

## OUTSIDE COUNSEL

BY MICHAEL BACHNER

### *Asking SEC About Parallel Criminal Probes, Information Sharing*

**A**fter receiving a subpoena from the Securities and Exchange Commission (SEC) requesting Mr. Jones' testimony and personal documents, Mr. Jones, a licensed stockbroker and CEO of a publicly traded corporation, retains the services of a law firm specializing in securities law and white collar defense.

After reviewing the SEC's Formal Order of Investigation, defense counsel learns that the SEC is investigating violations of market manipulation under §10b-5. As the return date for the subpoena draws near, defense counsel asks the SEC if a parallel criminal investigation is being conducted by the U.S. Attorney's Office and if information is being shared. The tight-lipped commission attorney tells defense counsel that the SEC does not comment on its investigations, and reminds counsel (as if you had forgotten) that Mr. Jones has been advised, in the documents accompanying his subpoena, that his testimony could be used against him in any criminal prosecution.

#### **To Testify or Not to Testify**

This poses a difficult choice for defense counsel and Mr. Jones. By testifying, Mr. Jones may be exposing himself to criminal liability. By not testifying, he will likely be asked to step down as CEO; public filings with the commission will reflect the fact of his Fifth Amendment assertion; and a negative inference will be drawn against him by the SEC in its investigation.

As Mr. Jones' luck would have it, the National Association of Securities Dealers (NASD), the self-regulatory organization (SRO) that governs stockbroker behavior, subsequently issues Mr. Jones a demand for his testimony related to the manipulation allegations. Pursuant to NASD Rule 8210, if Mr. Jones asserts his Fifth Amendment right against self-incrimination, his license to sell securities will be revoked. Defense counsel's inquiry to the NASD representative about parallel criminal proceedings and information sharing receives the same useless response given by the SEC.

During counsel meetings, Mr. Jones maintains his innocence and demands to testify on the record before the NASD and SEC. After weighing the options, defense counsel holds his breath and allows his client to testify. Immediately after Mr. Jones is sworn in as

a witness before the SEC and NASD, counsel reiterates his demand to know about parallel criminal investigations and information sharing and receives the same unhelpful response. Several months later, Mr. Jones' wife calls defense counsel. Her husband is en route to 26 Federal Plaza. The arraignment will be later that day. The charge is violation of §10-b5 and related federal criminal laws.

During the course of the ensuing representation of Mr. Jones, counsel learns that a parallel criminal investigation had, in fact, been ongoing and that the SEC, the NASD, and the FBI had been working hand-

in-hand, sharing information.

A recent case has given defense counsel some hope that Mr. Jones' testimony and the documents he produced before the NASD and SEC, should be suppressed in his criminal prosecution.

But, first, some background.

#### **SROs**

**A History of Government Entanglement.** The Securities Exchange Act of 1934 (Exchange Act) cloaked private SROs with the quasi-governmental authority to enforce the federal securities laws, their own rules and regulations, and to punish their members who violated those laws.<sup>1</sup> The Exchange Act also set forth various procedural protections similar to those afforded by constitutional due process.<sup>2</sup>

As the Exchange Act makes clear, SROs' rule-making and enforcement functions are closely entwined with government action.<sup>3</sup> SROs themselves have acknowledged this entanglement and have used it to their advantage. Indeed, SROs have successfully argued that in dispensing their duties in enforcing federal laws and Exchange rules, they were akin to federal prosecutors and, thus, entitled to absolute immunity.<sup>4</sup>

Federal courts have long acknowledged SROs' government function to the extent of requiring them to comply with the requirements of Fifth Amendment due process. In *Intercontinental Indus. Inc. v. American Stock Exchange*,<sup>5</sup> the U.S. Court of Appeals for the Fifth Circuit held that the American Stock Exchange was a state actor with respect to its disciplinary function and was, thus, required to pursue such action consistent with Fifth Amendment due process requirements. Likewise, in *Crimmins v. United States*,<sup>6</sup> the court explicitly stated that:

The day is long gone when a national stock exchange can be considered a private club when it conducts disciplinary proceedings against its members or their employees. When an exchange conducts such proceedings under the self-regulatory powers conferred upon it by the Exchange Act, it is engaged in governmental action, federal

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## Murder

minutes, Mr. Cutler confusing attack on analysts and questionnaires acting as gofers. He said that the old-time mob figured in the mid 1980s, virulent form of "you will," had taken onto the word "patina" of honor, but no more. Later he added: "When the hawks ate the doves, they started eating each other, and that gave rise to the moral and spiritual cancer."

The translation of all this: They do not make mobsters like they used to, and these witness witnesses will take down two forty police officers

said, all went government's door, "an I come in?"

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acked Stephen accountant in Las Vegas, badgered Mr. drug dealing and Eppolito while raising money for

Corso as a thief for \$9 million. Mr. Corso "the man being you'll

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orney for Mr. re blunt in his hoodlums had could get away ding to the gov- when officials rather than ade the calls.

r. Kaplan as a huge interna- Mr. Caral no need for had done well

y no motive," ted the Mafia." lay, Mr. Cutler outing match s, a former act- esse crime fam- fitness.

Mr. Cutler he s cross-exam-

orneys Robert E. Wenner are prosecution

hertz, of Mr. representing na Schein is Eppolito.

be reached at

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in character, and the Exchange Act imposed upon it the requirement that it comply with fundamental standards of fair play.<sup>7</sup>

The analysis, however, abruptly changes when defendants seek to invoke the Fifth Amendment right against self-incrimination.

## Fifth Amendment

Despite the well-established dual nature of SROs, courts of this circuit have consistently refused to deem them state actors for the purpose of extending the Fifth Amendment's right against self-incrimination. Accordingly, individuals subpoenaed in civil investigations face the full weight of the state without the protection of this right. This leaves defendants in the position of choosing between responding to SRO investigations and potentially opening the door to criminal liability, or asserting the Fifth Amendment right against self-incrimination and facing potentially devastating civil sanctions by the Exchange such as censure, suspension of membership, fines, expulsion or other sanctions.<sup>8</sup>

For example, in *United States v. Solomon*,<sup>9</sup> Mr. Solomon argued that the testimony he provided in response to an NYSE subpoena was compelled and tainted and should be suppressed in his criminal case. Moreover, Mr. Solomon argued, this testimony was "the only evidence presented to the Grand Jury on the criminal count on which he was convicted."<sup>10</sup>

The Second Circuit held that "interrogation by the New York Stock Exchange in carrying out its own legitimate investigatory purposes does not trigger the privilege against self-incrimination."<sup>11</sup> In rejecting the plaintiff's argument, the court cited two practical problems. First, the court feared that allowing this logic to prevail "among all these areas would result in a 'complete breakdown on the regulation of many areas of business if employers did not carry most of the load of keeping their employees in line and have the sanction of discharge for refusal to answer what is essential to that end."<sup>12</sup>

Second, by extending the Fifth Amendment's right against self-incrimination to these proceedings, *Solomon* was concerned that SROs would be vested with an unbridled "power to grant use immunity in circumstances where refusal to testify entailed a potential loss of employment or some similar economic harm."<sup>13</sup> Such power would be unchecked by the typical requirement to "weigh the need for the evidence against the undesirability of conferring an immunity which goes beyond the testimony or information itself, and without the supervision of the Attorney General to which government agencies are subjected."<sup>14</sup>

These concerns, however, are ill-founded. SROs in the securities and commodities industry are unique in that they possess "federal law enforcement authority pursuant to federal law, together with the authority to impose sanctions including monetary penalties and suspensions" on their mem-

bers.<sup>15</sup> Accordingly, *Solomon's* fear that extending the right against self-incrimination in this limited arena would remove a vital enforcement tool for all other self-regulating industries is misplaced. Furthermore, any use immunity power conferred to the SROs as a result of extending the Fifth Amendment would, necessarily, be limited to the SROs' function as an agent of federal law enforcement.<sup>16</sup> Such treatment is both consistent with the requirements of the Fifth Amendment and the state action doctrine.

## Winds of Change

Recently, courts have begun recognizing the potential for abuse inherent in the current system, where SROs engage in both enforcing compliance with its own civil rules and prosecuting members for violating federal securities laws. In *Cromwell Investments v. NASD Regulation, Inc.*,<sup>17</sup> plaintiffs sought an

injunction barring the NASD from compelling them to testify in a civil investigation and preventing any proceedings penalizing them for asserting their rights against self-incrimination. The NASD countered that it was a private actor and was "not required to recognize the invocation of the privilege against self-incrimination by persons subject to its regulatory powers."<sup>18</sup> The court did not grant the injunction and dismissed plaintiff's claims.

What is most interesting, however, is that despite the court's reliance on the NASD's "uncontroverted explanations" of various, facially suspicious facts,<sup>19</sup> the court was sufficiently troubled to issue a warning regarding the apparent informality between the NASD's Criminal Prosecution Assistance Group (CPAG)—formed to assist

"federal and state law enforcement authorities investigating securities matters"—and the NASD's Division of Enforcement (DOE).<sup>20</sup> At the end of its opinion, the court noted that while the contact "between and among the government, CPAG and DOE staff concerning *Cromwell* in a period during which both the U.S. Attorney's Office and DOE were conducting investigations of the company" was not enough to render the NASD a state actor, the situation was a close call.<sup>21</sup> The court cautioned that:

Regulation may wish to give careful attention to its arrangements concerning assistance to criminal investigations and to the relationships, both physical and administrative, between CPAG and the DOE. The present arrangement left doubt sufficient to require a trial as to the independence of DOE's 8210 request in this matter, a situation that perhaps could have been avoided by more careful controls.<sup>22</sup>

In the recent case of *U.S. v. Stringer, et al.*,<sup>23</sup> a District Court in Oregon took the warning issued in

the *Cromwell* case to its logical conclusion. In *Stringer*, the defendants were indicted on 50 counts of conspiracy and securities fraud based largely on testimony obtained and information gathered as a result of the SEC's civil investigation. In response, defendants sought to dismiss the indictment or, in the alternative, suppress the testimony given to the SEC on the grounds that it was obtained in violation of their rights under the Fourth and Fifth Amendments. Specifically, the defendants argued that although they asked the SEC on the record, just prior to testifying, if they were the targets of a criminal investigation, the SEC, with the connivance of the prosecutors, affirmatively misled them. Had the defendants been notified of the likelihood of the pending indictment, the defendants argued, they would not have produced documents, a *Wells* submission, or offered their testimony at all.

The government countered that these were merely parallel investigations, and pointed to the pro forma Fifth Amendment disclosures issued to the defendants prior to their testimony.

The court held that given the U.S. Attorney's active role in the proceedings, these were not mere parallel investigations. The court chastised the government for engaging in a "strategy to conceal the criminal investigation from the defendants" and termed the government's behavior deceptive and "an abuse of the investigative process."<sup>24</sup> Indeed, although prosecutors considered the defendants criminal targets from the very beginning, the government "intentionally shielded its intentions behind the guise of a civil prosecution, resorting to subterfuge to maintain the secrecy of its involvement."<sup>25</sup> The court then dismissed the indictments on the ground that the defendants' statements were obtained "in violation of defendants' due process and Fifth Amendment rights," including the right against self-incrimination.<sup>26</sup>

## Representing 'Mr. Jones'

Pursuant to the decision in *Stringer* and the warning issued in *Cromwell*, counsel representing the Mr. Joneses of the world should not hesitate to obtain affirmative

representations from the SEC and the various SROs regarding the existence of criminal investigations related to the subject matter of their testimony, and whether the testimony is being shared with prosecutors. By posing such a direct question in light of *Stringer*, the heretofore tight-lipped commission and SROs should be more inclined to be open in their disclosures and less-inclined to conduct covert criminal investigations designed to extract information from defendants without affording them their constitutionally protected rights. While the applicability of Fifth Amendment's right against self-incrimination remains open to debate in cases less flagrantly deceptive than that described in *Stringer*, what is clear is that left alone, the current system is ripe for abuse.

1. See "Ending Securities Industry Self-Regulation as We Know It," 57 Rutgers L.Rev. 1351, 1352, Ernest E. Badway and Jonathan M. Busch (Summer 2005).

2. See 15 U.S.C. §78(f)(b); Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law, 1995 Colum. Bus. L. Rev. 453, 458, Richard L. Stone and Michael A. Perino (1995).

3. See Exchange Act §§19(b); 19(h)(1); 21(e), (f); 1995 Colum. Bus. L. Rev. 453, 462-63.

4. See *DL Capital Group LLC v. NASDAQ Stock Mkt. Inc.*, 409 F.3d 93 (2d Cir. 2005) (NASDAQ was entitled to absolute immunity from allegations of fraud relating to its SRO activities); *D'Alessio v. NYSE, Inc.*, 125 F.Supp.2d 656 (S.D.N.Y. 2000) (NYSE members were entitled to absolute immunity despite their misinterpretation and misapplication of statutes and regulations), affirmed, 258 F.3d 93 (2d Cir. 2001); *Mandelbaum v. New York Mercantile Exchange*, 894 F.Supp. 676 (S.D.N.Y. 1995).

5. 452 F.2d 935, 941 (5th Cir. 1971).

6. 346 F.Supp. 1256, 1259 (S.D.N.Y. 1972).

7. See, also, *Villani v. New York Stock Exchange*, 348 F.Supp. 1185, n.1 (S.D.N.Y. 1972).

8. See, e.g. NASD Rule 8210.

9. 509 F.2d 863 (2d Cir. 1975).

10. 590 F.2d 863, 866.

11. 590 F.2d at 867.

12. 590 F.2d at 870.

13. *Solomon*, 590 F.2d at 870.

14. *Solomon*, 590 F.2d at 871.

15. 1995 Colum. Bus. L. Rev. 493.

16. 1995 Colum. Bus. L. Rev. 493.

17. 132 F.Supp.2d 248 (2001), affirmed, 279 F.3d 155 (2d Cir. 2002).

18. 132 F.Supp.2d 248, 251.

19. 132 F.Supp.2d at 252.

20. 132 F.Supp.2d at 249.

21. 132 F.Supp.2d 254.

22. 32 F.Supp.2d 254.

23. 2006 U.S. Dist. LEXIS 3435 (D. Or. Jan. 9, 2006).

24. U.S. Dist. LEXIS 3435, at \* 13.

25. U.S. Dist. LEXIS 3435, at \* 14.

26. *Stringer*, U.S. Dist. LEXIS 3435, at \* 18.

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