CHAPTER **8**

Criminal Enforcement of Securities Laws

A Primer for the Securities Practitioner

Contents

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A Primer for the Securities Practitioner

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A. Overview

An SEC enforcement investigation may lead to an SEC civil enforcement proceeding or a Justice Department federal criminal prosecution. Under section 24 of the Securities Act of 1933, section 32 of the Securities Exchange Act of 1934 and comparable provisions in other federal securities laws, any person or entity may be subject to criminal prosecution for "willful" violations of the securities laws.[1] In addition, the Sarbanes-Oxley Act added a new federal criminal offense which broadly prohibits any kind of securities fraud with respect to public companies.[2] An individual or a company subject to federal criminal prosecution for substantive violations of the federal securities laws also may be subject to prosecution for violations of mail and wire fraud statutes and other federal crimes.

Criminal prosecution may also result from offenses relating to the investigatory process itself. These "process offenses" encompass perjury, false statements, and obstruction of justice during the course of a Commission or Justice Department investigation. Under new provisions enacted by Sarbanes-Oxley, a person or entity may also be prosecuted for destroying records "in contemplation" of an investigation even before receiving a subpoena or document request from the government.[3] Process violations may be brought in addition to a criminal prosecution for a substantive offense uncovered by the Commission's investigation, or may stand on their own without any substantive securities offense.

Criminal violations are prosecuted by the Fraud Section of the Criminal Division of the Department of Justice in Washington and by United States Attorneys throughout the country (collectively the "DOJ"). DOJ prosecutors may seek indictments for criminal violations of the securities laws on their own initiative[4] or through referrals from the Commission. The Commission has a formal process for the referral of criminal cases to the DOJ. Under this process, the staff prepares a criminal reference report for the Commission, which in turn decides whether to refer the matter to the DOJ.[5]

In practice, this formal referral process is rarely used; an informal referral process is the norm. Under Rule 2 of the Commission's Rules Relating to Investigations, an SEC staff member may discuss a nonpublic investigation with other governmental authorities, including DOJ prosecutors, if the staff obtains prior approval from an Enforcement Division official at or above the level of assistant director or assistant regional administrator.[6] Commission rules permit the Enforcement Division to share its investigative files with DOJ upon a written request from DOJ.[7] Informal contacts between Commission staff and Assistant United States Attorneys also may encourage prosecutorial interest and lead to such a request.

Given the availability of the informal process by which the SEC staff often communicates with federal prosecutors, it is not surprising that the far more cumbersome formal process for referring cases to DOJ has fallen into disuse. The demise of the formal referral process has resulted in a lack of consistency in case referrals to DOJ. This, in turn, makes it more difficult to assess the likelihood of a criminal prosecution for securities law violations.

Although state prosecutions for securities violations are less common, such prosecutions do occur under a state's general fraud statutes and/or blue sky laws.[8] Typically, there is no double jeopardy protection against successive federal and state criminal prosecutions. Under the law, the federal and state government are treated as if they were different governments—different "sovereigns" under double jeopardy case law—so that a prosecution by one typically does not bar a subsequent prosecution by the other. As discussed more fully below, DOJ has a policy, called "the Petite Policy," not to bring a case if a prior state prosecution of a defendant has resulted in an acquittal, conviction, dismissal or other termination on the merits after jeopardy has attached arising from substantially the same act or transaction, but it is subject to broad exceptions.[9] Clearly though, the possibility of state prosecution, even where a federal prosecutor declines to proceed, and a federal prosecution following a state prosecution, must be factored into the overall analysis of potential criminal exposure.

B. Federal Criminal Prosecution in Securities Cases: The Current Environment

The history of DOJ's criminal enforcement of federal laws arising from securities and securities--related offenses in the early 2000s makes plain that the government is strongly focused on criminal enforcement of securities offenses and related process offenses, and that this focus is unlikely to dim, at least in the short term.

1. Major Corporate Fraud Cases

Dozens of cases arose in the early 2000s which reflected corporate excess targeted by the government. Perhaps most notable were the prosecutions against Enron and its auditor, Arthur Andersen. In the 1990s, Enron Corporation was one of the fastest growing companies and Andersen one of the world's largest and best known accounting firms. By late 2001, Enron was the seventh largest corporation in the United States. On December 2, 2001, however, Enron filed for bankruptcy protection as a result of accounting and financial irregularities which came to light in 2000 and 2001. Eventually, Enron collapsed under the weight of a series of frauds charged by a federal grand jury in Texas. Individuals associated with Enron were charged with various schemes and frauds as well as instances of lying, perjury and other efforts to obstruct justice, reflecting DOJ's focus on both substantive and process-related offenses.[10]

As discussed in more detail below, Andersen became enmeshed in the Enron case, as well. Andersen's staff in its Houston office destroyed electronic and paper documents as Enron began to unravel, resulting in "substantial destruction of paper and electronic documents,"[11] including a "smoking gun" document.[12] Although document destruction occurred only in one Andersen office, the entire firm was indicted and convicted of one count of obstruction of justice, a

conviction later overturned on appeal to the Supreme Court—well after Andersen ceased to exist as a going concern as a result of the prosecution.

The prosecutions stemming from the collapse of WorldCom also illustrated the excesses of corporate fraud against which DOJ would react. In mid-2002, WorldCom, a global communications company which reached every major urban center in the world,[13] announced major accounting irregularities. Eventually, an $11 billion accounting fraud came to light. In July 2002, WorldCom filed what became the largest bankruptcy proceeding in American history. Thereafter, WorldCom's chief executive officer, Bernard J. Ebbers, was indicted and charged with engaging in an "illegal scheme to deceive members of the investing public, WorldCom shareholders, securities analysts, the SEC, and others, concerning WorldCom's true operating performance and financial results."[14] Ebbers was convicted and sentenced to 25 years in federal prison. Other senior officials at WorldCom pled guilty to various criminal charges.[15] Eventually, the SEC obtained the largest penalty in its history against WorldCom.[16]

2. DOJ's Corporate Fraud Task Force

In response to these and other financial scandals, President Bush created the Corporate Fraud Task Force in July, 2002.[17] With respect to investigative and prosecutive functions, the Task Force is comprised of the Deputy Attorney General (the second in command of DOJ under the Attorney General), the Assistants Attorney General responsible for the Criminal and Tax Divisions, the Director of the FBI, the United States Attorneys for the Eastern and Southern Districts of New York (including Brooklyn and Manhattan in New York City), the Northern District of Illinois (Chicago), the Eastern District of Pennsylvania (Philadelphia), the Central District of California (Los Angeles), the Northern District of California (San Francisco), the Southern District of Texas (Houston), as well such other DOJ offices or employees as the Attorney General may designate. Among other things, the Task Force is responsible for directing the investigation and prosecution of securities fraud, accounting fraud, mail and wire fraud, money laundering and other related financial crimes by commercial entities and individuals if the Deputy Attorney General deems the case to be significant. [18]

The Task Force quickly became very active in bringing corporate fraud cases. By the summer of 2004, the Task Force had charged more than 400 cases and more than 900 defendants, including more than 60 corporate CEOs and presidents, with some form of crime stemming from corporate fraud, and secured the convictions of more than 500 defendants.[19]

The Corporate Fraud Task Force also seeks to coordinate its work with that of the SEC. For example, in 2003, the Task Force pursued actions leading to the SEC's filing of 199 financial fraud and reporting cases. The SEC cases were often brought as parallel actions to criminal charges through coordination with criminal investigations.[20] This coordination, and the issues it engenders, is discussed further below in the section on parallel proceedings.

3. The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002, which became law on July 20, 2002, is intended to provide the government with further tools to combat corporate fraud. Among other things, Sarbanes-Oxley enhanced financial disclosure requirements for corporations, required CEOs and CFOs to personally certify company financial reports, and augmented SEC and federal court authorities

(see Chapters 3 and 4 for a discussion of Sarbanes-Oxley's impact on SEC investigations and enforcement actions).

With respect to criminal enforcement, Sarbanes-Oxley added new corporate fraud and obstruction of justice offenses carrying stiff penalties. These included:

- *Section 807:* Section 807 enacted a new criminal offense, punishable by fines and/or imprisonment for up to 25 years, for knowingly engaging in or attempting a fraudulent scheme in connection with the securities of any public company, or fraudulently obtaining money or property in connection with the purchase or sale of such securities.[21] As noted above, prior to Sarbanes-Oxley, such securities frauds were (and still are) prosecutable under other statutes, such as those prohibiting mail and wire fraud and the specific criminal penalty provisions of the securities laws. However, in the wake of corporate scandals, Congress wanted to address the "patchwork" of existing laws by enacting a general securities fraud statute, comparable to the statutes prohibiting bank fraud and health care fraud, that would be broad and flexible and that would avoid some of the technical limitations of the other statutes.[22]

- *Section 906:* Section 906 of Sarbanes-Oxley requires chief executive officers and chief financial officers to certify that periodic reports that the company files with the SEC which contain financial statements comply with all reporting requirements and fairly represent, in all material respects, the financial condition and results of operations of the issuer. *Knowingly* providing a false certification is a federal crime punishable by a fine of up to $1 million and up to 10 years in prison. *Knowingly* and *willfully* doing so is punishable by a fine of up to $5 million and up to 20 years in prison.[23]

- *Section 802:* Section 802 of Sarbanes-Oxley makes it a crime, punishable by a fine and/or imprisonment for up to 20 years, to knowingly alter, destroy, conceal, or falsify any document or record with the intent to obstruct, impede, or influence any matter before a federal agency or bankruptcy proceeding, or "*in contemplation of*" any such matter or proceeding.[24] Section 802 was intended to fill gaps in existing obstruction of justice statutes by enacting a "general anti-shredding provision."[25] Importantly, Section 802 eliminates distinctions between different types of proceedings that some courts had read into preexisting obstruction of justice statutes. Further, the statute applies even when the defendant acts "in contemplation of" a matter before a federal agency, so that the defendant's act even before the beginning of federal investigation is not a bar to prosecution.[26] Thus, Section 802 was intended to encompass conduct such as was at issue in the Arthur Andersen case, where company employees engaged in extensive document destruction in anticipation of an SEC investigation, but prior to receiving a subpoena. Section 802 also makes it a crime for anyone who conducted an audit of a securities issuer to which Section 10A(a) of the Exchange Act applies, to (1) knowingly and willfully (2) fail to maintain all audits or review work papers for five years from the end of the fiscal period in which the audit was conducted.

- *Section 1102:* Section 1102 amended the witness and document tampering provisions of the United States Code (15 U.S.C. § 1512) to make it a crime, punishable by a fine and/or imprisonment of up to 20 years, to (1) corruptly (2) alter, destroy, mutilate, or conceal a record, document, or other object, or attempt to do so, (3) with the intent of impairing the object's integrity or availability for use in an official proceeding, or to obstruct, influence,

or impede an official proceeding in any other way. Previously, the tampering provisions of Section 1512(b) were limited to persons who induced others to engage in such conduct.

- *Section 1107:* Section 1107 of Sarbanes-Oxley provides protection to whistleblowers through criminal penalties. Section 1107 makes it a crime, punishable by a fine and/or imprisonment for up to 10 years, to (1) knowingly, (2) with the intent to retaliate, (3) take harmful action against any person because that person provided law enforcement with truthful information regarding the commission or possible commission of a federal offense. A harmful act includes interference with lawful employment or the livelihood of any person.[27]

In parallel to these new offenses, Sarbanes-Oxley enacted stiffer criminal sanctions for existing offenses. Section 903 of Sarbanes-Oxley increased the maximum prison terms for mail fraud and wire fraud,[28] often charged in criminal securities cases, from five years to twenty years. Section 1106 increased the penalties for willful violations of the Exchange Act and associated rules from a maximum of $1 million ($2.5 million for entities) and 10 years in imprisonment to $5 million ($25 million for entities) and 20 years imprisonment.[29] Section 902 of Sarbanes-Oxley increased the penalties for attempts and conspiracies to violate various fraud statutes (including securities fraud, false CEO/CFO certifications, wire fraud, or mail fraud) to the same level as the primary offenses; essentially 20–25 years in prison.[30]

4. SEC/DOJ Coordination: Parallel Proceedings

a. Parallel Proceedings Generally

Corporations, their officers, and directors are commonly subject to criminal prosecution, civil enforcement investigations, and actions by a multitude of state and federal governmental agencies and Self Regulatory Organizations (SRO's), as well as lawsuits by private parties.[31] Moreover, the Commission is authorized to provide assistance to foreign securities regulators in connection with the enforcement of their securities laws.[32] Those regulators may institute their own administrative, civil and criminal proceedings based on conduct similar to the conduct that is the subject of the United States inquiry.

As early as 1912, the Supreme Court recognized that parallel proceedings—that is, the pursuit of a civil case at the same time as a criminal prosecution—are generally permissible. In the landmark case of *Standard Sanitary Mfg. Co. v. United States*, the Court upheld the parallel prosecution of both criminal and civil antitrust actions, noting that "[a]n imperative rule that the civil suit must await the trial of the criminal action might result in injustice or take from the statute a great deal of its power."[33]

The general rule is that parallel criminal proceedings are permissible to SEC investigations and enforcement actions, as well. In *SEC v. Dresser Industries, Inc.*, the Court of Appeals for the District of Columbia refused to bar the simultaneous pursuit of a criminal action by DOJ and an investigation by the Commission.[34] As the court noted,

> the civil and regulatory laws of the United States frequently overlap with the criminal laws, creating the possibility of parallel civil and criminal proceedings, either successive or simultaneous. In the absence of substantial prejudice to the rights of the parties involved, such proceedings are unobjectionable under our jurisprudence.[35]

The following year, the Fifth Circuit applied *Dresser* to permit a simultaneous Commission civil enforcement action and DOJ criminal prosecution.[36] Absent substantial prejudice, parallel civil and criminal proceedings are recognized to be appropriate. Indeed, simultaneous criminal and civil enforcement investigations are the norm and can be challenging to defend. In addition to the obvious logistical problems raised by simultaneous investigations and/or litigation on two fronts, a party subject to parallel proceedings faces the additional concern posed by the use in one proceeding of information gained in another. Information gathered by the Commission during an investigation may be passed on to federal and state authorities. Indeed, in cases where there are parallel proceedings, the SEC and DOJ frequently will conduct joint witness interviews, usually with an FBI agent in attendance.

b. Limitations on Information Sharing

Although the exchange of information among the Commission, DOJ and other law enforcement agencies during parallel proceedings can be extensive, there are several limitations upon this transfer of information.

Although the government may pursue parallel civil and criminal cases absent substantial prejudice, a civil proceeding with its liberal discovery cannot be instituted solely for the purpose of gathering evidence for a pending criminal investigation or prosecution. This prohibition is based upon the need to protect the constitutional rights against self-incrimination held by those who are the subject of criminal scrutiny.[37] Similarly, under the so-called "sole or dominant purpose" test, prosecutors cannot use the grand jury solely or even primarily for the purpose of gathering evidence to obtain additional evidence to use in a trial of an already-indicted criminal case,[38] and cannot use the grand jury at all to investigate a civil proceeding.

Under the Federal Rules of Criminal Procedure, a defendant in a criminal prosecution may not be compelled to disclose materials generated by the defendant or his attorney, including his or her own statements or statements of an actual or prospective witness made to the defendant or to defendant's counsel.[39] No such restrictions apply to civil discovery, where parties may discover any non-privileged information relevant to the subject matter of the proceeding.[40]

In *Dresser*, the D.C. Circuit stated that a court can stay civil proceedings in cases where forcing "a party under indictment for a serious offense . . . to defend a civil or administrative action involving the same matter . . . might undermine the party's Fifth Amendment privilege against self-incrimination, expand rights of criminal discovery beyond the limits of Federal Rule of Criminal Procedure 16(b), expose the basis of the defense to prosecution in advance of criminal trial, or otherwise prejudice the case," and there deferral would not seriously injure the public interest.[41]

Successful due process challenges are infrequent. [42] Nonetheless, two recent cases illustrate that courts may be willing to step in when the SEC and DOJ work too closely and attempt to use each other's processes without full and fair notice to the subject of the investigation. These cases may suggest an approach for practitioners who believe the SEC and DOJ have improperly brought joint harm to a client.

In a criminal case, *United States v. Scrushy*,[43] the district court granted a motion of the defendant, former HealthSouth CEO Richard Scrushy, to suppress Scrushy's SEC testimony, and dismissed perjury counts against Scrushy that were based on the suppressed testimony as a result of improper collusive conduct between SEC and DOJ investigators. The *Scrushy* case arose from the SEC's investigation of Scrushy's company, HealthSouth, for false statements and omissions in quarterly reports or press releases. The SEC worked with the U.S. Attorney's Office ("USAO") in preparing for and taking Scrushy's deposition, without informing Scrushy that criminal prosecution was looming that targeted him as a defendant.[44] The SEC was scheduled to take the

testimony of Scrushy in connection with its investigation of HealthSouth on March 14, 2003, in Atlanta, Georgia.[45] Two days before the testimony, the Birmingham, Alabama USAO participated in a conference call with the SEC's Atlanta office. During the call, the USAO informed the SEC that it was investigating a massive fraud that allegedly occurred at HealthSouth.[46] In connection with its investigation, the USAO was interviewing Weston Smith and Bill Owens, potential witnesses in the HealthSouth investigation, later that week. The USAO asked the SEC staff to participate in those interviews and to move the Scrushy testimony to Birmingham. The USAO suggested Mr. Scrushy might be more forthcoming on his "home turf," and also that moving the testimony to Birmingham would establish venue in that district in the event of perjury. To prevent Scrushy from discovering the USAO's involvement, the SEC staff, at the USAO's request, agreed not to inquire about certain subjects, including cash, property, plant and equipment, accounts payable, income statements, and earnings per share.[47]

The SEC staff moved Scrushy's testimony to Birmingham, despite its preference to take the testimony in Atlanta.[48] During the testimony, the staff asked questions based on the information that it learned in the conference call with the USAO.[49] On the day after the testimony, the staff participated in the USAO's interviews of Messrs. Smith and Owens. Later, the USAO charged Scrushy with perjury.

In ruling on Scrushy's motion to suppress, the court held that the government departed from the proper administration of justice because the government "manipulated the simultaneous investigations for its own purposes." [50] Specifically, the court observed that the government failed to advise Scrushy and his attorneys (1) that there was a criminal investigation in which he was a target, (2) that the SEC staff had been pulled into the criminal investigation, and (3) that his testimony was moved to Birmingham for criminal venue purposes.[51] The court thus suppressed the SEC testimony and dismissed the perjury allegations based on that testimony.

The court in *United States v. Stringer* [52] reached a similar result. In that case, the defendants, who were charged with fifty counts of conspiracy and securities fraud, filed separate motions to dismiss the indictments against them, or alternatively, to suppress testimony they provided to the SEC.

In 2000, the SEC began investigating the defendants, J. Kenneth Stringer, J. Mark Samper, and William N. Martin, all former executives of FLIR Systems, Inc. ("FLIR"). Shortly after the SEC commenced its investigation, it began cooperating extensively with the Oregon USAO, which had been conducting a criminal investigation of the defendants.[53] In October 2000, representatives from the SEC, the Federal Bureau of Investigation ("FBI"), and the USAO met to discuss the investigations. At that meeting, the parties decided that the criminal investigation would be held in abeyance so that the SEC could continue to receive statements from defendants and other witnesses. Later, the USAO and FBI decided they would continue to hold off in investigating the criminal matter because of the useful results that the SEC's investigation was producing.[54]

Despite its decision not to resume its investigation, the USAO was intimately involved in the SEC's investigatory process. The civil and criminal investigators regularly exchanged information and discussed strategy.[55] For example, an Assistant United States Attorney told the SEC staff that he was interested in false testimony cases and instructed the staff on how to create a record that would allow him to bring such a case.[56] The SEC staff circulated this information to all persons who were involved taking testimony in order that "we will know and understand what [the AUSA] needs/wants to prosecute a false testimony case."[57] The SEC also agreed to conduct an interview in Oregon, so that the Oregon USAO would have jurisdiction over potential cases arising from the investigation.

As the investigation continued, the SEC and USAO tried to conceal the USAO's involvement in the investigation and misled Stringer's attorney about whether the SEC was cooperating with the USAO.[58]

The court found that the close level of cooperation between the USAO and the SEC effectively merged the two investigations into one. Evidence of the close cooperation included the regular meetings between the USAO and the SEC staff, the USAO's instructions on how to question the defendants in order to develop information for a charge of false testimony, the USAO's request that the SEC conduct interviews in Oregon, and the efforts of the USAO and SEC to conceal the USAO's presence. The court held that the SEC and the USAO violated the executives' Fifth Amendment rights,[59] by failing adequately to notify the defendants of the criminal investigation. The court found that the government's failure was particularly egregious under the facts. The government not only failed to advise the defendants that criminal prosecution was anticipated, it concealed the USAO's involvement and misled counsel about the fact that the government was conducting a criminal investigation under the guise of a civil case, which evidenced the government's trickery.[60] Ultimately, the court found that the government's acts were so egregious that dismissal of the cases against all the defendants was warranted.[61]

c. Limitations on Sharing Grand Jury Information

Grand jury secrecy restrictions also limit the exchange of information between the DOJ and the Commission. [62]

Rule 6(e) of the Federal Rules of Criminal Procedure generally prohibits the DOJ from sharing grand jury materials with the Commission.[63] The exact scope of the materials covered by the Rule 6(e) prohibition is sometimes difficult to define. Generally, grand jury materials are those materials which directly or indirectly reveal what transpired before the grand jury.[64] Courts have held that protected information and materials include those

> naming or identifying grand jury witnesses; quoting or summarizing grand jury testimony; evaluating testimony; discussing the scope, focus and direction of the grand jury investigations; and identifying documents considered by the grand jury and conclusions reached as a result of the grand jury investigations.[65]

An inventory of all documents subpoenaed also falls within the protected sphere Rule 6(e) since it reveals the direction of the grand jury's investigation and the persons involved in the matter being investigated.[66]

Disclosure of information obtained from a source independent from the grand jury proceeding, although ultimately obtained for the purpose of using it before the grand jury, is not "grand jury material" and falls outside the scope of Rule 6(e).[67] Moreover, business records and other documents produced to the grand jury are not cloaked in secrecy if they do not reveal something about the grand jury proceedings.[68]

There is an exception to the grand jury secrecy requirements set forth in Rule 6(e)(3)(a)(i) that permits disclosure of a grand jury matter (other than the grand jury's deliberations or vote) to "an attorney for the government for use in the performance of such attorney's duty." However, this exception only permits disclosure to assist with the enforcement of federal criminal law, and does not permit the USAO to provide information for an SEC enforcement or other civil case.[69] Indeed, the Supreme Court has held that the use of the grand jury to elicit information not available to a civil attorney through normal discovery is *per se* improper.[70]

Another exception, Rule 6(e)(3)(E)(i), permits disclosure by court order "preliminary to or in connection with a judicial proceeding." This exception requires the Commission to demonstrate "a particularized need in the relevant sense of an inability to obtain through ordinary processes, timely and diligently pursued, the particular documents, or the particular category of documents, requested from the grand jury."[71] A mere showing of a general need for the information in the Commission enforcement action is not sufficient.[72]

d. Blocking Parallel Proceedings

A defendant can address his concern over the government's use of the more liberal discovery rules applicable to civil proceedings as a device to obtain information for use in a criminal investigation by moving to stay the entire civil proceeding, moving to stay discovery in the civil case until completion of the criminal case, or moving for a protective order limiting the use of evidence obtained in the civil case.[73] A court is not required to grant this relief. A stay of the parallel civil proceedings will be granted only where there are "'special circumstances' in which the nature of the proceedings demonstrably prejudices substantial rights of the investigated party or of the government."[74] "Special circumstances" may include circumstances in which the civil case is being used to obtain information for a criminal action, the subject is unrepresented, or there is a likelihood of adverse pretrial publicity.[75] Moreover, courts have recognized that forcing a party to litigate simultaneously on two fronts may constitute a "special circumstance."[76] However, the mere possibility that a party facing both civil and criminal actions would be required to assert the Fifth Amendment in the civil case from which a negative inference could be drawn is not necessarily a special circumstance justifying a stay.[77] However, a party can obtain relief by agreements with the SEC, as the SEC typically will stipulate to a stay of a civil proceeding in order to permit a criminal action to conclude. This is, after all, often in the SEC's interest—if the defendant is convicted, the SEC is in a much stronger position to resolve its enforcement action.

An alternative to a stay of a parallel civil proceeding is a stay of discovery in the civil case until after completion of the criminal proceeding.[78] Such stays are not routinely granted to defendants in Commission civil actions. Ironically, DOJ is more successful obtaining such stays for itself of civil discovery when it is prosecuting the defendant in a criminal action, since discovery in the civil proceeding would allow the defendant access to information from the government not otherwise available under the Federal Rules of Criminal Procedure.[79]

A defendant who is confronted with parallel proceedings also can seek a protective order under Federal Rule of Civil Procedure 26(c) to prevent the Commission from sharing its information with DOJ. For instance, in *SEC v. Gilbert*,[80] the defendant was subject to concurrent criminal and civil proceedings. The court refused to grant a defense request to stay the civil discovery until the conclusion of the criminal proceeding, finding that the civil action was not "solely" brought to obtain evidence for the criminal action and did not impose an undue burden on the defendant. However, "to prevent the possibility of abuse," the court ordered the Commission "not to furnish the U.S. attorney . . . with any information procured in the course of discovery."[81] Other courts, however, have refused to impose such a limit upon the Commission, citing the "clear statutory authorization and the prior judicial interpretation of that authorization" in support of the Commission's ability to transmit information to other agencies.[82]

The potential problems created by parallel proceedings may be avoided by negotiating an early settlement of the SEC enforcement action. However, settling with the Commission does not prevent the DOJ from bringing a criminal action, nor does it prevent the Commission from sharing with the DOJ the information it has obtained.[83] According to the Commission's rules, "any person involved in an enforcement matter before the Commission who consents, or agrees to consent, to any judgment or order does so solely for the purpose of resolving the claims against him in that investigative, civil, or administrative matter and not for the purpose of resolving any criminal charges that have been, or might be, brought against him."[84]

5. Assessing the Potential for Criminal Prosecution

At an early stage in an SEC investigation, a subject company should make an assessment of the likelihood that the inquiry will evolve from a civil to a criminal proceeding. Indeed, such an assessment should be made at periodic intervals throughout the Commission investigation. Any significant likelihood that an investigation might "turn criminal" should trigger a wide range of considerations.

Typical cases that will likely lead to a criminal investigation include those involving allegations of accounting fraud, especially revenue recognition fraud where there are side letters, fake or inflated or roundtrip sales or other false documents; insider trading cases, especially those involving high level officials; embezzlement; stock option backdating (especially if false documents were used to conceal the backdating); Ponzi schemes; and false disclosure cases where it appears that corporate insiders or their boards lied to auditors or shareholders. Even in cases where a government prosecutor is not able to prove the underlying securities fraud that he or she is investigating, there are criminal statutes that guard the integrity of the investigative process that can be used to prosecute wrongdoers. These include statutes which criminalize false statements made to FBI agents, perjury or false statements made to the SEC, obstruction of justice and destruction of evidence.[85]

Generally speaking, DOJ instructs prosecutors to charge the most serious readily provable offenses[86] once they have decided to bring criminal charges. Unsurprisingly, not all cases of readily provable criminal conduct are prosecuted. Prosecutors have wide discretion whether to bring a criminal charge. Prosecutors often focus on particularly egregious conduct especially where there are vulnerable victims, demonstrable harm to investors or newsworthy facts and circumstances. Some United States Attorneys offices establish their own guidelines for prosecuting cases. While these guidelines vary across the country, generally the factors that help to guide a prosecutor's exercise of discretion include readily provable loss or gain greater than $100,000, clear evidence of fraud, and facts and circumstances that a prosecutor can boil down into something simple that a jury will understand and recognize as being criminal. This, in turn, usually involves a good story involving greed, innocent victims (especially elderly or unsophisticated investors) and some element of deceit, falsehood and clear misrepresentation. A prosecution may be more likely where the prospective defendant is perceived to be arrogant, selfish and uncaring, and the case may be especially compelling if the defendant has testified in an SEC or civil proceeding and his explanations for his conduct ring false. Finally, widespread publicity about an issue or target often spurs prosecutors into action.

There is no precise method of determining whether an SEC investigation "will go criminal." Of course, the most direct way to acquire this information is to ask the SEC staff during the course of settling an SEC civil action whether it intends to recommend criminal prosecution. While absolute assurance is typically not attainable, the staff often is willing in the course of settlement negotiations to represent, in appropriate cases, that it has no present intent to recommend a criminal referral on the basis of the evidence known to it, but reserves the right to change that intent on the basis of newly discovered evidence. The staff in all probability will caution further that it has no control over decisions by United States Attorneys and other law enforcement authorities. Nevertheless, even such qualified disclaimers of present intent to seek criminal prosecution provide meaningful feedback.

a. Factors Supporting a Criminal Prosecution

Apart from settlement negotiations, directly asking the SEC whether it will refer a case for criminal prosecution may not always elicit a meaningful staff response. It also has the obvious drawback of signaling concern over such a prosecution. Accordingly, more often than not, it may

be more appropriate to explore the possibility of a criminal prosecution through the more indirect route of independently analyzing and reviewing a number of factors, such as whether:

- the case has criminal prosecutorial appeal—as discussed above, it presents compelling facts to which a jury can relate (*e.g.*, major corporate fraud, securities fraud involving elderly people, and strong evidence of significant fraud), or the matter offers the government an opportunity to "send a message"—i.e., the Commission or the DOJ wishes to use the case to make a point or to set an example in an effort to thwart future misconduct of a similar nature; there are significant, provable losses to victims; there is an unsympathetic defendant; and the crime at issue is one which is publicly perceived as a significant law enforcement problem;
- the Commission staff is working with an Assistant United States Attorney, an FBI agent, or some other federal criminal investigator;
- grand jury subpoenas have been issued for documents or testimony;
- a related criminal investigation is under way, particularly if the client has received a "target" or "subject" letter concerning a grand jury investigation;[87]
- the case has generated a high level of publicity that in and of itself will result in public pressure to bring a criminal prosecution.

Counsel should assess these factors in the light of all other available information that might be relevant to the likelihood of a criminal prosecution. In many cases, the judgment will be difficult to make. It is, however, a vitally important judgment in connection with such critical decisions as a witness's decision to assert the Fifth Amendment privilege against compulsory self--incrimination.[88]

When it becomes clear during the course of a staff investigation that criminal prosecution is a possibility, retention of criminal counsel is prudent, notwithstanding the significant increased cost associated with additional counsel and the potential differences in the approaches of securities and criminal practitioners.

b. Factors Discouraging a Criminal Prosecution

The significant factors that discourage a decision to prosecute violations of the federal securities laws in a criminal proceeding include:

- complicated facts and evidence inherent in presenting highly complex and intricate transactions to a jury in an understandable fashion;
- the difficulty of satisfying the relatively high standard of "willfulness" in criminal cases;[89] and
- the more substantial burden of proof required in criminal cases.

ENDNOTES

1. *See* section 24 of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77x (2006); section 32(a) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78ff(a) (2006); section 49 of the Investment Company Act of 1940 ("Investment Company Act"), 15 U.S.C. § 80a-48 (2006); section 217 of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. § 80b-17 (2006). A "person" is defined to include natural persons as well as corporate and other business entities. *See* section 3(a)(9) of the Exchange Act, 15 U.S.C.A. § 78c(a)(9) (2006); section 2(2) of the Securities Act, 15 U.S.C. § 77b(a)(2) (2006).

2. Section 807 of Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), 18 U.S.C. §1348 (2006).

3. Section 802 of Sarbanes-Oxley, 18 U.S.C. §1519 (2006).

4. *See, e.g*., Chiarella v. United States, 445 U.S. 222 (1980).

5. *See* 17 C.F.R. § 202.5(b) (2006).

6. 17 C.F.R. § 203.2 (2006).

7. 17 C.F.R. § 200.30–4(a)(7) (2006).

8. *See infra* Chapter 10 for a discussion of state blue sky laws.

9. *See* USAM §9-2.031 (2006) (describing DOJ policy under Petite v. United States, 361 U.S. 529, 531 (1960)). The DOJ publishes a multi-volume treatise entitled the Department of Justice Manual (2006), of which Volume 9 is referred to as the United States Attorneys' Manual ("USAM"). The USAM, now available on CD-ROM and on the internet at http://www.usdoj.gov/usao/eousa/foia_reading_room /usam/index.html, establishes policies and procedures for DOJ prosecutors. The USAM provides useful guidance regarding what a company can expect in a federal prosecution from a federal prosecutor.

10. *See, e.g.*, United States v. Richard A. Causey, Jeffrey K. Skilling, Kenneth L. Lay, Case No. 4:04-cr-00025 (S.D. Tex. 2006) and United States v. Lay, F. Supp. 2d 869 (S.D. Tex. 2006) (plea agreements with and indictments against Enron's chief executive officers for engaging in wide-ranging scheme to deceive the investing public, the SEC, the credit rating agencies and others about Enron's financial performance; conspiracy to commit securities and wire fraud, bank fraud, securities fraud, wire fraud, false statements, insider trading alleged); United States v. Andrew S. Fastow, Ben F. Glisan, Jr., Dan Boyle, Case No. 4:02-cr-00665 (S.D. Tex. 2006) (indictments against Enron's chief financial officer, treasurer, and global finance vice president, respectively, for devising schemes to defraud Enron, its shareholders, the investing public, the SEC and others; conspiracy to commit wire fraud and securities fraud, to launder money and to falsify books, records and accounts; wire fraud, securities fraud, money laundering, false tax returns, insider trading, aiding and abetting and obstruction of justice alleged); United States v. Lea W. Fastow, Case No. 4:03-cr-00150 (S.D. Tex. 2006) (indictment against Enron's assistant treasurer for devising a scheme to obtain money through false and fraudulent
pretenses and representations and to defraud Enron, its shareholders, the United States and others; conspiracy to commit wire fraud and defraud the United States; conspiracy to launder money; money laundering; filing false tax returns, and aiding and abetting alleged); United States v. Daniel Bayly, James A. Brown, Robert S. Furst, Case No. 4:03-cr-00363 (S.D. Tex. 2005) (indictments against three Merrill Lynch executives for engaging in fraudulent scheme with Enron executives and concealing it from the Enron Grand Jury, the SEC, Congress and the Enron Bankruptcy Examiner; conspiracy to commit wire fraud and falsify books and records, obstruction of justice and perjury alleged); *see also* United States v. Brown, 459 F.3d 509 (3d Cir. 2006), *cert. denied*, 2007 U.S. LEXIS 5177 (U.S., May 14, 2007).

11. Arthur Andersen v. United States, 544 U.S. 696, 701 (2005).

12. *Id*. at 701 n. 6.

13. United States v. Bernard J. Ebbers, Case No. 1-02-cr-1144-BSJ (S.D.N.Y. 2005) (hereinafter, "Ebbers Indictment"), at ¶5.

14. Ebbers Indictment, at ¶15. Ebbers was charged with conspiracy to commit securities fraud, securities fraud, and filing false documents with the SEC.

15. *See, e.g.*, United States v. David F. Myers, Case No. 1:02-cr-01261 (S.D.N.Y. 2005) (information against WorldCom's senior vice president and controller for engaging in an illegal scheme to artificially inflate WorldCom's publicly reported earnings by falsely reducing reported line cost expenses; conspiracy to commit securities fraud, securities fraud and making false filings with the SEC alleged); United States v. Troy M. Normand, Case No. 1:02-cr-01341-BSJ (S.D.N.Y. 2005) (information against director of WorldCom's Legal Entity Accounting for engaging in an illegal scheme to artificially inflate WorldCom's publicly reported earnings by falsely reducing reported line cost expenses; conspiracy to commit securities fraud and securities fraud alleged); United States v. Scott D. Sullivan, Buford Yates, Jr., Case No. 1:02-cr-01144-BSJ (S.D.N.Y. 2005) (indictments against Sullivan, WorldCom's chief financial officer, treasurer and secretary, Yates, WorldCom's director of general accounting, for engaging in an illegal scheme to artificially inflate WorldCom's publicly reported earnings by falsely reducing reported line cost expenses; conspiracy to commit securities fraud, securities fraud and making false filings with the SEC alleged; bank fraud and related charges later alleged in a superseding indictment against Sullivan); United States v. Betty L. Vinson, Case No. 1:02-cr-01329-BSJ (S.D.N.Y. 2005) (information against WorldCom general accounting employee for engaging in an illegal scheme to artificially inflate WorldCom's publicly reported earnings by falsely reducing reported line cost expenses; conspiracy to commit securities fraud and securities fraud alleged), *available at* http://-www.usdoj.gov/dag/cftf/ (follow "Second Year Report to the President: Corporate Fraud Task Force" hyperlink).

16. Second Year Report to the President: Corporate Fraud Task Force, at 2.2 (July 20, 2004).

17. Exec. Order No. 13, 271, 67 C.F.R. 46,091 (July 9, 2002), *available at* http://www.usdoj.gov/dag/cftf/execorder.htm.

18. Executive Order 13271, §3(a).

19. Second Year Report to the President: Corporate Fraud Task Force, at iii (July 20, 2004).

20. *Id*. at 2,3.

21. 18 U.S.C. § 1348 (2006).

22. 148 Cong. Rec. S7420–21 (daily ed. July 26, 2002) (statement of Sen. Leahy).

23. 18 U.S.C. § 1350 (2006). See section C(2), *infra*, for a discussion of knowledge and willfulness requirements in criminal law.

24. 18 U.S.C. § 1519 (2006).
25. 148 Cong. Rec. S7419 (daily ed. July 26, 2002) (statement of Sen. Leahy).
26. *Id*.
27. 18 U.S.C. § 1513 (2006).
28. These statutes are found at 18 U.S.C. §§1341 and 1343.
29. 15 U.S.C. § 78ff(a) (2006).
30. 18 U.S.C. § 1349 (2006).
31. Marvin G. Pickholz, *The Expanding World of Parallel Proceedings*, 53 Temp. L. Q. 1100 (1980).
32. 15 U.S.C. § 78u(a)(2) (2006).
33. 226 U.S. 20, 52 (1912). The Court reaffirmed this position in 1970, allowing simultaneous civil and criminal actions by the Food and Drug Administration for violations of the Federal Food, Drug, and Cosmetic Act. *See* United States v. Kordel, 397 U.S. 1 (1970); *see also* United States v. Funaro, 253 F.Supp.2d 286, 296 -297 (D.Conn. 2003).
34. 628 F.2d 1368 (D.C. Cir. 1980), *cert. denied*, 1980 U.S. App. LEXIS 15687 (1980).
35. 628 F.2d at 1374. *Accord* SEC v. Incendy, 936 F. Supp. 952, 955 (S.D. Fla. 1996) ("The decision to grant or deny a stay of a civil action pending resolution of a criminal prosecution . . . will depend upon the facts of each case, the discretion of the court, and the public interest. However, unless substantial prejudice to the rights of the parties is shown, simultaneous or successive prosecution of civil and criminal actions is permissible.").
36. SEC v. First Fin. Group of Tex., Inc., 659 F.2d 660, 667 (5th Cir. 1981) ("The simultaneous prosecution of civil and criminal actions is generally unobjectionable because the federal government is entitled to vindicate the different interests promoted by different regulatory provisions even though it attempts to vindicate several interests simultaneously in different forums").
37. SEC v. Dresser Indus., Inc., 628 F.2d 1368, 1375–76 (D.C. Cir. 1980); United States v. Kordell, 397 U.S. 1, 11–12 (1970) (government permitted to use civil discovery in parallel criminal prosecutions; no evidence the government brought a civil action "solely to obtain evidence for [a] criminal prosecution" or otherwise use the liberal civil discovery rules in bad faith).
38. *See, e.g.*, United States v. Moss, 756 F.2d 329, 332 (4th Cir. 1985*)*; In re Grand Jury Proceedings (Johanson), 632 F. 2d 1033, 1041 (3d Cir. 1980).
39. Fed. R. Crim. P. 16(b)(2).
40. Fed. R. Civ. P. 26(b).
41. The Court further stated that it may defer civil proceedings "where there is specific evidence of agency bad faith or malicious governmental tactics." Dresser, 628 F.2d at 1375–76.
42. *See* United States v. Armada Petroleum Corp., 700 F.2d 706 (Temp. Emer. Ct. App. 1983), in which the Department of Energy issued a subpoena for documents concerning conduct that was also the subject of a criminal indictment. The judge refused to enforce the DOE subpoena, noting that the enforcement of the subpoena "would be the impermissible expansion of the government's right to pretrial discovery in the criminal prosecution." *Id*. at 709.
43. 366 F. Supp. 2d 1134 (D. Ala. 2005).
44. *Id.* at 1136–38.
45. *Id*. at 1135.
46. *Id*. at 1136.
47. *Id*.
48. *Id*. at 1135, 1136.
49. *Id*. at 1137.
50. *Id*. at 1139, 1140.
51. *Id*.
52. 408 F. Supp. 2d 1083, 1084 (D. Or. 2006), *appeal pending*, No. 06-30100 (9th Cir. 2006).
53. *Id*. at 1085.
54. *Id*. at 1086.
55. *Id*. at 1088.
56. *Id*. at 1086.
57. *Id*.
58. *Id*. at 1086–87.
59. *Id*. at 1088–90.
60. The court stated that even if it found that the investigations were parallel, it could still dismiss the indictment or suppress information because the government engaged in deceit, trickery, or intentional misrepresentation. *Id.* at 1089.
61. *Id*. at 1090. The case of SEC v. Reyes, 2007 U.S. Dist. LEXIS 11712 (N.D. Cal. 2007), provides another example of the apparent willingness of some courts to protect defendants against potential prejudice resulting from improper cooperation between criminal prosecutors and the SEC. The court found that the DOJ had selectively and "tactically" used its power to grant immunity to witnesses in order that the government would be able to obtain information from the witnesses while calculating, at the same time, that the witnesses would assert their Fifth Amendment rights and refuse to answer the defendant's questions at deposition. The court indicated that it would consider "depriv[ing] the SEC of the benefit of the government's selective grants of immunity" by excluding from the SEC's case any evidence obtained from the witnesses if the witnesses persisted in their refusal to be deposed.
62. *See* SEC v. Dresser Indus., Inc., 628 F2d 1368, 1382-83 (D.C. Cir. 1980).
63. Fed. R. Crim. P. 6(e)(2) provides that "[a] grand juror, an interpreter, a court reporter, an operator of a recording device, a person who transcribes recorded testimony, an attorney for the government . . . must not disclose a matter occurring before the grand jury." *See also* John Sturc & Alan Scorcher, *Parallel Proceedings: The Acquisition and Use of Information by Regulators and Prosecutors*, at 479, PLI Securities Enforc. Inst. Course Handbook Series No. B692 (1990).
64. United States v. DiBona, 601 F. Supp. 1162 (E.D. Pa. 1984).
65. Fund for Constitutional Gov't v. Nat'l Archives & Records Serv., 656 F.2d 856, 869 (D.C. Cir. 1981).

66. *See, e.g.*, In re Sealed Case, 801 F.2d 1379 (D.C. Cir. 1986); In re Grand Jury Impaneled October 2, 1978 (79–2), 510 F. Supp. 112 (D.D.C. 1981).
67. DiBona, 601 F. Supp. at 1164–65.
68. United States v. Stanford, 589 F.2d 285 (7th Cir. 1978).
69. *See* United States v. Sells Eng'g, Inc., 463 U.S. 418, 427 (1983), superceded by rules as stated in United States v. Tabori, 2007 U.S. Dist. LEXIS 13,255 (S.D.N.Y., Feb. 22, 2007).
70. United States v. Procter & Gamble Co., 356 U.S. 677 (1958).
71. In re Sealed Case, 801 F.2d 1379, 1382 (D.C. Cir. 1986).
72. Sells Eng'g, Inc., 463 U.S. at 443.
73. *Id.*
74. SEC v. Dresser, 628 F.2d, 1368, 1377 (D.C. Cir. 1980).
75. *Id*. at 1375.
76. Dresser, 628 F.2d at 1370. *See also* Texaco, Inc. v. Borda, 383 F.2d 607 (3d Cir. 1967).
77. Dresser, 628 F.2d at 1375.
78. *See* Dresser, 628 F.2d at 1375. *See also* Brock v. Tolkow, 109 F.R.D. 116 (E.D.N.Y. 1985).
79. *See, e.g*., Maher v. Monahan, 2000 U.S. Dist. LEXIS 6898, at *8 (S.D.N.Y. May 16, 2000).
80. 79 F.R.D. 683 (S.D.N.Y. 1978).
81. *Id*. at 687.
82. *See, e.g*., SEC v. Rubinstein, 95 F.R.D. 529 (S.D.N.Y. 1982).
83. *See, e.g.*, United States v. Marcus Schloss & Co., 724 F. Supp. 1123 (S.D.N.Y. 1989).
84. 17 C.F.R. § 202.5(f) (2006).
85. *See e.g*. 18 U.S.C. § 1001 (2006); 18 U.S.C. § 1012 (2006); *See, e.g.*, section D(3), *infra*.
86. *See* USAM § 9-27.300 (2006) (discussed in detail in section C(4), *infra*).
87. These terms are defined in section D(2), *infra*
88. *See supra* Chapter 3, section I.
89. *See* section C(2), *infra*