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REACTING TO A REGULATORY INVESTIGATION INTO DERIVATIVES MARKET ACTIVITY

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SUPPOSE you are a senior officer at a public corporation, registered broker-dealer or registered commodities firm. You get up in the morning and each day that you go to work you have the following entities watching you to make sure you, your company or firm, and the employees are complying with a myriad of rules, regulations and statutes: The Department of Justice, the CFTC, the SEC, the various self-regulatory organizations ("SRO's") such as The New York Stock Exchange ("NYSE"), the NASD, and the National Futures Association. Further, there are state securities commissions acting through their respective state commissioners or state attorneys general. Then, there are state and local prosecutors, some of whom, and I tell you from experience, do not know the difference between a stock certificate and a parking ticket. To top it all off, there are the plaintiff class action lawyers waiting to sue you and your company.

Derivatives present unique problems for these various layers of regulation. I am not sure I am too far off the mark when I say that people who trade market derivatives often do not understand what they are trading; entities and individuals that invest in derivatives often do not understand what they are getting into; and regulators often do not understand how derivatives work or what it is that must be regulated. From my perspective, the biggest concern in the area of derivatives is valuation. Valuation for net capital purposes, valuation for customer statements and valuation for corporate balance sheets. How do you put a value on the derivative? Who decides the actual value or better said—the fair value of the derivative? What representations can you make to the customer? Then there is the issue of supervision in both the public corporation and registered entity. Who is supervising the people who are involved in trading and valuing the derivatives? What are the risk managers doing to make sure that problems do not arise and if problems do surface, who is responsible for fixing the problems? What does a corporation or firm do not only to institute appropriate compliance procedures but to make sure those procedures work effectively? Put another way: What are the systems that need to be put in place? Who are the people who are managing these

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systems? Are they competent and do they understand what they are supposed to do? You can be sure if there is a problem the regulators are first going to address supervision or the lack thereof. In a few moments, I will mention what I call preventive medicine.

I am often asked: How do prosecutors and regulators learn about potential violative conduct? The answer is really quite simple. There are generally six different sources from which prosecutors and regulators obtain information leading to the commencement of an investigation. First, just like you and I, they read the newspapers and derive information from reported court filings and stories related to the financial markets. Second, the SROs such as the NYSE follow the trading in the securities listed on the NYSE looking for "spikes" and any aberrations in trading activity. Third, the investing public files oral and written complaints with the regulators by the tens of thousands, the vast majority of which are inconsequential in nature and not worth pursuing; others lead to very significant matters. Fourth, the regulators to the extent possible, review public filings for any potential misconduct. Fifth, informants, anonymous and disclosed, bring cases to the attention of the regulators. Sixth, as in most so-called white-collar cases, existing investigations, prosecutions, and civil actions often lead to other cases. Investigations often commence by the service of a grand jury subpoena issued by a prosecutor, a request by the SEC or CFTC for the voluntary production of documents followed frequently by a subpoena served pursuant to a Private Order of Investigation or by a request for testimony by an SRO. Sometimes investigators acting on behalf of prosecutors simply appear at the home of a perceived vulnerable, but knowledgeable, employee of the entity for an interview at night before the employee can discuss the matter with superiors or the entity's counsel.

When a regulator or prosecutor commences an investigation, public corporations and registered entities have to move very quickly. One approach, of course, is to conduct an internal investigation. Find the problem, isolate it, solve the problem and put in place procedures to make sure the problem, does not recur. All that is good because the regulators expect you to do that. Once an internal investigation is commenced, however, numerous issues often must be addressed immediately. For example: Who conducts the internal investigation? In-house or outside counsel? What are the attorney-client privileges that arise during the course of the investigation? Counsel clearly represents the entity, and not the employees; or, outside counsel may represent the outside directors or the audit committee but not the inside board; and what approach should be followed if senior management such as the CEO, President, and/or CFO may be culpable or at the very least the subject or target of the grand jury?

As I just mentioned, frequently these issues must be addressed at the commencement of the internal investigation but, even more frequently, counsel does not have enough information at the get go to make those decisions. If an entity and its employees are under investigation, the issue of who pays the legal fees of those individuals must also be addressed. Prosecutors often frown upon a corporation paying its employees' legal fees. They view the payment of legal fees as collusion, conspiracy and even worse—a payoff to keep the individual's mouth shut, notwithstanding the fact that the corporate by-laws or statutes of the state where the corporation is incorporated may provide for the indemnification or advancement of legal fees. What does one try to do in those instances where several prosecutors and regulators all seek to commence separate enforcement proceedings against your client? In the past, the civil regulators generally went first. They would investigate the case, package the case after obtaining sanctions, and then send it off to be reviewed to determine whether it should be referred criminally. Today, we have parallel proceedings, with regulators often at the federal, state and local level, all operating on separate tracks heading for one place—charges against your client. Thus, at any one time you might have a local state prosecutor investigating the client, the Department of Justice on a parallel track with its own investigation, the CFTC and/or the SEC on another track, and the NASD or the New York Stock Exchange also running on their own tracks. What is one to do? Sometimes you try to go into court and stop one or more of the regulators from doing what they are doing until the criminal prosecution has run its course. There has been some very limited success in recent years in doing that, but for the most part you will be unsuccessful. At the end of the day, if you have a client who is going to be charged, you try to work out what we call the global settlement—one settlement with all the parties that are trying to get a piece of your client—then hope that the plaintiff's class action lawyers go away, which generally doesn't happen. Often a global settlement is very difficult because each of the parties, whether it is the local prosecutor or an SRO, is looking for a "stat."

There are those who argue that there should not be an internal investigation or at least that no reports should be issued and no notes be taken because written reports or notes are going to get out and wind up in the hands of the regulators and plaintiff's class action lawyers. The firm will never be able to protect itself. In fact, although there is a corporate attorney-client privilege, the United States Attorney for the Southern District of New York, while conceding that the government recognizes the existence of the privilege, has stated unequivocally that if you want to be a good corporate citizen you should waive the privilege if you expect any benefit. Under this latter scenario, a firm is in the untenable position of acting almost as an agent for the prosecutor and inevitably all the regulators. Thus, you begin the internal investigation attempting to protect the corporation but at the end of the day, turning over all you have done to the government.

What is it then that you bring to the regulators when you start such an investigation and assist the regulators? What you bring to the regulators is the hope that if the entity has exposure, civilly or criminally, your client, having acted as a good corporate citizen by bringing to the regulator all the information that you gathered, can mitigate any potential legal problems. You may not make the matter go away, but you will mitigate your client's problem. There have been few corporations indicted since the organizational guidelines kicked in, in 1994, but I fully expect that this is going to change in the next few years.

Let us talk for a moment about the sanctions that can be imposed if and when a regulator determines that a brokerage firm or public corporation should be charged. There was a time when the SEC would seek an injunction and/or commence an administrative proceeding. The SEC went to federal court and sought an order directing the violator not to engage again in violative conduct. In an administrative proceeding the SEC might seek a censure, a suspension from the business, a bar of the individual from associating with a registered entity and/or a revocation of the entity's license. It was a much simpler process in those days. Today, the civil regulators have far more weapons. In addition to seeking injunctive relief and a bar from the business, they might seek cease and desist orders, fines, penalties and disgorgement. On the corporate side, there are injunctions against corporations, and bars against individuals being officers and directors of public corporations. The civil regulator can also seek court-appointed monitors to go into firms and not only monitor the brokerage firm or corporation but with the blessing of the regulator require companies to change their compliance procedures, accounting procedures, and/or amend their filings. Moreover, the threat of prosecution today not only comes from the federal prosecutors and federal regulators, but also from state and local prosecutors. Witness in New York alone the aggressiveness demonstrated recently by the District Attorney for New York County in the indictment of a number of principals of the brokerage firm of A.R. Baron & Co., not for violations of the United States Code or the Securities Acts (over which the District Attorney has no jurisdiction), but for violations of the New York State Penal Laws. The aggressiveness of the local regulators is not limited to the local prosecutors. State securities commissioners and the various State Attorneys General have also recently exhibited a desire to pursue the more traditional white-collar defendant, applying state criminal statutes to what has historically been the domain of the federal government. Look what happened to Merrill Lynch: Merrill was on the cusp of being indicted in the Orange County case, and that case involved complex securities transactions that raised issues of suitability, authorization, knowledge, and sophistication. There you had local criminal prosecutors putting Merrill right at the edge of a criminal prosecution.

I close with reference to what I call preventive medicine. Preventive medicine particularly in the derivatives area is crucial. What do I mean by preventive medicine? Obviously you need good risk managers, you need people in your shops who understand whether you are Procter & Gamble, Banker's Trust, or the proverbial widow or orphan. You have to know what you are selling, you have to know what you are buying, and you need people to understand that. Clearly, if you are the seller, if you are the party marketing the derivative, you had better make sure that the people marketing the instrument understand it and, as importantly, know the customer to whom they are marketing this particular instrument and whether the customer understands the instrument and it meets, within reason, the customer's investment objectives.

What else do you need? You need good compliance systems in place that are managed by supervisors who, at every level, are aware of the transaction not only when it is entered into but observing the transaction as it goes through the process of working its way towards conclusion. I mention supervisors again because supervision is a hot topic with the civil regulators. You need guidelines for employees, and the people who are involved in these transactions to understand the guidelines and compliance involved in marketing and monitoring these transactions. Putting all these things in place before the problem explodes is crucial in dealing with the potential liability that you may face.

I will leave you with this one thought. I think the most dangerous problem we face is regulation by enforcement. Until the regulators fully understand these instruments—what they do; how they work; who should be involved in them; and what the process is in terms of educating the people who get involved with these instruments—until that is done, I think regulation by enforcement will be a disaster.

Notes & Observations