CHAPTER 1

Overview

The Multilayered Securities Enforcement System

Contents

A. Introduction 3
B. SEC Enforcement 7
C. Self-Regulatory Organizations 8
D. State Regulation 9
E. Criminal Prosecution 11
A. Introduction

The United States securities markets, as well as broker-dealers, investment advisers, issuers of securities, and other participants in those markets, operate under a multilayered system of securities regulation. The system is administered by the Securities and Exchange Commission (“SEC” or “Commission”), industry self-regulatory organizations (“SROs”) and securities regulators of the 50 state jurisdictions, and the District of Columbia. The SEC, under the federal securities laws, and each of the state regulators, under their respective blue sky laws, have extensive authority to take enforcement action by initiating administrative proceedings or civil injunctive actions or by referring matters for criminal prosecution. The federal securities laws also give SROs extensive disciplinary authority over their members and persons associated with them. Recently, the U.S. Department of Justice and certain state attorney generals also have become very active in the criminal enforcement of federal and state securities laws. In addition, with the increasing globalization of the securities markets, U.S. participants in foreign securities markets subject themselves to the enforcement authority of regulators in those markets.

As a greater percentage of U.S. households invested in the securities markets during the 1980s and 1990s, securities regulators became far more active. In the aftermath of the Enron-WorldCom debacles, regulatory activism has reached new heights with state and federal regulators (and sometimes SROs) vying with each other to assert the most aggressive enforcement positions and to seek the harshest sanctions against alleged securities violators. This regulatory activism has been accompanied by an acceleration in the trend toward the criminalization of securities law enforcement as cases once considered too complex for most prosecutors have become a staple of white collar criminal prosecution units.
Moreover, the publicity generated by securities enforcement actions over the years has leaped from the back pages of our newspapers’ financial sections to front-page headline news. The heightened public interest in fair and honest securities markets means that enforcement action by securities regulators against perceived violators of securities regulatory requirements will continue to operate in a highly charged environment.

For these reasons, a basic knowledge of the strategies and tactics of dealing with securities enforcement investigations and actions is important not only for securities litigators but for all those who must cope with the multilayered system of securities regulation in the United States and abroad.

This enforcement manual is designed to assist both laypersons and legal counsel who need to understand the important components of this multilayered system of securities enforcement. It outlines the basic legal frameworks for the enforcement of state and federal securities laws and the procedural mechanisms through which government regulators and the SROs operate. The manual’s primary focus, however, is on practical considerations—the tactics and strategy for dealing with enforcement issues before the SEC, state securities regulators, the SROs, and criminal prosecutors.

Accordingly, the manual discusses, among other things:

- the tactics for handling seemingly routine inspections and investigatory inquiries;
- the strategies for handling the production of documents, for representing witnesses called to give testimony, for preparing Wells Submissions, and for taking other post-testimonial action in defending enforcement investigations;
- the process of negotiating settlements of enforcement actions while taking into account the framework of sanctions available to the regulators and prosecutors and the potential collateral consequences flowing from such sanctions;
- the legal, procedural, and tactical issues involved in the defense of SEC injunctive actions, administrative proceedings, and criminal prosecutions;
- the issues raised by the enforcement activities of state securities administrators and state attorney generals;
- the enforcement processes of the SROs, particularly the National Association of Securities Dealers, Inc. (“NASD”), and the New York Stock Exchange LLC (“NYSE”);\(^2\)
- the uses and misuses of internal investigations;
- the issues raised by claims of evidentiary privileges;

---

2. On November 28, 2006, the NASD and the NYSE announced a plan to combine their member regulators and much of their enforcement operations into a new self-regulatory organization that will be the sole private sector regulator for all securities brokers and dealers doing business with the public in the United States. This plan is discussed further in Chapter 9 of this manual.
• the special problems imposed by potential conflicts when representing multiple clients in an enforcement investigation and other ethical issues;
• the increasingly common issues raised by extra-territorial enforcement of foreign securities laws;
• the unique and difficult issues presented in criminal enforcement actions; and
• the different challenges posed when dealing with enforcement issues before the Financial Services Authority.

The purpose of this manual is not rigidly to prescribe the specific strategy and tactics for each case but to identify key strategic and tactical issues so that informed judgments can be made in particular matters. It recognizes that the choice of strategy and tactics invariably depends on the particular facts and circumstances of individual matters. For every general rule there are many exceptions. Moreover, strategy and tactics rely heavily on highly complex and subjective judgments that often are based on the professional’s particular orientation and experience. The strategies and tactics throughout this manual are the product of the particular professional judgments of the authors—judgments that other experienced practitioners may challenge.

The need for effective strategies to deal with securities enforcement actions begins with the first notice of a regulatory inquiry. Most securities enforcement actions are preceded by a lengthy informal or formal investigation. In addition, investigations of broker-dealers and other regulated entities often are preceded by an inspection or examination conducted by regulatory personnel. Typically, the rules of the regulators require that all securities enforcement investigations be kept confidential until commencement of an enforcement action. Because enforcement actions by the SEC or state securities regulators are public proceedings, the initiation of an enforcement action by the SEC or by a state securities regulator often represents the first public disclosure of an enforcement problem.

In recent years, some state officials, notably former New York Attorney General Eliot Spitzer, have, through the selective disclosure of evidence unfavorable to the targets of investigations, used the pressure of publicity to obtain quick settlements in connection with their offices’ enforcement actions. The NASD and certain other SROs will, upon request by anyone, release a copy of a disciplinary complaint with appropriate caveats that the matter has not been fully adjudicated and, in some instances, will affirmatively publicize the filing of a particularly high-profile complaint.3

Wholly apart from the merits of an enforcement action, the publicity that precedes or accompanies such actions can be devastating to those who depend on investor confidence for their business. It is often extraordinarily difficult during the pendency of such an action for publicly held companies to maintain public confidence in their securities and securities firms and professionals to maintain

3. NASD rule IM-8319-3. The NASD may also upon request release copies of adjudicated cases that are subject to appeal, again with appropriate caveats as to their status and possible ultimate disposition. Id.
the confidence of their customers. For this reason alone, the overwhelming portion of securities enforcement actions are settled by the time the action is made public. Accordingly, the investigation preceding initiation of the action is very often the only “day in court” for potential defendants.

For this reason, it is critically important, in most cases, to mount a proactive response at every stage of an investigation preceding the initiation of a public enforcement proceeding. Being proactive throughout the investigatory process is important not only to prevent an enforcement action from being brought but also to negotiate a settlement on the most favorable terms if it becomes clear that such an action will be instituted and there is not a strong interest in litigation. Thus, the posture of defense counsel in an enforcement investigation often differs significantly from the posture in the pre-trial processes of civil or criminal litigation where the parties generally seek to provide as little information as possible to each other. Furthermore, the desire to be aggressive in responding to an enforcement investigation must be balanced against the need to avoid unnecessary confrontational impasses with regulators who may have continuing oversight over the client. Moreover, to an increasing extent, regulators take into account the clients’ “cooperation” in exercising their discretion whether to initiate an enforcement action and as a factor in the settlement of any such action.

The rules of the SEC and those governing the investigations and examinations of other regulatory agencies generally contemplate a relatively passive role for those being investigated and their counsel. Nevertheless, there are myriad opportunities in the course of inspections and investigations to explain away unfavorable evidence, to focus the staff on favorable evidence, and to argue issues of legal and regulatory interpretation. This is particularly true of SEC investigations where the examination of witnesses is largely conducted on the record by lawyers who usually, although not always, tend to be more sensitive to considerations of fair process than law enforcement agencies generally.

The handling of securities investigations and enforcement actions is complicated by the overlapping jurisdiction of the different agencies that are charged with enforcing federal and state securities laws. An investigation by one regulator frequently arouses the enforcement interest of other regulators. A company or individual may be under investigation by the SEC, by several state securities regulators, and by one or more SROs for alleged violations arising out of the same or related transactions. Defending against multiple enforcement investigations can be enormously complex. This complexity often is augmented by the pendency or likelihood of private class actions and other litigation relating to the matter under regulatory investigation.

The tactics and strategy of settling and litigating securities enforcement actions are quite different in other important respects than those employed in other types of cases. Settlement of a securities enforcement action requires a keen awareness of the enforcement practices and culture of particular regulators as well as the collateral consequences that may flow from a settlement. Litigating an enforcement action also has its peculiarities. Some arguments that can be effective in court simply will not play before an administrative tribunal. Similarly,
defending civil and criminal securities actions in federal and state courts has dif-
ficulties that may not arise in other types of litigation. These include, for example,
the often “hallowed” reputation of the government regulator as the protector of
investors and the tendency of both judges and juries to identify with investors.

For all these reasons, those handling securities enforcement actions must be
sensitive to, and conversant with, the difference in tactics and strategies that need to
be employed in the context of enforcement actions by the various securities regula-
tory agencies. Experience is undoubtedly the best teacher; there is no substitute.
Hopefully, however, this manual will help those involved in securities enforcement
matters by describing the tactics and strategies that the authors have found to be ef-
fective based upon their many years of experience dealing with the particular chal-
lenges of securities enforcement in the multilayered system of securities regulation.

B. SEC Enforcement

There is no question that, within the multilayered pattern of securities enforce-
ment, SEC enforcement efforts are preeminent. The SEC administers and main-
tains a vigorous program to enforce the federal securities laws with large staffs in
the enforcement division of its Washington headquarters and in 11 regional located
in the nation’s financial centers.

The various federal securities laws administered by the Commission give it
authority to conduct wide ranging investigations, to institute and adjudicate
administrative proceedings, to commence injunctive actions in the federal dis-
trict courts, and to refer cases to the appropriate United States Attorney for
criminal prosecution. Congress also has given the SEC nationwide subpoena
power to facilitate its conduct of investigations and administrative proceedings.

Congress has authorized the Commission to impose administratively a wide
variety of sanctions including:

- a temporary or permanent administrative cease and desist order against
  any person who commits a violation of the federal securities laws and any
  other person who is a “cause” of a violation by reason of his or her participa-
  tion in the violation with knowledge or reason to know that his or her
  acts or omissions would contribute to the violation;
- monetary penalties against persons associated with regulated entities, i.e.,
  broker-dealers, investment advisers, investment companies, municipal
  and government securities dealers, transfer agents, and persons associated
  with such entities;
- a temporary suspension or permanent bar from engaging in the securities
  business or from associating with a firm engaged in the securities business;
Self-Regulatory Organizations

- an accounting for and disgorgement of any profits made from certain violations of the securities laws;
- a bar or suspension from serving as an officer or director of a publicly held company against any person found to have violated the anti-fraud provisions of the federal securities and to be unfit for such service;
- a stop order against fraudulent registration statements for public offerings of securities filed under the Securities Act of 1933 ("Securities Act");
- an order correcting false and misleading reports and proxy materials filed with the Commission by publicly traded companies; and
- a bar or suspension of accountants, attorneys, and other professionals who engage in improper conduct from practicing before the Commission.

The Commission is also authorized to seek in federal district court injunctions against persons who violate, or aid and abet the violation of, the federal securities laws. The Commission may also obtain in federal district court monetary penalties, bars against serving as an officer of a publicly held company, and a wide variety of ancillary relief, ranging from disgorgement of unlawful profits to temporary asset freezes and the appointment of receivers to marshal a defendant’s assets.

As noted, all Commission enforcement actions are public, and the publicity accompanying the institution of such actions very often causes substantial harm. For this reason, the heart of the enforcement practice of most securities lawyers is defending potential enforcement targets in private SEC investigations so as to avoid or minimize any public enforcement action.

C. Self-Regulatory Organizations

The SEC’s enforcement program with respect to broker-dealers in securities and persons associated with such broker-dealers is supplemented in very substantial ways by the activities of SROs, particularly the NASD and the NYSE. Each SRO is required by the Securities Exchange Act of 1934 ("Exchange Act") to register with the Commission and to adopt ethical rules of fair dealing that often go beyond the legal requirements of the securities laws. The SROs operate under pervasive SEC oversight and must maintain and implement programs to enforce not only their own rules but the requirements of the federal securities laws.

4. SROs are defined in the Exchange Act as "any national securities exchange, registered national securities association, or registered clearing agency, or (solely for the purposes of Sections 19(b), 19(c), and 23(b) of this title) the Municipal Securities Rulemaking Board ["MSRB"]). For purposes of this book, we will use the term “SRO” to refer to the exchanges and the NASD with particular emphasis on the NASD and the NYSE since these two SROs initiate the vast majority of disciplinary actions.
Under the Exchange Act, all broker-dealers must become members of a registered securities association, e.g., the NASD unless they effect transactions solely on a national securities exchange. Similarly, exchange rules require that brokers transacting business through their facilities become exchange members and subject themselves to the disciplinary rules of the exchange.

The rules of each SRO empower it to conduct disciplinary proceedings and impose sanctions on its members and their associated persons for violations of its rules or the federal securities laws. Each of the SROs has broad power to suspend (temporarily or indefinitely) membership in the organization and to impose substantial monetary penalties for violations.

Because of the mandatory membership requirement for broker-dealers, an SRO suspension or bar order is, in effect, a suspension or bar from the broker-dealer industry. SROs can impose disciplinary sanctions only after providing an opportunity for hearing and appeal to the SRO’s board of directors. In addition, the Exchange Act provides for an appeal of an SRO disciplinary action to the Commission and ultimately for review in the United States Courts of Appeals.

Despite the fact that they bring more enforcement actions than the SEC, both the NYSE and the NASD have been criticized by the SEC for allegedly lax enforcement in their markets. These criticisms have led to SEC enforcement actions against both SROs and to structural reorganizations that separate and make independent their regulatory and enforcement activities from the operation of their markets. As a result of the SEC’s efforts, both the NYSE and the NASD have committed increased resources to their enforcement functions. Together, these two SROs brought more than 1500 disciplinary actions in each of the four years from January 1, 2002 through December 31, 2005 against member firms and associated persons. The sanctions resulting from these disciplinary proceedings have included expulsions and suspensions of firm memberships, bars and suspensions of individual registrations, and many millions of dollars in fines. Given the active role of these regulators and the significant sanctions that they can impose on a firm or associated person, any investigation or examination initiated an SRO should be treated very seriously.6

D. State Regulation

The securities regulators in the 50 states are becoming an increasingly important component of securities enforcement. The enforcement authority of state regulators and the exercise of that authority varies somewhat from state to state. In
most states, a securities administrator exercises enforcement powers under the state's securities laws. In other states, such as New York and Maryland, the state attorney generals are the states' primary securities regulators. In most states, the designated regulator can impose very significant disciplinary sanctions upon persons engaged in securities-related activities within their jurisdiction. With the notable exception of New York, these enforcement powers generally include the power to institute an administrative cease and desist proceeding against any person violating state regulation. These powers are usually supplemented by authority to impose monetary penalties, to apply to appropriate state courts for injunctive and additional relief, and to refer matters for criminal prosecution to state attorneys general. While the attorney generals of New York and Maryland are their states' primary securities regulators, all state attorney generals have jurisdiction at least over the criminal enforcement of their state's securities laws. State attorney generals tend to have political aspirations and many of them have demonstrated a tendency to exercise their civil and criminal enforcement powers in highly aggressive and public ways.

Again, with the exception of New York State, most state securities laws also empower their regulators to suspend broker-dealers, investment advisers, and persons associated with such broker-dealers and investment advisers, or to revoke their right to do business within their states. Moreover, these laws generally authorize such action on the basis of findings of violations, injunctions, or other enforcement action by other states or by the SEC. Thus, a sanction imposed in an SEC or state enforcement action can lead to administrative proceedings to revoke broker-dealer and investment adviser registrations in a number of states.

The increase in enforcement activity of state securities regulators is likely to continue for the foreseeable future. Legislation enacted by Congress in 1996 preempted the states from examining certain mutual fund and other Securities Act registration statements and from performing certain other regulatory functions that were considered duplicative of SEC functions. State power to require payment of filing fees, however, is unaffected, and fee revenue that might otherwise be spent in regulatory activities serves to fund expanded enforcement programs.

Defending against state enforcement actions can be exceedingly difficult. Not only is a state enforcement action often accompanied or preceded by SEC or SRO action but other state regulators may (and often do) initiate separate actions on the basis of the same or similar violations. The defense of multiple securities enforcement investigations and actions under these circumstances requires close coordination. Moreover, settlement may be exceedingly complex because each state regulator may want to outdo the enforcement efforts of other regulators and may be reluctant to relinquish any of its independence in the interest of a coordinated settlement. For these reasons, even preliminary inquiries from state securities regulators should be addressed with great care.
E. Criminal Prosecution

Violations of the federal and state securities laws also can lead to criminal prosecution and sanctions. Neither the SEC and nor the state securities regulators have the authority themselves to initiate criminal prosecution, but they do have the power to refer cases for criminal prosecution to the Department of Justice or to a state attorney general. Frequently, the regulators work closely with such authorities in the prosecution of their cases.

Over the last few decades, there has been a steady increase in criminal prosecutions of securities violations both on the federal and state level. In the aftermath of the Enron-WorldCom debacles, this increase has been dramatic. The trend toward criminalization of the securities laws, at its roots, reflects the dramatic increase in securities investments by investors, as well as the heightened public and media interest in securities matters. This trend is reflected in the SEC’s internal procedures. At one time, the SEC enforcement staff normally could refer cases to the Department of Justice only with Commission approval of a formal criminal reference report prepared by the enforcement division. Now even lower ranking enforcement officials are authorized to solicit interest in a criminal prosecution simply by contacting an appropriate U.S. Attorney’s office. Indeed, to an increasing extent, criminal inquiries into securities violations are commenced upon the initiative of the FBI and/or white collar crime units in the offices of the various U.S. attorneys and other prosecutors. Increasingly, criminal investigators work closely with the SEC’s enforcement division in conducting a joint investigation into alleged securities violations.

The potential for criminal prosecution overhangs and sometimes inhibits the defense of an SEC investigation or civil enforcement action. At every stage in the process, the likelihood of criminal prosecution should be assessed in fashioning a response to the investigatory inquiry. A determination, at an early stage of an investigation, that criminal prosecution is not likely permits an aggressive proactive effort to persuade the investigators to abandon the case or settle on acceptable terms. If there is a realistic threat of criminal prosecution, however, such a strategy creates a risk of revealing too much of the client’s defense to the prosecutors.

For this and other reasons, it is critically important during an enforcement investigation to assess the potential for criminal prosecution. This requires a thorough investigation into the facts and circumstances of the client’s involvement and an analysis of the results of that investigation by counsel experienced with the securities enforcement process and, in some cases, by a white collar criminal defense specialist.