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What to Do If the SEC Comes Knocking on Your Door

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Justin and Michael discuss what may happen when you are served with a subpoena from the SEC, or get approached by the Department of Justice, and what steps you should take in response. In the second half of the discussion, Justin and Michael focus on some issues in the crypto space.

Transcript:

Justin: Hello, this is Justin Wales. I am the co-chair of Carlton Fields' Blockchain and Virtual Currency Practice Group, and with me is Michael Yaeger from our New York office. He is a partner and a former federal prosecutor, and today we're going to be talking about what to do if you were in the situation of having conducted a token raise, potentially raising millions of dollars, and now the SEC or some other federal agency or state agency is contacting you with a subpoena or requesting more information about that token sale. So, Michael do you want to give a little background about your practice?

Michael: Sure. Well, yes, I was in the government prosecuting securities fraud and cybercrime, and I have come into private practice, and now I help people and companies with sensitive issues with a variety of regulatory agencies, including the Department of Justice and the SEC. U.S. Attorney's Offices are just part of the Department of Justice. And, yes some of the people I help are people in the crypto space.

Justin: Great, well I think what we should do in terms of this podcast, is try to give an overview of what is the mindset of a federal prosecutor, or a person on the investigatory side of a regulatory agency, in terms of seeking more information, communicating with a business that may have raised a significant amount of money in a token sale, and what are generally the procedures that follow the issuance of a subpoena and what, you know what does a subpoena really mean, what does it

potentially signal to you as a defense attorney?

Michael: So, when an investigator sends out a subpoena, that investigator is doing it either because they want to get information from you, to look into somebody else, or because you are yourself the subject of the investigation. Obviously it's a little bit scarier when you're the subject of the investigation. But there are a wide range of reasons why a prosecutor or an SEC attorney would want to get documents or to interview people, and it's not necessarily bad. It's just that there's a lot of issues you have to spot at the beginning of an investigation, and you just don't want to do this casually, because there are a lot of decisions points that come pretty early in the process. They can be asking you for documents, they can be asking you to testify.

And one of the first issues is, do you want to speak to them? I mean, just to get really basic, if you think of your cop shows, you have a right to remain silent. That's true—in the criminal context. And, so you can choose not to speak to the SEC. If you do that, that fact can't be used against you in a criminal case, but it can be used against you in a civil case by the SEC.

Justin: Sure, so Michael I know just a couple weeks ago the SEC filed a civil complaint against Kik related to their token sale. What's the difference and maybe can you define what a civil action in terms of regulatory agency means. What's the difference between how the SEC would proceed on a civil action versus a criminal action?

Michael: Well, once the SEC has decided to bring a civil action, the SEC staff has looked into something, investigated and it has been approved by the SEC commission and they bring a case, they can get a variety of relief against you. They can make you pay money, you can be barred from the securities industry. But they can't put you in prison. So, there are a lot of consequences, it's very important.

But if someone is going to try and create a criminal consequence, it's going to be the U.S. Attorney's Office, or the DOJ. That's really the same thing, the Department of Justice is the overall organization, the U.S. Attorney's Office is the local offices of the DOJ that have some autonomy, but are formally part of the same organization. And, the SEC and the U.S. Attorney's Office can work in parallel. So these two investigations can be going on at the same time.

Often, if there is a criminal case, the civil case will be stopped, will be stayed while the criminal case proceeds. That doesn't happen automatically but sometimes the defense seeks it, sometimes the prosecutors seek that. They want the criminal case to go first. But, the fact that there's a civil case does not mean there can't also be a criminal case, generally speaking.

But once a civil case starts, it's a regular civil case, it's just that the government is the person bringing it against you. So, you produce documents, there are depositions, and motion practice and eventually if the case isn't dismissed or summary judgement, there's a trial.

Justin: Now, as someone who may be the subject of an investigation, at what point would I be aware that I am the subject? Is it when I receive a subpoena or when someone around me receives a subpoena or will they try to bring me in for maybe a softer questioning, some general information before they actually go and file a subpoena? And, maybe what would be helpful is if you could define what a subpoena is, and what does it ask of the recipient?

Michael: Alright, so if you get a subpoena, it can be a subpoena seeking documents. The Latin phrase there is subpoena duces tecum, with my terrible Latin pronunciation. Or it could be a subpoena seeking testimony which is the subpoena ad testificandum, or both. And, a document subpoena wants you to give documents by a certain date. Your lawyer can call up the SEC attorney and adjust the deadline, discuss what's reasonable, hold back stuff if it's privileged, meaning, if you had emails with your lawyer where he was giving you legal advice. Testimony could be, if we're talking about the SEC, an on-the-record interview, or not.

But the first thing that usually happens is your lawyer calls up and tries to get the SEC to tell them more about what the case is about. And, sometimes you're just a witness. Often they'll say things like well, we're just exploring, you know this is a, this person could evolve into a subject of investigation but they're not a target, or, you know we can't say for sure but we really just think you're just a witness. They'll say things like this but you also would glean what the SEC believes by what they're asking for. And, some of that is you read this request, and you try to drill down, and you try to get more from them. There's a bit of a dance that goes on between the government lawyer and the private lawyer, trying to find out a little bit more, and get some direction.

Justin: Is there a way once a party receives a subpoena to potentially narrow the scope of inquiry, or to set parameters for what is asked, is requested? I know for instance I've seen subpoenas that are incredibly broad in the documentation they ask for, such that it would be an incredible burden to try to produce those records. Do you ever see that as part of the dance

and the negotiation between the lawyers and the government?

Michael: Absolutely. There's no question. This is a process where if it's incredibly burdensome, just as a matter of strict, simple negotiations, the government will often tailor its requests if it thinks that you're acting in good faith and you have good reasons for why they're asking for is just incredibly voluminous. They don't want to have to go through millions and millions of documents if they don't have to. And so, yes that kind of thing does happen. There can even be more serious formal remedies sometimes where you do process to try to limit discovery. But the first thing that happens is just a conversation drilling in and, I mean, this is one of those reasons why it's just a practical small reason you want to have a lawyer doing this, not you. When the lawyer speaks it's just a conversation and an exploration. When the witness speaks, basically everything is on the record.

Justin: So is it ever advisable to speak to regulators without a lawyer present? I know the reason I ask is we represent a lot of clients for instance on the regulation side seeking licensors from different state regulators from FinCEN perhaps, and there's often a line of communication between the regulators and either a high level executives or internal counsel or outside counsel about, you know, talking through business plans in order to make sure that you're in compliance with the existing regulations. Is there ever an instance where if the SEC calls you up or sends a letter or requests a meeting that you would want to go at it without a lawyer? Just, you know, show that you have nothing to hide?

Michael: Pretty much no. You know it's different when you're speaking to the SEC outside of an enforcement inquiry. But when you get a subpoena, in the context we're speaking about here, and you are talking to enforcement personnel, no. You should never be doing that without a lawyer present. When you get into the criminal context it's even more sharp.

I mean, one thing that people don't realize, or they forget, is that the government is actually allowed to lie to you. I mean that is what a sting operation is. When the government pretends to be a drug dealing gang and sells drugs to somebody, they're lying to the drug dealer in pretending to be something. So, for a less dramatic example, an FBI agent comes to somebody's house at, you know, 8:00 in the morning, knocks on the door and shows them a picture of someone and says: do you know who this is? It could be someone they've never seen before. It could be someone they know very well dressed deliberately differently. You don't know what you're being asked and why you're being asked it, and yet you're going on the record. And that can hem you in. That can mislead you and you can say things where you don't remember it well, and you want to be able to slow the action down, get more facts before you have to speak about something that may have happened a long time ago.

So that's much more dramatic, the FBI knocking on your door. But, if you are in a situation where you're worried about criminal charges, you may not want to speak to the SEC at all, even though, in a civil case, that could hurt you. If you don't speak and you take the 5th, they can use that against you in the civil case to prove facts. Your silence can be used against you in a civil case. But, it may still be worth it if you were unfortunately in a situation where you were worried about criminal liability. So, I mean this is one of these things where there's really no substitute for sitting down and having an extremely frank conversation with your lawyer and going over what you think the facts are and what the risks might be. Because a lot of what your lawyer's doing is just spotting issues and trying to see how things could go wrong.

Justin: That's great advice. Now let's say that you receive a subpoena and you are, you know, you believe that either you or your company, or maybe someone who you know, you know, someone within the company you work for is the subject to an investigation. What duties do you have once you obtain that subpoena in terms of keeping documents, keeping notes on conversations? Are there any obligations that trigger once a subpoena is issued to you?

Michael: Yes. You have to be careful that you're saving everything. You may decide after consulting with your lawyer that certain things are not responsive, the subpoena doesn't actually call for certain documents. Or you may say actually, these are emails where I was asking my lawyer for legal advice, or these days it could even be text messages. And you may say okay, that's privileged, I don't have to produce it. But the first thing you have to do is save them. And so, to preserve documents, people put out a litigation hold, your lawyer drafts that. What kinds of things should be held back and there's a decision on who in the company should get it. Maybe you don't want to notify absolutely everyone in the company that there's been an inquiry. There can be reasons why it just makes sense to keep things tighter, because you don't want people to start talking and giving rumors about things that they don't fully know.

Justin: This is the loose lips sink ship doctrine?

Michael: It can be. It can also just can affect the record in a way that you don't want to. You don't want people to be

changing their stories or something. You want to preserve documents and put out a careful litigation hold, and they'll, the decisions of exactly how you do that are very case-specific. You know, the broad outline here, you get a subpoena, talk to you lawyer, you think very carefully, you issue spot, but the details very widely depending on the facts.

Justin: Now, I imagine that some of the documents requested in a subpoena duces tecum would contain trade secrets, sensitive information about the finances of the company.

Michael: Right.

Justin: Is there any risk to the company in producing these documents that they will at some point become a public record? How do you make sure that you are not only complying with the investigation, but you are doing so in a way that doesn't necessarily damage your ability to compete in the marketplace?

Michael: Well, you can negotiate protective orders and agreements with the regulatory agency. The government typically is sensitive to that kind of a problem. They have an investigation, they want to look into things, but they are not interested in just throwing this information around everywhere. So you can negotiate legal protections. If for some reason the SEC were hacked by the People's Liberation Army in China, well, that's a different problem.

Justin: Right.

Michael: But in terms of what they would legally commit to, yes. You can get protections over what you disclose to people, over what you produce and what you don't. I mean one concern, for example, is that people can file Freedom of Information Act requests with the SEC. And, it's pretty standard to ask the SEC that they at least notify you before they produce any documents in response to a Freedom of Information Act request.

Justin: I've done, I've litigated several cases involving what's called reverse FOIA suits, and what ends up happening in these situations is, you know, you have an interaction with the government agency. They request all types of documents that contain trade secret information and someone, and it's typically a plaintiff's lawyer actually, will file a Freedom of Information Act request for that specific information because they're trying to build a case. And, what ends up happening is you have this interesting posture where you are now litigating against the agency who's in some instances actually on your side not wanting to give this information…

Michael: Right.

Justin: …debating whether something is or is not a trade secret under you know, various data or federal statutes. So it's, it can be an interesting type of procedure that comes from this situation.

Michael: Absolutely. But as you say, as difficult as it can be at times, and it isn't always so straight forward, typically the people doing the investigation are not interested themselves in throwing it around. There are other people who may want it, but for all the problems you may have with regulatory agency, that's typically not one of them. They want to be informed and they want people to give them information and they're usually not throwing it around.

Justin: Now Michael, I think all of the information you've given at this point is really applicable to any type of regulatory investigation. Is there anything you see as the crypto industry develops that is unique or a unique problem to that industry? And, to telegraph a bit of what I'm thinking, one of the really interesting things about the crypto space, is that you have a lot of companies that raised a ton of money in a way that may or may not have been fully compliant and after the raise, they start to maybe legitimize, they start to hire internal counsel. They start to interact more with their regulators to make sure that they mitigate any risks associated with that initial raise or with what they did in the earliest stages. Is there any advice for, or considerations that those specific types of companies should be thoughtful of as opposed to maybe a company that has already grown, has already established before they, you know, are subject to the investigation?

Michael: Sure, the details of the facts always matter and, you know, that particular fact pattern does have some special wrinkles to it. I do think in my experience that the SEC appreciates that this is still a new area that people are formalizing and growing up with. These startups are getting more compliant, but there always are risks when you move that way. And, you want to be especially sensitive to protecting your privilege and to not just conducting your defense in public the same way. You will always be honest and forthright with your regulator. But that doesn't mean that you should be doing all of that formalization and new policies in public quite the way that people might sort of have an instinct if they're not familiar with very regulated industries, the securities industry, other things like this. I mean it's not the same thing as just a Kickstarter campaign or someone conducting a sort of freewheeling kind of discussion that you would have on slack. As you are putting

in these controls, you are going to have to talk to legal counsel and you are going to have to bring yourself there. But, I do think that the SEC does appreciate that this is an area where there are a lot of people who are well meaning, but less knowledgeable. As time goes on, that's going to shift. I mean, with the Kik complaint, they are laying down a marker. They've been laying down markers of different kinds for quite a while now. And, over time they're going to expect a higher level of compliance.

Justin: And this is, this is probably why in, you know, in the Tomahawk guidance they mention the DOW. In the Kik guidance they mentioned Tomahawk, and they are saying if you're operating after x date, you should be pretty much aware of what we think because we issued these guidance whereas, if you were doing something maybe in 2015-2016, there's a little more leeway. Is that what you're finding?

Michael: Yes, definitely. It's a sliding scale and it's one thing to have conduct in the past and to show that you have made real efforts to clean things up and to, I mean I shouldn't even say clean things up, more formalize. More just understanding that you are in an industry that is different than perhaps you might have perceived it when it first started. But, as time goes on, you are going to be given a lot less leeway. I mean this is just a classic way that people think of precedent. And, that's how the SEC acts, that's how American regulators act to a certain extent. You know once you're warned, there are consequences.

Justin: Now let me ask you a final question. I know there are a lot of folks out there who have received a subpoena, they are the subject of an investigation. But, when they were actually doing their token sale, they may have been doing it on advice of counsel at the time, who may still be their attorney. They might have a letter in their hand from an attorney that says at what they were doing what not a security sale. And now the SEC is coming and they're saying well this was a security. What considerations do those folks have? How valuable is that letter, that opinion letter that says what you were doing was not a security when it may well have been the sale of a security. And, do you hire the same attorney who gave you the advice to represent you in the investigation? What are the considerations there?

Michael: Okay, there's a lot in there. Let me see if I can catch each piece. I mean, first of all it certainly helps if you have previously spoken to a lawyer, if you spoke to a lawyer before you took certain steps and you relied on that. So, before you had an ICO, you got an opinion from a lawyer and you relied on that opinion. That's good. What did you tell your lawyer exactly? Did you give them a really incomplete account of what you were doing that didn't really discuss the most important aspects of the token and the analysis under the how we test the name of the case, whether something's a security or not? Because if your lawyer wasn't really well informed, that opinion means less. So you may not be able to rely on it if you weren't fully honest with your lawyer certainly, or if you were honest but just extremely incomplete.

All that stuff can help. Regardless if you went to a lawyer and you did so in good faith and doesn't look like you were just setting up some kind of placeholder defense, that will be looked on favorably that you were honest and you tried to get an opinion and act in reliance on it. But, whether or not this actually counts as a security or not is not always about your good faith. It's about the legal status of your ICO. Whether you thought you were right or not, that decision will be separate. But, if you acted in good faith, that'll help you. If you're perceived as acting as good faith that will help you with the regulators in terms of what the consequences will be. So, you know, the decision of whether it's a security is different from whether you acted in good faith.

Moving onto the other part of whether you might want a different lawyer, yes, it can help you a great deal to keep your counsel a little compartmentalized, just because you have a new lawyer as a practical matter, it may be rhetorically easier for them to make certain arguments, and to show that you are taking a new approach to the problem. There can be – not always – some conflicts with previous counsel if they are deeply embedded in this fact pattern, and now they're going to help try and defend you on it. That can create some issues. It doesn't always and if you love your existing lawyer and you think you've gotten great advice you can probably stick with them. But, there is definitely some value to looking at this a new time, getting a second opinion, and, unlike getting a second opinion from a doctor that, there's also some rhetorical value with the regulator to having a new lawyer sometimes. It can be part of your legal arsenal.

Justin: Great, well I think those were the main questions we have for this podcast. I think if anyone is looking for more information about our practice, the kinds of things we write about, the types of presentations we give within the crypto space, you can go to our website at Carlton Fields and search for a Blockchain or virtual currencies. Michael, before we leave, is there anything you want to leave our listeners with in terms of regulators, enforcement actions and what to do if they are the subject of an investigation?

Michael: Well, be careful out there. It is an interesting time. But, you can have faith that if you're thoughtful and careful and you talk to counsel, you're going to find a way through this. Don't panic, as they say in the Hitchhikers Guide to the Galaxy. This is a problem perhaps, but it's a problem you can handle with the right advice.

Justin: Well great, Michael thank you so much for your time. This is the end of our episode, Why Does the SEC Want to Talk to Me, and I think in the future we'll have more of these topical episodes about things that are affecting the crypto space and the interaction between law and technology and regulation. Thanks so much.