale of unregistered securities. Maybe somebody is conducting an offering they thought was exempt and they didn't quite meet the

[8] Financial Industry Regulatory Authority.

expectations of that exemption, or they didn't even realize the Securities Act existed. So it is a wide array of things that we get and then of course along with those would be omission or misstatement of material information in connection with that offering, and then the unlicensed individual or firms they may be selling that offering, that is a large portion of the complaints that we receive. We do of course get the suitability concerns and other sale practice type, but the biggest chunk is typically the unlicensed. Investigations have been conducted a little bit differently then they were in the older days if you've been dealing with a client who is under investigation. Typically the first step when we get a consumer complaint is we will send a notice to the respondent, most of the time it will include a copy of the complaint - we're not trying to hide the ball - give the respondent an opportunity to dispute the allegations, come back and identify exemptions if the registration may be in question. So that's really going to create a really great opportunity at that point if the respondent comes to the attorney to really put together the response, identify the exemption, and really the best thing you can do at that point is to make the argument. If those letters are ignored, under our Act, the burden of identifying and proving any exemptions is on the Respondent, so we may move forward with an administrative action when they could have claimed an exemption. So it's really important at that stage to put together a good written response, which explains what's going on.

Mark Kowalsky
Lindsay at that stage, when you would receive a response is it almost always from an attorney or do the individual business people involved try to deal with you?

Lindsay DeRosia
Both, if it is a licensed firm like a broker dealer, it will often be the compliance department. For unregistered people, they do sometimes get a securities attorney, which frankly I like to see because then I know that I am going to be dealing with somebody who knows the law, and I'm not going to have to explain well this is what a security is, so we get both. I think, it tends to make the process much more efficient if there is a securities attorney involved because then you get to at least frame the argument initially, and you know what the debate is.

Clarence L. Pozza Jr.
How would you if you're a practitioner, do you have any advice on how we can make our submissions as good as possible on behalf of a client?

Can you differentiate a really good response from a poor one? And that's a very crude question, but for those of us who do it, what might help?

Lindsay DeRosia
Well I think the practitioners, if they can understand where the regulator is coming from, and for many complaints kind of take the regulator's state and say, "Okay what concern may they be looking at?" Are they trying to assess there is ongoing harm because I can tell them right away there is no more activity occurring and that may slow things down a little bit, or if they know off the bat there's an exemption, not only identify the exemption but to explain why they complied with the exemption, because if you just come back and say, "Oh I was relying on 202A," and not identify why it meets that, the next thing that is going to happen is we are going to draft another letter and say, "Well tell me why you can rely on this?" So, I think just addressing the issues head on understanding where the regulator might be coming from as far as harm to the investors so that we understand the scope of the problem that has occurred because of this transaction and that it's being addressed.

Clarence L. Pozza Jr.
If a practitioner called before they submitted something could they talk it through informally with you?

Lindsay DeRosia
They can certainly talk, call the examiner to just get an idea of, you know what kind of response we're looking for. At my stage of the game, we're certainly not in a position to settle, or anything like that. However, you could certainly shed some light onto what's going on and what sort of information as to what we're looking at, as far as the response, absolutely. And the notice to the respondent will include the assigned examiner or the assigned investigator on the matter. And typically we're looking for a response within fifteen days of the notice. And again that is not administrative action it's simply here's a complaint we have, what's your side of the story. Now if it does get to this stage where we determine that's there has been a violation and administrative action is initiated, what will happen is the investigative team will make a recommendation to our Division Director, who may refer to our Bureau Director's office, and there may be an administrative order which is issued. The administrative order would be issued by our Regulatory Compliance Division. So they would be in charge of drafting the order

and serving it on the respondent. At this stage, the opportunity for a hearing would be identified and you would contact the regulatory compliance division. If the hearing is requested, an attorney from the Attorney General's Office would be assigned to represent the Bureau in that matter. And so in that stage of the game is where you go in to request the hearing, and you want to talk settlement and possibly consent order, things like that. That would be the time when those things come into play.

Clarence L. Pozza Jr.
Could you do that before you get to that stage, when you're doing your fifteen day submission, or is it too early?

Lindsay DeRosia
You can certainly, I wouldn't be in a position to accept any sort of settlement. You could certainly if you come back with your response and acknowledge that there's been a violation, put it in writing and say, "This is what we propose to correct the deficiency." I think that would come into play and that would certainly help as the file moves up the chain and the information would be received and essentially already considered, I think as part of the process. Oh, and I wanted to point out that the website has obviously changed as well. On our website we do have the disciplinary action reports, which identifies administrative actions that have been initiated by the Bureau for all of our occupations, including securities. You can also see a copy of the complaint form on the website. Some examples of administrative actions that might be initiated under the Michigan Uniform Securities Act, if it's a licensing issue and your client wants to come in and become licensed and there some problems with their history, it's possible there may be a conditional registration order. I did include in the materials some examples of that. I think that one's especially helpful because it gives some ideas of the conditions that the Bureau is going to look at in granting that registration. And of course the cease and desist order is a very common example of administrative action. Then of course consent order, and examples of each of those are also included in the materials.

Clarence L. Pozza Jr.
Lindsay do you see that in these, going back and then a little forward, in the submission stage, are folks using outside experts in addition to counsel at that point? Have you seen that, or would that be a rare event?

Lindsay DeRosia
I don't know, I don't typically see outside experts. Not that there may not be a reason that that could possibly come into play, but it's not typically something that's seen at that stage. The examination procedures -I'm not in the examination unit - but I did speak with some of the examiners and I kind of wanted to highlight that program has been working. Typically if the broker dealer or investment advisor is going to be subject to an exam, they'll get notification a few weeks ahead of time, and that will include a request list and identification of the assigned examiner, so that they could contact the examiner, talk about any conflicts in scheduling, or questions about the materials they want to look at. When they're onsite during the examination, they'll be doing interviews of the compliance officer, possibly some staff, reviewing records. Typically the culmination of an examination would be a deficiency letter, which may or may not require actual written response to Bureau, depending on the nature of the deficiencies highlighted. Some common exam deficiencies that they're seeing: contract deficiencies, especially in the advisor capacity, they're going to be comparing the contract requirements with what's disclosed in the ADV[9], parts one and two. And then of course making sure that parts one and two are consistent. Books and records, and adequately maintaining those books and records. Discrepancies in fees between again what's disclosed in the ADV, what's in the contract and from what's actually being charged. And then inadequate disclosures regarding third party referrals. So if you have an IA[10] whose primary business is referring to third party IAs making sure that compensation and services in connection with those arrangements are disclosed.

Clarence L. Pozza Jr.
Where do the hearing officers come from?

Lindsay DeRosia
Their mothers, I don't know? *[laughter]*

Clarence L. Pozza Jr.
Ask a bad question and you get it right back.

[9] Form ADV is the uniform form used by investment advisers to register with both the Securities and Exchange Commission and state securities authorities.
[10] Investment advisor.

Lindsay DeRosia
Do you mean in the process?

Clarence L. Pozza Jr.
Right. I assume they are civil service, they are part of the hearing system.

Lindsay DeRosia
You know, Tim may be able to better answer how they are hired. And as far as how they get that position. How they work in the scheme of things is typically my stage - it's the investigations stage. We're just gathering information. It may get closed; nothing further happens. If we do recommend administrative action, administrative order issued, the respondent of course has the opportunity to request a hearing. And they certainly can do that, and so that would be at the stage at which it's at Kim's unit. And then once they request the hearing, there would be a hearing scheduled and then at that point there would be talks between the attorneys handling the matter for our Bureau and the respondent.

Unknown speaker
It's the hearing are held with the Michigan Administrative Hearing Systems, so the administrative law judge is assigned from that part.

Clarence L. Pozza Jr.
Would they be experts in securities cases or they basically do all kinds of administrative hearings?

Unknown Speaker
They do all kinds of administrative hearings.

Clarence L. Pozza Jr.
Ok, so if you're appearing before them, you shouldn't assume that they have this forty year history in security regulation, and so you might have to do some teaching along the way.

Unknown Speaker
That is correct.

Clarence L. Pozza Jr.
Alright, thank you. Mark?

Lindsay DeRosia
I can hand over to this guy.

Mark Kowalsky
Thank you. I have litigator throughout my DNA, and as a litigator I like to be on my feet, so I'm going to move over here. I think the hardest part is to work with the technology, and let me get my PowerPoint here. Great. Well thank you very much to everyone for staying until the end of the program, and I know it's been said, but thank you so much Joe, not only for today, but all of your years and years of moving this program forward. I think the first program that I attended might have been the Pontchartrain, downtown. And it - we've - come a long way in all positive, so thank you for your help in taking over the leadership. We have heard a lot today about rules and regulations and rule proposals, and I want to get a little bit more practical. I want to focus on the situation as a practitioner you receive a call you receive an email; you have a meeting with a client who has received notice from a regulator that they are under investigation. And this can come in many different forms from many different places. And I would like to spend the next few minutes walking through, what to do at that point, and give some practical tips as to whether or not you decide to litigate, or whether you quickly decide to settle. And you should have in your material today, my PowerPoint with some of the specific tips and I'll go over a number of them.

But some of you may remember there was either a pamphlet or a poster that had a listing of items under the category of "everything I need know in life I learned in kindergarten." And I think one of those items on that list was to do your homework. And to distill down everything that I am going to go over really comes down to that. You have to be prepared, you have to do your homework, you have to understand the facts, you have to understand the issues, and you have to understand the consequences. And you can't adequately represent your client when faced with the question, "Ok, do I litigate or do I settle?" without doing all of that work in advance. And if you don't do it, you may be in a situation where you may not be giving your client the best advice. There is a big gap between the perception and reality of what actually happens if you decide to settle versus whether you litigate. A lot of people believe that if you are going to litigate against a regulator, you are going to start with either one hand, or two hands, tied behind your back—that you are putting yourself in an impossible position. So the perception is that it's an unfair fight. If you choose to litigate, the people that you're going to be in front of have at least some background that is at least suspect if you're an advocate because when litigating against the S.E.C., the proceedings are in front of an administrative law judge whose authority comes right from the S.E.C. If you're in front of F.I.N.R.A., you're going to be in front of a hearing officer who is actually an employee of F.I.N.R.A. So you have to tell your client that if we fight, these are the people who are ultimately going to be making the decision. And with the State, we heard the question a few moments ago, that you are going to have a person—a civil servant of some kind—that the state has appointed to decide your fate. You also have to belief that the regulators on the other side have unlimited resources available to litigate against you.

But the statistics show that despite the perception, the reality is drastically different. The most recent statistics that I've been able to find from the last couple of years show that, of matters that do proceed—and you see this in the last bullet point—nearly half of the people—the advisors, brokers, dealers, and their representatives—who litigate with F.I.N.R.A. or with the S.E.C. actually end up receiving a sanction that is less than what was offered before settlement. So it's a long road, but at the end of the road statistics show that—chances are—you are going to get less of a sanction for your client. Specifically, based on 2010 statistics, 47% of people who chose to litigate either had the charges dismissed, or they received a lower sanction. On appeal—the next step up if you were not happy with the initial adjudication—18% of people received relief from either F.I.N.R.A.'s national adjudicatory council, or from the S.E.C., or from the Court. 43%—and that's a large number—43% of the A.L.J.s found that the S.E.C. had not met its burden to prove the charges. And, one of the most startling statistics that I have to relay, is that in this reporting period, 100% of the A.L.J.s imposed a sanction less than what was being offered with respect to a monetary sanction, and 17% of the A.L.J.s imposed less than the requested suspension or bar.

What are the advantages of pursuing litigation? The first bullet point shows what I just said—the statistics, to a large extent, are in your favor. You do have a fighting chance. The second bullet point—and to some clients this is the most important—is that if you litigate it's the only clear path that you have for your client to clear his or her name, and to maintain a clean regulatory record. Because any settlement—whether there is an "admit," or a "neither admit nor deny"—has certain connotations, and certain results. If, for whatever reason—for personal reasons, for business reasons—your client needs a clean record in order to continue to earn income, they may tell you, "I have no choice. I have to litigate. I have to win because anything less than that truly is not victory."

Now what are the advantages when you're talking to your client about settling? One, it's quicker. Clients like to stay focused on their business, they don't like the distraction. Litigation can take at a minimum 10 to 14 months. If clients settle they can do it a lot quicker, they can have lower professional fees, and it gives them a sense of predictability in the process. Through a settlement, for example, you can negotiate and avoid a finding that you committed fraud, or that it was willful activity.

Now, why might that be important? For your client—for other business dealings, for purposes of insurance coverage—if you can remove the fraud term, you can remove the intentional act term, you may be able to get insurance coverage, or you may be able to limit the collateral damage. So that could be an important item that you can control if you're able to negotiate a settlement. You may be able to determine how the ultimate penalty is classified; again for some of the reasons I just mentioned, if you call it a fee, or you call it a penalty, or you call it disgorgement, this could have drastic consequences to your client, and the ability to get the funds to pay any of that amount as to whether or not there is insurance or other coverage. If you do settle, you may be able to negotiate whether or not it will be a "neither admit nor deny." If there is a finding that your client did intentionally violate something, that is a permanent finding, and you lose the ability to negotiate that language.

The last bullet point on that is that if there is a settlement, you can make the argument that under the evidence rules, it's inadmissible under rule 408, and that if there are other civil lawsuits out there, or other civil matters out there, you can argue that the settlement is inadmissible, and should not be considered. You can't do that necessarily if there is a specific finding.

So, how do you obtain the best settlement for your client? This comes back to my initial comment—you have to understand the process; you have to understand the consequences of what's being offered, and you have to understand the consequences of what you ultimately choose. I can quickly go over this. At the beginning, Lindsay [DeRosia] talked about the different steps of the process.

First thing, understand where you are in that process, because if you don't understand it, you may be talking to the wrong people, you may be looking at the wrong rules, you may be giving the wrong advice. Understand what the possible outcomes are—you can't negotiate without knowing, "What are my choices? What have they agreed to in the past? Is it possible to get a 'no action' letter, or a dismissal? Is a 'consent order' something that's available? The 'conditional registration order,'" that Lindsay [DeRosia] talked about, "is that applicable to my situation, and does that give my client what he or she needs? Is there an 'undertaking provision,' where you simply agree to do something?" Do your homework. Understand what the possibilities are. Lindsay [DeRosia] mentioned that you can go on the State [of Michigan] website and find out what other disciplinary actions have been taken, what other complaints have said. Do the same thing for the F.I.N.R.A. settlements. Do the same thing for S.E.C. litigation results. All of this is publicly available. If your client is being accused of a records violation, through resources you can say, "O.K., records violations similar, normally it's a $10,000 penalty and no suspension." Understand that so that you know how to make your arguments to ensure that your client is treated certainly no worse than what the precedent is. You don't have to guess; all of that information is publicly available.

Be prepared, in your conversations, to argue all the mitigating factors about why your client should be treated in a different way. We heard from an earlier panel about the S.E.C.'s formal cooperation process—if you're dealing with the S.E.C., understand that process, and take advantage of that process if it's possible. The S.E.C. publishes guidelines with respect to sanctions as to about half a dozen or so factors that they look at in determining how to gauge the sanctions. Even if you're dealing with the State [of Michigan], those factors could be important—look them up, and understand them. Have you voluntarily reported this? Have you voluntarily corrected the problem? Have you dismissed people from the company? Have you hired an outside consultant? Have you undertaken additional continuing education, or changed your policy manual? Is this the first instance that anything has been involved? Has a client been harmed at all, or is it a technical violation? All of those things are available factors to look at, so when you have the phone call and say, "Treat my client this way because: all of these mitigating factors."

It goes to the last bullet point, that if you receive an offer, you can make a reasonable counter-offer. If you were told $50,000, you're simply not going to come back and say, "O.K. How about $25,000." There's no reason to that, and it may not be persuasive. If you do your homework, you can say, "In the Jones' case, in the Johnson's case, in the Wilson's case—similar situations—the fine was only $20,000." You may be more persuasive with the regulators.

Clarence L. Pozza Jr.
Mark [L. Kowalsky], can I ask at that point, where you're negotiating, would you see a situation where you might bring in—early—an outside expert, a former regulator, to kind of help? Sometimes as counsel we're advocates—although skilled, and we've done it a long time—that has a lot of throw weight. But what about bringing in an outsider?

Mark L. Kowalsky
Rocky, I've done it in this context—when there was a systemic problem with my client, I've gone to an outside person, had my client hire them, and that outside consultant is now working with the client to remedy the situation. Re-writing the policy manual. Putting in different procedures. Then you can go to the regulators and say, "We're taking this very seriously. We're not ignoring it. We've hired someone"—hopefully someone the regulators are going to know—"and we've already started to correct the problem." In one of the earlier panels, there was a little quip made about don't high-five with your client that you've reached this settlement on the civil side, and find out the next day that your client is subject to criminal prosecution because that's certainly a bad situation for the client, and it's a terrible situation for the attorney who has now counseled their client on all these reasons why the settlement was appropriate.

It comes to the next few slides, and that is you have to thoroughly understand the consequences of anything you agree, or recommend to your client that they agree to. Because if you don't do that, you've put you and your client into harm's way that they really didn't understand and appreciate that. I have a number of these listed, and I'm just going to touch on a couple of them. Your client may want to put this all behind him or her—it's been a terrible experience, and they don't want to ever have to think about it again. But, if it's something that is involving a F.I.N.R.A. matter, we have the public broker-check system that is set up that publicly reports any problems—with certain limitations—someone in the industry has had, and that remains a public record for a great number of years. So, make sure your client understands that that they can't settle this and think that no one will ever ask them about it because—in all likelihood—somebody is going to retain them in the future to be their broker or investment advisor, that public customer may look broker-check, and this is going to be public and not truly behind them.

Understand and counsel you client whether or not anything that can be used against them in other civil actions—if it involves a product that your client sold to ten people, if you settle on this one issue, does that set a precedent where the next nine people are going to come to you and say, "We understand that you've already acknowledged to the State that this is a problem, send us our check." Understand that.

There are—on the state and federal levels—numerous statutory disqualifications that you cannot continue in the industry if, for example, you've been previously enjoined, or there's been an order entered against you. Understand the statutory disqualifications because, again, you don't want to settle, and then the next day the regulators are saying, "Well you still can't be in this industry because what you just agreed to constitutes a statutory disqualification."

I'm going to skip over this, but it's important that you read it. One of the terms, or one of the methods of resolution when you're dealing with F.I.N.R.A. is entering into this "A.W.C.," and in that A.W.C. acceptance, you're acknowledging certain things. One of the things that your client has to acknowledge when they sign this settlement to the A.W.C. is that it will be public. It will be part of their permanent record. F.I.N.R.A. may issue a press release, which may get picked up by Crane's or the Wall Street Journal. Again, know these terms, and go through them with your client.

It may be an important point to your client as to how many dollars are going to be paid. Understand what is being asked. Is it a payment that's going to be required immediately, or is it a payment that is only required if your client decides to re-enter the industry. That could be very important for your client because if the dollars are short, and they never want to be in the securities industry again, they may agree to a higher dollar settlement knowing that they'll never have to pay that amount.

The regulators—either on the state or federal level—may say, "Well, we can resolve this, but we want your client to obtain an independent consultant for a two year period." Your client may say, "Oh, that's great!

I can get out of this. All I have to do is retain an independent consultant." Understand that could cost $50,000, $70,000 per year. For your client to agree and then find out that there is going to be this tremendous cost of hiring this outside person, that's a bad discussion. Understand it in advance.

Understand the language of your settlement on your possible client's insurance claim to cover the payment. I'm involved in a situation right now with the S.E.C. We were negotiating over my client's ability to re-apply to be involved in the industry after a certain number of years, and we're talking about one year, two years, six months, and then we get further into the discussion and we find out from the regulators that, as a practical matter, it will not be six months, one year, or two years, because, historically, the S.E.C., under these circumstances, has never granted a right to re-apply. So it was a wasted conversation. If you don't ask, if you don't understand that, you can't make an informed decision.

So you've done your homework, you understand the various terms, you understand the consequences, you've advised and you have reached a logger head with the regulator. What they're asking is nowhere close to what your client can accept. How do you get beyond that? How do you avoid an impasse? I find it very helpful, even if it means getting on an airplane, to request an in-person with staff and supervisors. Come up to Lansing, go the S.E.C., or go to F.I.N.R.A. Have that meeting, face-to-face. A lot of times, after those discussions, you can move forward with coming to an appropriate settlement.

Be creative in what you're willing to offer and what you're willing to suggest to your client. Accept an undertaking, a promise to do something. Heightened supervision, maybe that's something, "You can be in the industry, but you have to have heightened supervision." Understand what that means. I was involved in a number of situations where the State wanted our client to be under heightened supervision. You have to work with your client and determine whether or not that heightened supervision—that their supervisor will look after them more carefully—whether or not that's really a death knell to a future job. It may be that if your client is going to one of the wirehouses like a Merrill Lynch, or a U.B.S., they may have a policy that, for whatever reason, "We don't accept people that are under heightened supervision." So don't agree to something like that unless you understand the consequences, and that you talk to your client about that. Try to cast the payment under different categories. Are there other, non-monetary, sanctions available, and, again, agree to retain a consultant.

We've talked about all the work that you have to do to get to a settlement, and once you tell the client—and there is a shaking of the hands, or a meeting of the minds—you can't let down your guard at that point. You have to be extremely diligent in documenting the settlement. There are multiple documents involved in a settlement. The words have a lot of nuances. Make sure you review them very carefully. There may be—if it's with the S.E.C.—part of the settlement may be a court filing, if one hasn't been filed already, a civil action. Understand what the civil action is going to say because that's public record. The A.W.C. that we talked about—look at the preamble in it. I think as part of the material there are some samples that you can look at. If there is a court action to be filed, there will be a written judgment—that's a negotiated item with the regulators. Make sure you are comfortable with what it says. Find out if the State, or the S.E.C., or F.I.N.R.A. is going to issue a press release. There may be some little leeway that you can work with them in advance. Understand and know what the press release says. Remember, all of these items become public record with the internet. They're not "public" in the sense that you have to go and ask for them. They're "public" in the sense that if you Google your name and they come up. A slight difference in the language can have drastic differences in the consequences. An "admit" verses a "neither admit nor deny," how you classify the payments, whether something is a "negligent" or an "intentional" violation.

The last bullet point here is damage control. You have to get ahead of the curve on this, and if you are going to reach a settlement—depending on the situation—communicate in advance, both internally and externally, if this is going to get publicity. If there's other employees in the office, you don't want to have them hearing about it and whispering about it. Explain it in advance. Externally—depending on your company, depending on the situation—do you want to work with an outside public relations consultant who has some expertise in this area so that you can minimize whatever the announcement is going to be? Whenever the reporter calls you from the Wall Street Journal, or from Crane's, or from Investment News, there are answer prepared, or a decision has been made that you're not going to comment. Be prepared in advance for that.

In summary, the rules are very simple. Be informed, be co-operative, be creative, don't throw out the litigation option. The presumption generally is, “We can't fight because it's going to cost us a lot more in the end.” Understand the consequences, and watch every word in the document. I have found it extremely helpful on the State-level, working with some of Lindsay [DeRosia]’s colleagues, some of the people in the Attorney General's office who handle matters in the enforcement option. They have been very sensitive to business concerns. We've worked on agreements. Then my clients have gone back to their employers or potential employers to review language to see what would be problematic, and the State has been flexible in changing things, and rewriting things, to get us to the point to where the State can get what it wants, and we can provide the best service to our clients. So it comes back to do your homework, understand the issues, and don't be afraid to ask a lot of questions. I think Rocky may have posed a question earlier about whether there's the ability to communicate by telephone, and my experience has been that it has always been useful.

Clarence L. Pozza Jr.
Mark [L. Kowalsky], on independent consultants, do you think it would be worthwhile to carefully work with the regulators on the scope of the engagement so that you don't get a runaway consultant who basically says, “I'm going to redo your entire compliance system,” or, “Redo X,” because the scope isn't really defined?

Mark L. Kowalsky
Rocky, a couple of different responses. One, I have, unsuccessfully, tried to ask the State, or other regulators for suggestions as to consultants to work with, and they, appropriately so, always say, Well, we're not in a position to tell you that.” But, once I've worked with someone, and we’ve tried to talk through what the scope is, I've had very productive conversations.

Clarence L. Pozza Jr.
Good. John?

John Birkenheier
Could you just touch on, for a second, the different types of discovery that might be available during the process?

Mark L. Kowalsky

That's a good question. It depends on who you're dealing with. For example, the S.E.C., a lot of times to start their process—in my experience with the S.E.C.—frequently you find out about the investigation when the client calls you and says, "I got this subpoena. What am I supposed to do?" To have a subpoena issued, the S.E.C. has had to, in most cases, get a formal order which describes what they're looking at, and the formal order, while it's somewhat generic, it does have certain descriptions in it that are very helpful, and there are specific rules on how you gain access to the formal order. They simply won't just give it to you, [and] there are certain representations you have to make about confidentiality. So, on the S.E.C., that's a good start, and for each of the regulators, their practice manuals have provisions as to the very specific path that you have to go down to try and get any discovery. It's not like civil litigation. You're not going to get a data dump of everything. But, there are ways to get, in advance, certain pieces of information. If there is a series of depositions that are being taken by the regulators, you don't really have advance notice necessarily of those being taken, but you may have the ability ultimately—if you weave the right path—to get copies of those depositions and understand the scope of what's really going on and being looked at.

Clarence L. Pozza Jr.
Mark [L. Kowalsky], looking at taking something to hearing, and the statistics are interesting, because I was surprised. I hadn't looked at them in a while. Is there much of a risk, in your experience, that the sanctions could come back worse? Like a runaway jury, if it come back far worse, "Why did I go to hearing?" Or, is that not really much of a risk as a practical matter?

Mark L. Kowalsky
It's certainly a risk. I haven't ever had that happen, and that if—for some reason—the train goes a little bit differently, regulators are generally willing to revisit settlement discussions. And you can reel it back in and get it under control before you go too far. And I just find generally, the system is set up that the regulators do not have the time or personnel or resources to try every case.

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