



CORPORATE AND SECURITIES LITIGATION

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Parallel Proceedings: When Rights Are Denied

On appeal from a disciplinary ruling by the National Association of Securities Dealers (NASD), the Securities and Exchange Commission (SEC) recently mandated reconsideration by NASD of its decision permanently barring a securities broker who, asserting a Fifth Amendment right against self-incrimination, had refused to provide testimony in violation of NASD's Procedural Rule 8210.

Reconsideration was warranted because the broker was denied requested discovery to show that NASD was a "state actor" due to its joint action with government authorities. *In re Application of Justin F. Ficken*, SEC Admin. Proc. File No. 3-12143, Release No. 34-54699 (Nov. 3, 2006). This decision echoed *In re Application of Frank P. Quattrone*, SEC Admin. Proc. File No. 3-11786, Release No. 34-53547 (March 24, 2006), in which the SEC set aside a similar summary bar because Mr. Quattrone had not been given a chance to demonstrate that NASD's proceeding constituted "state action," which would entitle him to decline to testify.

These decisions may reflect an increasing awareness, if not recognition, by the SEC of the perils of parallel proceedings, an awareness heightened by its own recent legal problems with such parallel investigations.

The 'Ficken' Proceeding

In 2003, NASD began to investigate whether Justin Ficken had engaged in improper market timing and late trading in mutual fund shares while previously employed as a general sales representative. At NASD's request, Mr. Ficken appeared at an on-the-record interview and answered questions about market timing for over three hours. However, when questioned about his involvement in late trading activity, he asserted his Fifth Amendment privilege, noting his awareness that a grand jury in Boston was



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receiving information from the SEC and that NASD members were consulting with the SEC. Thereafter, Mr. Ficken declined to appear for further testimony after being informed by the U.S. Department of Justice (DOJ) that he was a target of a federal criminal investigation and was likely to be indicted on matters about which NASD was seeking his testimony. SEC Rel. No. 54699 at 2-4.

In 2004, NASD's Department of Enforcement filed a complaint against Mr. Ficken, alleging that he failed to appear and respond to questions relating to allegations of late trading and then moved for summary disposition. Mr. Ficken sought to show that an NASD employee had worked with the SEC on the case, to support his claim that NASD was a "state actor," and that evidence existed of cooperation among the SEC, NASD, DOJ, and the New York Stock Exchange (NYSE) in investigating the same conduct. The hearing officer deferred a ruling on the motion pending the completion of discovery of evidence supporting Mr. Ficken's allegations. However, the SEC and NASD refused to make their respective employees, whom Mr. Ficken had specifically identified, available for testimony. Id. at 4-5.

A new hearing officer was assigned (without explanation) and Mr. Ficken again asserted that information being developed by NASD was being provided to DOJ. Nonetheless, a hearing panel granted NASD's motion for summary disposition, and barred Mr. Ficken from associating with any NASD member in any capacity, due to his violation of NASD Procedural Rule 8210 and Conduct Rule 2110. Id. at 2, 6. This holding was affirmed by NASD's National

Adjudicatory Council, which found that Mr. Ficken's "unsubstantiated, generalized assertion" that NASD staff forwarded information to the SEC and DOJ did not demonstrate "government coercion or significant encouragement" necessary to find that the NASD investigation constituted state action. Thus, Mr. Ficken was not excused from his obligation to provide testimony. Id. at 6.

On appeal, the SEC reviewed the law concerning the "close nexus" between the state and the challenged action necessary to establish state action, including its own recent *Quattrone* decision. In addition to the "coercive power" and "significant encouragement" tests, state action may also be shown where a private actor operates as a "willful participant" in joint activity with the state—sometimes called the "joint action" test. This test looks to factors such as whether the state and the private entity are "interdependent" such that the private entity is a "joint participant" in the challenged activity, or whether the private entity's challenged actions are "inextricably intertwined" with those of the government. Id. at 8-9. In its *Quattrone* decision, the SEC had set aside an NASD summary disposition which failed to address Mr. Quattrone's argument that NASD cooperated with the government in its investigation of him, noting that he did not need to show that NASD was acting solely at the SEC's behest, but only that it had willfully participated in joint action with the SEC. Id. at 9 (quoting *Quattrone*, Rel. No. 53547 at 6-7 n. 5, 10 n. 25). Similarly, the SEC observed, NASD had not addressed the question of joint action in its *Ficken* decision, which preceded the SEC's *Quattrone* decision. *Ficken*, Rel. No. 54699 at 9-10.

The SEC reviewed Mr. Ficken's contention that he was denied the opportunity to discover information essential to his defense. Mr. Ficken pointed to the four contemporaneous proceedings in which identical information was sought and to an SEC press release acknowledging the assistance of NASD, the Massachusetts Securities Division, and the NYSE in its investigation leading to the SEC's civil complaint against him. He also made assertions of information sharing and collaboration between NASD and DOJ, that were not refuted by any testimony or affidavits from NASD—contrary

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to NASD's past practice of making its employees available for testimony or providing responsive affidavits. Rel. No. 54699 at 10-11. The SEC reiterated its *Quattrone* instruction that the burden of demonstrating sufficient joint action is high and that the mere fact of cooperation between the SEC and NASD is generally insufficient, standing alone, to demonstrate state action. Rel. No. 54699 at 11; Rel. No. 53547 at 11. Nonetheless, Mr. Ficken was entitled to try to obtain evidence to support his assertions.

The SEC emphasized that, although a party is entitled to a full opportunity to conduct discovery to oppose a summary disposition motion, he may not go on a fishing expedition. Thus, Mr. Ficken would have to demonstrate how the facts he already had supported his claims, why he needed additional discovery, what information he hoped to obtain with further discovery, and how that information would support his claims. If he satisfied this burden, NASD would be expected to give "due consideration" to his request for additional discovery. Rel. No. 54699 at 11-12.

Since *Quattrone* was decided after NASD's *Ficken* decision and questions existed concerning whether Mr. Ficken had sufficient access to relevant information, the SEC remanded to NASD for further consideration. The SEC expressly disavowed any view on the outcome of the remand. However, in response to Mr. Ficken's complaint about the harshness of the sanction imposed, the SEC observed that, while a bar is the standard sanction for a Rule 8210 violation, where an individual fails to respond in "any" manner, a two-year suspension is recommended if there is mitigation; and Mr. Ficken had appeared at the initial interview and answered questions for over three hours. Id. at 12 & n. 38.

A Possible Trend

In both *Quattrone* and *Ficken*, the SEC sought to ensure that respondent had a fair chance to demonstrate that interactions in parallel proceedings had transformed NASD into a state actor, sufficient to permit respondent to assert his Fifth Amendment privilege without an NASD Rule violation. These decisions reflect an increasing awareness of the possible deprivations resulting from the combining of self-regulatory, government and criminal investigations.

The SEC itself has recently been in the middle of several cases where joint civil and criminal investigations were adjudged to constitute government abuse of parallel proceedings and to have deprived defendants of fundamental rights. In January 2006, the U.S. District Court for the District of Oregon dismissed criminal charges, finding the defendants' constitutional rights were violated by DOJ's covert role in an earlier related SEC civil investigation. *United States v. Stringer*, 408 FSupp2d 1083 (D. Or. 2006). The court found that the government feared defendants' awareness of a criminal investigation "would halt the successful discovery by the SEC, witnesses

would be less cooperative and more likely to invoke their constitutional rights, and that the rules of criminal discovery would be invoked." Consequently, the government concealed that the U.S. Attorney's Office "was actively involved in the SEC investigation: meeting regularly, receiving documents, requesting interviews be conducted in Oregon to establish jurisdiction, advising what information was needed for a successful criminal prosecution, specifically instructing on how best to conduct interviews to gather evidence for false statement cases, intentionally hiding its presence from [defendants'] attorneys...." This "strategy to conceal the criminal investigation from defendants was an abuse of the investigative process." Id. at 1087-88. In addition to dismissing the indictment, the court held that, if the dismissal was deemed error on appeal, defendants' statements to the SEC would be suppressed as gathered in violation of defendants' due process and Fifth Amendment rights. Id. at 1090.

In 'Quattrone' and 'Ficken,' the SEC ensured that respondent had a chance to show that interactions in parallel proceedings had changed NASD into a state actor, which would let respondent assert his Fifth Amendment privilege without an NASD Rule violation. This shows awareness of deprivations from combining self-regulatory, government and criminal investigations.

Similarly, last year in *United States v. Scrushy*, 366 FSupp2d 1134 (N.D. Ala. 2005), an Alabama judge dismissed a perjury indictment based upon deposition testimony obtained in an SEC civil suit. Evidently the U.S. Attorney's Office had caused the SEC to move the deposition from Georgia to Alabama so that it would be within the U.S. Attorney's perjury jurisdiction and had dictated the parameters of the SEC's questioning at the deposition. However, the U.S. attorney's role, and the fact that the defendant was a target, were concealed from the defendant. This concealment and commingling of SEC and DOJ investigations belied the government's claim of separate parallel investigations. Id. at 1138-40.

Itself embroiled in claims of improper joint action with criminal authorities, the SEC undoubtedly has a heightened awareness of excessive entwinement between NASD and government agencies. The SEC's own position on parallel proceedings, including that it need not disclose the existence of a criminal investigation

even in response to a direct inquiry, will now be heard by the Ninth Circuit in *Stringer*. (SEC amicus brief in No. 06-30100, Sept. 13, 2006, at 11-17).

The parallel government proceeding cases may provide guidance concerning where to draw the state action line in NASD proceedings. Although the NASD cannot compel a respondent to submit to an on-the-record interview, it can sanction that person for failure to comply with NASD rules. From a respondent's perspective, the potential sanction of a permanent bar, i.e., being deprived of the ability to earn a living, is equivalent to being compelled to testify. That inherently coercive dynamic crosses the line into state action when the respondent's "voluntary" testimony is being procured by NASD specifically for use by criminal authorities. The close interaction between NASD and DOJ has long been a sore spot, particularly given NASD's ability to issue a permanent bar by summary proceeding. See *D.L. Cromwell Investments, Inc.*, 279 F3d 155, 162-63 (2d Cir. 2002). The better practice in such cases would be to await the outcome of any criminal investigation before taking such summary regulatory action, or to recognize partial cooperation or a pending criminal investigation as mitigating factors warranting only a temporary suspension.

Conclusion

Ficken and *Quattrone* may reflect unanticipated fallout from recent cases criticizing the SEC for its own involvement with DOJ in civil enforcement proceedings and an increasing awareness of the due process implications of joint investigatory action. However, the SEC made clear in *Ficken* that it did not intend to modify the high burden a respondent must meet (a) to demonstrate state action by NASD and (b) to oppose a summary disposition motion with a request for additional discovery. There is thus no assurance that these decisions will significantly improve a respondent's chances of successfully mounting a state action defense in a summary proceeding after refusal to give an on-the-record interview.

For now, they should ensure that NASD will give serious consideration to respondents' arguments and requests for discovery on the state action issue. The issues raised by *Stringer* and *Scrushy*, the loss of constitutional rights through government action in parallel proceedings, are similar to the concerns raised by NASD's use of Rule 8210 to summarily bar a broker for asserting the Fifth Amendment during the pendency of a parallel criminal proceeding. By addressing excessive entwinement in parallel SEC/DOJ proceedings, the upcoming Ninth Circuit decision in *Stringer* may have an impact on where the state action line will be drawn in parallel NASD/government proceedings.

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