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HEADLINE: Taking The Fifth During SEC Probe;
Client's Assertion Of Rights Should Be Irrelevant in Later Civil Enforcement

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WHAT ARE THE consequences of asserting the Fifth Amendment during an investigation by the Securities and Exchange Commission? Is it inevitable that taking the Fifth will come back to haunt the asserting party in litigating against the SEC?

Consider the following common scenario. Your new client has just learned that he is being investigated by the SEC. He comes to you having just received a subpoena to testify before the staff of the agency's enforcement division. The formal order authorizing the investigation is often of little to no help at this stage, and your initial look at a complicated set of facts and a large volume of documents is just beginning.

The exposure to criminal prosecution arising out of the events in question is serious enough, and your investigation is at an early enough stage that, as a cautious lawyer, you advise your client to assert his Fifth Amendment rights in his quickly approaching testimony. On the basis of your advice, your client refuses to answer any of the SEC staff's questions. Years later, the Commission completes its investigation and files a complaint in federal court against your client.

In the agency's enforcement action, what use can it make of your client's assertion of his Fifth Amendment rights during the investigation? For example, should the SEC, or a private civil litigant for that matter, be able to refer to the fact that your client took the Fifth during the investigation to satisfy its burden at the pleading stage of a civil case?

In this article, we argue that the assertion of Fifth Amendment rights during an SEC investigation is legally irrelevant during a subsequent civil enforcement action. The fundamental nature of an SEC investigation makes the assertion of the Fifth Amendment useless as evidence and impermissible under Supreme Court precedent. This is particularly true in light of a Supreme Court decision from March 2001 which reinvigorates the notion that the Fifth Amendment protects the innocent from being "ensnared by ambiguous circumstances," just as much as it acts as a shield for the guilty.[1]

'Baxter' and Beyond

It is by now accepted law that courts may draw an adverse inference when a party to a civil case asserts the Fifth Amendment's protections against compelled self-incrimination. However, wise defense counsel will remind courts to hew carefully to the Supreme Court's directives in permitting the inference in only limited circumstances. Often, the inference is unwarranted, impermissible or both.

In the seminal case of *Baxter v. Palmigiano*, the Supreme Court held that:

> [The] Fifth Amendment does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them: the Amendment "does not preclude the inference where the privilege is claimed by a party to a *civil cause*."[2]

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[1] *Ohio v. Reiner*, 121 SCt 2542, 1254 (2001).

[2] 425 US 308, 333 (1976) (emphasis in original).

Two criteria for drawing the adverse inference clearly emerge from this holding. Courts interpreting *Baxter* should permit the adverse inferences from the assertion of Fifth Amendment rights only: (1) where the assertion occurred in an actual *civil case*; and (2) in response to *evidence* offered against the person asserting the Fifth Amendment.[3]

In the few instances where courts have permitted an adverse inference based on a target's behavior during an SEC investigation, the defendant normally reasserted the Fifth Amendment during the subsequent civil enforcement action.[4] Often, a witness who asserts the Fifth Amendment during an SEC investigation will choose to testify at deposition and at trial in the subsequent civil enforcement action.

This view of *Baxter* sensibly reflects several underlying policies and recognizes the realities of how actual litigants behave. First, failure to respond to official questioning, in particular, by asserting the Fifth Amendment, is meaningful only "if it would have been *natural* under the circumstances to object to the assertion in question."[5] In order to determine what is "natural" behavior, courts must look at the nature of the proceedings under which a person responded, or failed to respond, to official questioning. For example, in considering the grand jury, the Supreme Court has observed that:

> [The] nature of the tribunal which subjects the witness to questioning *bears heavily on what inferences can be drawn from a plea of the Fifth Amendment*. Innocent men are more likely to plead the privilege in secret proceedings, where they testify without advice of counsel and without opportunity for cross-examination, than in open court proceedings, where cross-

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[3] See, e.g., *United States v. Solano-Godines*, 120 F3d 957, 962 (9th Cir. 1997) (holding that immigration judge was entitled to draw adverse inference from assertion of Fifth Amendment in deportation hearing because "[deportation] proceedings are civil proceedings"); *Reasonover v. Washington*, 60 FSupp2d 937, 960-61 (E.D. Mo. 1999) (permitting adverse inference from assertion of Fifth Amendment where assertion occurred during hearings on petition for writ of habeas corpus and noting that habeas petition is a civil proceeding); *Fujisawa Pharm. Co., Ltd. v. Kapoor*, Case No. 92 C 5508, 1999 WL 543166, *9, 1999 U.S. Dist. LEXIS 11381, *29-30 (N.D. Ill. July 21, 1999) (excluding from civil case evidence of defendant's invocation of Fifth Amendment rights during congressional hearings because "questions put to [defendant] are not 'evidence' within the meaning of *Baxter*"); compare *National Acceptance Co. of Am. v. Bathalter*, 705 F2d 924, 930-32 (7th Cir. 1983) (holding that "a valid claim of [the Fifth Amendment] privilege in response to the allegations of a complaint must not be treated as an admission of those allegations" because "[a] *complaint* ... no matter how detailed, is not *evidence*"), with *LaSalle Bank Lake View v. Seguban*, 54 F3d 387, 390-92 (7th Cir. 1995) (permitting adverse inference where defendant asserts Fifth Amendment in response to statement of material facts submitted in support of summary judgment motion because of evidentiary content of statement of material facts).

[4] See, e.g., *SEC v. Colello*, 139 F3d 674 (9th Cir. 1998); *SEC v. Cassano*, Case No. 99 Civ. 3822, 2000 WL 1512617, 2000 U.S. Dist. LEXIS 15089 (S.D.N.Y. Oct. 11, 2000). But see *SEC v. Farrell*, Case No. 95-CV-6133T, 1996 WL 788637 (W.D.N.Y. Nov. 6, 1996). Similarly, where courts have taken the drastic step of entering orders precluding defendants in SEC enforcement actions from proving certain facts based on an assertion of the privilege against self-incrimination, they have normally done so only where such defendants asserted their Fifth Amendment rights in *both* the SEC investigation and subsequent enforcement action, not simply on the basis of what occurred during the investigation. See, e.g., *SEC v. Drexel Burnham Lambert Inc.*, 837 FSupp. 537, 606 n.6 (S.D.N.Y. 1993), aff'd on other grounds, 16 F3d 520 (2d Cir. 1994).

[5] *United States v. Hale*, 422 US 171, 176 (1975) (emphasis added).

> examination and judicially supervised procedure provide safeguards for the establishing of the whole, as against the possibility of merely partial, truth.[6]

That is, in determining whether to draw, in a subsequent SEC enforcement proceeding, an adverse inference from the assertion of the privilege, it must make at least some difference whether the assertion occurred during a prior SEC investigation, before a grand jury or in a civil case.[7]

Second, *Baxter* and its progeny recognize that the evidentiary value of an assertion of the Fifth Amendment, whether in an SEC investigation or otherwise, is often very low. An assertion of the Fifth Amendment is a poor substitute for affirmative proof of wrongdoing. Indeed, the assertion "has never been thought to be in itself a substitute for evidence that would assist in meeting a burden of production."[8]

Assertion of the privilege against self-incrimination is also not significantly probative because the innocent are equally justified (and, in an SEC investigation, perhaps just as likely) to assert their Fifth Amendment rights as the guilty are. The Supreme Court reminded us just this spring that even a witness who loudly proclaims innocence has a valid Fifth Amendment privilege against self-incrimination.[9] As a result, "once a witness invokes [the] privilege it is nigh to impossible to determine why he has done so... [Triers of fact] are left with nothing but rank speculation in attempting to draw inferences from such an event."[10]

SEC Investigations

Under the lens of *Baxter's* two specific requirements and the policies reflected in it and cases interpreting it, we turn to consider SEC investigations. An SEC investigation bears none of the hallmarks of a civil case.

In light of fundamental differences between a true civil case and an SEC investigation, it is often not "natural" to respond affirmatively to the enforcement staff's invitation to testify and, as such, an SEC investigation cannot satisfy the requirements of *Baxter*.

First and foremost, an SEC investigation adjudicates no legal rights.[11] Although the results of the investigation -- particularly the enforcement staff's recommendations to the full Commission

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[6] *Grunewald v. United States*, 353 US 391, 423 (1957) (emphasis added).

[7] See, e.g., *Doe v. Glanzer*, 232 F3d 1258, 1265 (9th Cir. 2000) (determination of whether to draw an adverse inference from a party's assertion of the Fifth Amendment is to be made "on a case-by-case basis under the microscope of the circumstances of *that particular civil litigation*") (emphasis added and discussing criteria for drawing adverse inference set forth in *SEC v. Graystone Nash Inc.*, 25 F3d 187 (3d Cir. 1994)).

[8] *United States v. Rylander*, 460 US 752, 758 (1983); see *United States v. Stelmokas*, 100 F3d 302, 311 (3d Cir. 1996) (holding that adverse judgment cannot rest on adverse inference alone), cert. denied, 520 US 1241 (1997).

[9] *Reiner*, 121 SCt at 1254-55 (discussing *Grunewald and Hoffman v. United States*, 341 US 479 (1951)).

[10] *In re Nat'l Liquidators Inc.*, 182 B.R. 186, 195 (S.D. Ohio 1995) (alteration and ellipses in original).

[11] *SEC v. Jerry T. O'Brien Inc.*, 467 US 735, 742 (1984) (discussing investigations by administrative agencies); cf. *Family Television Inc. v. SEC*, 608 F. Supp. 882, 883-84 (D.D.C. 1985) (holding that SEC investigation is not an

about whether to institute proceedings -- have important practical consequences for targets, the investigation itself is a legal nullity.

On the basis of this distinction between adjudicative and investigative proceedings, the Supreme Court has dispensed with many basic requirements of due process for non-adjudicative proceedings.[12] If SEC investigations should not be "[burdened]" said the Court, "with trial-like procedures,"[13] then it makes sense that what happens during an SEC investigation -- for example, whether a particular witness provides, or does not provide, testimony -- cannot be considered probative and should have fewer consequences down the road.

It is the very "trial-like procedures" present in a civil case -- notice of the charges, the opportunity to cross-examine and the right to present opposing witnesses and other evidence -- that make it "natural" for a witness to respond to an implication of wrongdoing in a civil case. None of these procedural requirements is present, however, in an SEC investigation.

For example, the formal order of investigation (FOI), the legal authority for the SEC staff to issue subpoenas in an investigation, rarely provides much insight into the alleged wrongdoing. These FOIs are famously opaque, often revealing little more than that unspecified persons are under investigation for securities fraud involving a particular issuer. There is certainly no requirement that the FOI specify a particular individual's allegedly illegal conduct in the same manner that a civil complaint would.[14]

Nor is there any opportunity in a non-public SEC investigation -- and the vast majority of SEC investigations are non-public[15] -- to respond to any implication of wrongdoing contained in the records of the investigation.[16] Also, the target of an SEC investigation does not have an opportunity to present evidence in response to the agency's assertions of wrongdoing.[17]

Even when the SEC finally concludes its investigation and gives a target notice that it intends to institute enforcement proceedings (a "Wells" notice), the agency requests that the target's rebuttal discuss only law and policy, not facts in the target's defense.[18] If we take seriously the

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"adversary adjudication" within meaning of provision of Equal Access to Justice Act, 5 USC §504, because, among other reasons, fee petitioners' rights are not at stake in SEC investigation).

[12] See, e.g., *Hannah v. Larche*, 363 US 420 (1960).

[13] Id. at 447-48.

[14] See, e.g., *RNR Enter Inc. v. SEC*, 122 F.3d 93, 97-98 (2d Cir.) (noting SEC's authority for industry-wide investigations and that FOI need not name a specific company or person suspected of securities law violations), cert. denied, 522 US 95 (1997).

[15] See *Jerry T. O'Brien*, 467 US at 748, n.14 (noting that "virtually all [SEC] investigations... are nonpublic"); 17 CFR § 203.5 (all formal SEC investigations are nonpublic, unless otherwise ordered).

[16] Prior to its admission in a civil case, whatever is contained in the SEC's investigative files is not yet "evidence," within the meaning of *Baxter*, thereby failing the second requirement of Baxter.

[17] See, e.g., 17 CFR §203.7(d) (limiting right to respond to "implications of wrongdoing" to public formal investigations).

[18] See Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Rel. No. 5310, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 79,010, at 82,185-86, 1972 SEC LEXIS 238, *4-5 (Sept. 27, 1972).

notion that truth is best found through the adversarial system, it cannot be said that an SEC investigation meets this standard, such that an assertion of the privilege against self-incrimination can be deemed probative.

In addition to not adjudicating legal rights or utilizing any of the procedural hallmarks of an adjudication, thereby failing the requirements of *Baxter*, an SEC investigation is not even unambiguously *civil* in nature. The "routine uses" to which the agency may put information collected during its investigations illustrate that one of the possible results of the investigation is the institution of criminal charges. Specifically, every person who is requested to supply information to the SEC is notified that: (1) the agency "often makes its files available to other governmental agencies, particularly United States Attorneys and state prosecutors;" and (2) "[there] is a likelihood that information supplied by [the person providing information] will be made available to such agencies where appropriate."[19]

In sum, where: (1) the rights of a target of an investigation are not at stake; (2) the target has no right to know exactly why he or she is under investigation; (3) the target has no right to respond to any implication of wrongdoing; (4) the target has no right to subpoena evidence on his or her behalf or to be present when other witnesses testify; (5) the target has no right to review the fruits of the SEC's investigation; and (6) the target has been warned that any information provided may be used to institute criminal proceedings against the target, can it be said that it is "natural" (as the Supreme Court means it) to provide the SEC with testimony?

Does a target have any incentive to assist the agency in its private fact-finding exercise? Under these same circumstances, is it probative that the target of an SEC investigation asserted the Fifth Amendment? By requiring that the assertion of the Fifth Amendment occur in a civil case for an adverse inference to be permissible, *Baxter* and its progeny answer these questions with a resounding "no."

Conclusion

Reducing the consequences of asserting the Fifth Amendment in an SEC investigation allows the defense to thoroughly evaluate the risk of criminal prosecution with less fear that such an assertion will come back to haunt the client. Successfully arguing that assertion of the Fifth Amendment during an SEC investigation is legally irrelevant may also allow a defendant in an enforcement action to avoid the sting of the adverse inference in civil litigation altogether if, after an attorney's initial evaluation of the case, the risks of criminal prosecution arising out of testimony during an SEC investigation are deemed minimal.

[19] See, e.g., *United States v. Teyibo*, 877 FSupp. 846, 850-51 (S.D.N.Y. 1995) (citing SEC Form 1662, "Supplemental Information for Persons Requested to Supply Information Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena"), aff'd mem., 101 F3d 681 (2d Cir. 1996).