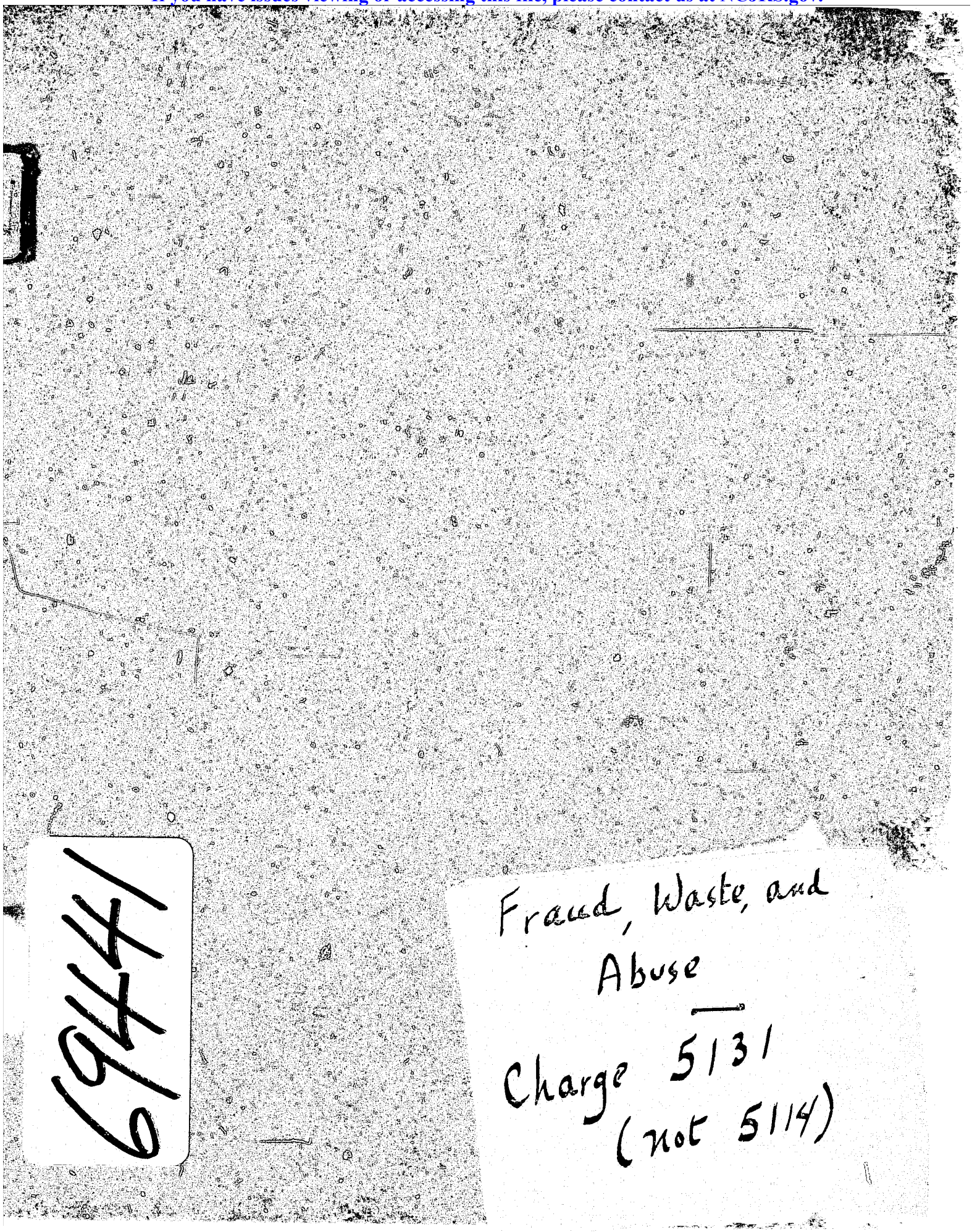

SECURITIES INVESTIGATION

By

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SECURITIES INVESTIGATION

By Richard D. Latham

When a matter comes to the attention of an inexperienced securities investigator, he is faced with real problems: what to do first and what to avoid. Experience is the only real teacher. There are thousands of variables in an investigation, all interrelated.

Mistakes in judgement are common. Entire investigations can be frustrated by early mistakes, so time spent in serious contemplation of future moves is seldom wasted. Sloppy investigation is a complete waste of time and is exemplified by the investigator not knowing what to do or not caring if a resolution is found.

Persons who are lazy, have explosive tempers, are easily frustrated or are not curious are not well suited to do securities investigation work. A securities investigator must use his common sense and must favor strong law enforcement as he is basically a white-collar cop or a detective. Two attributes of every successful securities investigator are a willingness to work hard and a large measure of common sense.

I. SOURCES OF INFORMATION WHICH MAY LEAD TO AN INVESTIGATION

Most information on which investigations are initiated is brought to the attention of the agency either by outsiders who have something to complain about or someone to rat on, or by persons who are seeking information and from whose inquiry evidence of a violation is drawn. No inquiry should be treated as routine, unless routine means giving serious attention to each inquiry.

A. COMPLAINING INVESTORS

The call or visit from a complaining investor is the best source of information. Such inquiry, in whatever form, puts the investigator in an advantageous position. He can explore deeply into the subject matter of the transaction, the issuer's affairs, the seller's representations, and events subsequent to the sale; in general, he can put together a fairly good picture of the entire operation of the company and its promoters without making the company aware that information is being collected. It is always wise to obtain as much information as possible before the subject becomes aware that he is being investigated.

Complaining investors should be treated with care, as the success of many investigations depends upon their cooperation. It is important to gather as much information as possible on the first contact with an investor. Do not take his cooperation for granted! The first contact may be the only opportunity you will have to gather information. In addition, gathering as much information as possible in one contact may save you time in the long run by avoiding additional conferences.

Some investigators have a check list of questions to ask investors on hand at all times. As the first contact from a complaining investor is frequently by telephone, always secure the caller's full name, home address and telephone number, and business address and business telephone number so that you or someone else may contact him again if necessary. Sometimes the initial contact is so vague that it becomes significant only in conjunction with other information already available within the agency. Specific questions to ask complaining investors will be discussed in Section VI.

Investors frequently want their money back and have difficulty understanding why the investigator is interested in the transaction but unable to secure a refund of their investment. Some investors also want assurances of anonymity which can usually be given within reasonable limits. Investors should be told, if they provide helpful information, that their testimony may be required at a formal proceeding. However, it is best not to disclose this until all the information sought is obtained from the investor. Investors frequently want to know if the investigator has derogatory information on the company or the principals. It is almost always best not to divulge such information even if it is available. At that stage of an investigation it is too early to make accusations since they may tarnish someone's reputation by speculating on unsubstantiated allegations. A securities investigator is in the business of gathering information and not of giving it out.

B. CONCERNED PUBLIC

Leads to possible securities law violations from the public are rare and are always suspect. Is the caller really an investor? Or is the caller a principal trying to find out if you are looking into his company? Many dishonest promoters who deal by fraudulent means are very crafty and it is wise to be alert to their deceptions. Believe nothing that they tell you and nothing that their records tell you. Believe only what you can substantiate by independent fact.

Tips from the "concerned public" are frequently inaccurate, or are based on fragmented information or a misunderstanding of the law. Therefore, check very thoroughly before committing yourself or your agency to any course of action based on this source of information unless the source has a reputation for reliability. Such sources may include attorneys who practice before the agency, registered dealers, and persons with reputations in their communities for integrity.

This does not mean that back-stabbing competitors, jealous wives and husbands and nosy neighbors do not provide good leads which must be checked out. However, remain constantly wary at the early stages of an investigation and do not take information received

from any source at face value. For example, a complainant may desire to institute an action against his competition, and the complaint may be valid. However, the complainant, himself, may be an equally suitable target for investigation.

C. ENFORCEMENT AGENCIES

Information received from another law enforcement agency is important and such leads as a general rule should be followed up quickly, especially if the other agency is conducting its own investigation. If an agency reporting a possible violation is not involved in the securities or investment field, it may be working on a case which will be enhanced by your efforts. Also, a good securities case may not be readily recognized by an inquiring agency. In any event, cooperation with other law enforcement agencies reaps benefits in the long run whether you are able to build a securities case or merely assist the other agency in its investigation.

Cooperation between law enforcement agencies is essential to good securities law enforcement. Sharing information on suspected securities law violations with other law enforcement agencies has built a firm alliance on which law enforcement depends. Any agency that refuses to share and cooperate with other enforcement agencies is not going to get information from them, and its effectiveness will soon diminish. Therefore, a good securities investigator should cultivate contacts in as many other law enforcement related agencies as he can.

D. OTHER

Newspapers are a good source of leads, especially the financial pages, business section and classified ads. Many promoters advertise the sale of their securities in violation of the securities registration, advertising and dealer provisions. Most jurisdictions consider printing an ad in the newspaper as public solicitation which voids any exemption.

Periodicals and trade journals seldom point to direct violations of securities laws, but may announce trends and practices which indicate new promotions which may involve new and exotic securities. TV and radio are generally poor sources of leads for an investigation.

Junk mail received by the agency and the agency's employees and telephone solicitation to agency employees at their homes provide good leads to public solicitation in the securities field. Information found on sidewalks and in parking lots has occasionally led to the opening of investigations.

Investigators in lull periods might check the telephone yellow pages listings of investment advisors and securities dealers against those registered in their state to determine if there are unregistered dealers advertising in the yellow pages.

II. THE PRELIMINARY CHECKS

Before a securities investigator acts upon a complaint or other lead which indicates a possible violation of securities laws, certain preliminary checks should be made. Examination of readily available source material, such as license and registration files, will frequently avoid an unnecessary waste of the investigator's

time. These may reveal that the security is registered and there is no problem, or that the misrepresentation was made by a registered dealer and it is a matter of extreme importance as a licensing problem. Sound investigative technique requires much dull, routine checking in the early stages.

A. INTERNAL FILES

A securities regulatory agency's files should be a wealth of information. Frequently this information is negligently overlooked by an investigator. Internal file information should always be checked, even in seemingly routine matters, as information discovered could reclassify a matter from routine to priority. Files and source matter which should be checked are: (1) Enforcement Division alpha files of all subjects who are, or who have ever been, under investigation or connected with an investigation, (2) Alpha lists of all general files maintained by the agency, (3) Alpha lists of all subjects ever licensed to sell securities in the state, (4) Alpha list of all subjects whose securities have ever been registered for sale in the state, (5) Index to SEC names in Securities Violations Bulletins, (6) Moody's, Standard & Poor's and Best's manuals, (7) Pink Sheets, (8) Other alphabetical indexes kept by the agency, (9) Other information, as available.

Examination of this material will frequently provide additional leads. Failure to discover any names in the above-mentioned material is itself enlightening in that it points away from chronic violators, established companies, registered dealers and salesmen, and registered securities.

B. FILES OF OTHER STATE AGENCIES

If the securities regulatory authority is not a division of the Secretary of State's Office, the records of the Secretary of State should be checked to determine the charter history, if any, of any corporation or limited partnership that may be involved. This information not only will establish identities of the original incorporators and directors, or general and limited partners, but also may reflect that the company ceased business at such a date in the past as to make further inquiry meaningless.

Information on a company still in existence may be obtained from records maintained by the state's taxing authorities such as Franchise Tax reports. These reports not only reveal the financial condition of the company but also list current officers and directors, and occasionally may reflect certain securities transactions.

Securities promoters are also frequently involved in the real estate or insurance business. Checking with the Real Estate Commission and Insurance Commission may reveal information regarding individuals in which you may be interested.

The state's police department usually maintains criminal record identification information, access to which is generally dependent on a full name and date of birth. That agency usually

maintains drivers' license records which may prove helpful in locating subjects.

In more particularized investigations, it might also be well to check with other state agencies and especially the Attorney General's Office, if it has a Consumer Protection Division.

Judicious use of the above-mentioned sources of information is advised as an investigator can make a nuisance of himself by repeatedly checking with an agency for information which does not produce significant results. As a general rule, it is over-investigation to check outside of the office files if you have no reason to be suspicious of the subject on which you are checking, or if you have no reasonable expectation of obtaining information from your search.

C. FILES OF THE SECURITIES AND EXCHANGE COMMISSION AND OTHER STATES

When facts or a solid hunch make the existence of a violation of your securities law probable, it is wise to check with the appropriate Regional Office of the Securities and Exchange Commission and any other states which may be affected as they may have information you need or may need the information you have. If the seller or the purchaser is in the state affected or if there is any reason to believe sales were made in more than one state, then checking with the other jurisdiction is a courtesy to which they are entitled. If that jurisdiction repeatedly expresses no interest in your information then you may safely assume that they need not be informed.

The SEC has a computerized information retrieval system in Washington which contains information on all subjects which have come to its attention. If the subject of your inquiry is other than a small one-shot deal, and a substantive violation of the securities laws is probable, a request may be made for a search of the SEC records. Judicious use of this source is also advisable so you will not become a nuisance.

D. OUTSIDE QUICK REFERENCE SOURCES

City directories and telephone books are frequently good sources of information for locating subjects. The Chambers of Commerce and State Libraries frequently have city directories of all major cities in the state and large cities nationwide. Major offices of telephone companies maintain telephone directories for many cities, especially those within the state. If a trip is being made to interview numerous persons, it is frequently a great time saver to locate the home and business addresses of subjects before beginning the trip.

City directories are also helpful in learning the occupation of subjects. This knowledge is sometimes helpful in the early stages of an investigation in determining the general character of the promoters.

Funk and Scott publishes an index to corporate items that have appeared in newspapers and periodicals. This source can give valuable information about the company under investigation.

E. HOW TO LOCATE THE PRINCIPALS

In many investigations, it will be necessary to locate the principals of the company so that they may be interviewed or so that books and records may be obtained from them by subpoena. In most cases, location of principals is not difficult. Occasionally, however, the whereabouts of principals, other insiders and shareholders are intentionally or unintentionally hidden. An unlisted telephone number can effectively conceal an address as well. If a person moves frequently and his place of employment is not known, locating him can be quite different.

If the address or full name of a principal is known, a city directory will probably state the business address where he may be reached during the day. If the person is believed to have an unlisted telephone number or if you have a telephone number and are not sure that it belongs to the individual sought, the Intelligence Division of the local telephone company may be helpful in locating the person. Personal contact with the intelligence agents is normally required to establish a friendly and workable rapport. This source should not be used unless absolutely necessary.

Telephone company records should be considered, however, in major investigations. Toll slips for long distance telephone calls can often prove very useful in locating offerees and purchasers, especially in investigation of boiler room selling operations where extremely large numbers of telephone calls are made.

In most cities, the Better Business Bureau is very cooperative and may be of assistance. A contact with the Retail Credit Bureau, usually difficult to establish, can furnish a wealth of information. The Retail Credit Bureaus keep track of people as well as maintain and run complete dossiers on them. They almost always have the most current address on subjects and may know a great deal about companies with which they are associated and their investments.

The Postal Inspectors can assist in locating persons who have recently moved and provide addresses on persons where the only address listed is a post office box. The Postal Inspectors may be interested in assisting you in your investigation, as many securities violations also involve mail fraud.

Building managers are good sources for tracing tenants who have recently moved. If the location of a subject's bank account is not known and you speak to the building manager, ask if he recalls the bank on which the individual or company drew checks paying rent.

Occupants of offices neighboring those that have been recently vacated can occasionally be of assistance. However, neighbors in residential areas are generally unproductive sources of information but should be tried as a last resort. Investigators must be inventive. When one method of locating a witness fails, others must be tried. Giving up is never the proper solution.

III. THE INITIAL DECISIONS

A. JURISDICTIONAL PROBLEMS

1. NO APPARENT JURISDICTION

State regulatory agencies receive many inquiries involving matters which are obviously not within their jurisdiction or in which no action can be taken because possible violations are long since barred by the Statutes of Limitations. These matters are easily disposed of as no thought is ever given to opening an investigation. In some cases, the complainant, the news story, or other source indicates a matter which appears to involve the sale of securities but subsequent inquiry reveals it does not. In this case the matter should be put aside at once or referred to an appropriate agency for further inquiry.

In some cases, a violation of securities laws is obvious but the jurisdiction of the violation is vested in another state or should more properly be assumed by the Securities and Exchange Commission. In such cases, the appropriate jurisdiction should be informed.

For violations too old for meaningful action, the names of the principals of the company should be indexed in permanent files of the agency and retained for future reference, as a connection with subsequent investigations may be established.

If a violation of law seems likely but it is not possible to determine that the agency has jurisdiction, then the agency should proceed with an investigation of the matter to determine whether or not facts exist which give it jurisdiction.

2. POSSIBLE JURISDICTION

Because of the ever-expanding field of securities law, there appear many new schemes every year which look like something else, but in fact involve the sale of securities. These investigations are the most difficult and require the greatest care. It is always better to assume that a security is involved and try to prove it rather than to let possible fraudulent activity go uninvestigated.

The general law enforcement agencies within a state investigate violent crimes and have very little expertise in the white-collar crime area. Therefore, the securities investigative agency within a state may be one of the few equipped to perform investigations this area. A securities agency would be derelict in its duty if it did not make at least a cursory examination into a promotion in which it may have jurisdiction, as it may be the only agency which could regulate the activity.

A securities investigator should not attempt to investigate cases that would be better handled elsewhere. Parallel investigations are generally a waste of time; therefore, if only a small amount of the securities transaction or fraud occurred within the state, it is better

to leave the matter to other jurisdictions, assuming that they wish to take the lead in the inquiry.

3. PROBABLE JURISDICTION

If the item sold is clearly within the definition of a security, the purchaser was in your state, and action is not barred by the applicable Statute of Limitations, then jurisdiction is easily established. When jurisdiction is probable, the investigator may concentrate on the secondary problems of deciding what type of case it is and what, if anything, he can do with it. Having jurisdiction simply opens the door to the vast maze of problems ahead.

B. WHAT TYPE OF CASE IS IT?

Violations of the securities laws are basically divided into: sales by broker-dealers and their salesmen, both registered and unregistered; sale of securities, both registered and unregistered; fraud in the sale of securities; and technical violations. These different types of cases require different procedures in order to get an investigation successfully started. Before actually commencing an investigation, it is important to have a rough idea of what you are after, where to obtain it, what the information will reflect and what you can do with it.

1. BROKER-DEALER OR SALESMAN

The sale of securities by an unregistered dealer is a standard violation. One of the first things to establish is whether or not the seller of securities is registered. If not, and no exemption from dealer registration is available, the violation is easily proved. The investigator, however, is advised to be extremely thorough in examining exemptions from dealer registration to be sure that none can be claimed. Many problems will arise in determining whether or not under a particular fact situation the exemption exists.

On occasion a registered dealer will employ unregistered salesmen in his office. In some jurisdictions a salesman can sell while his application for registration is pending; in others, this is a violation.

Registered broker-dealers are generally not subjects of investigative activity, however, when one does commit a violation of the securities laws, it is a serious problem which always deserves priority. The largest source of investigative activity in the broker-dealer, salesman area is the initial licensing of the companies and

individuals. States which have strict net capital requirements or which do periodic examinations of broker-dealers have their own specific criteria for broker-dealer examinations. Most securities laws make it punishable to file false applications and reports. License application forms should be read carefully to determine if derogatory information is revealed. A check with the state's law enforcement agencies and those of other states where the applicant has resided should be made unless an FBI fingerprint check is a routine part of the licensing procedure. If inconsistencies exist between what the investigation reveals and the answers made by the applicant, further inquiry is clearly warranted. Applicants, whose disregard for the public welfare has been established by past criminal convictions or whose propensity for lying is revealed by failures to disclose information on the application form, should be viewed with extreme suspicion. It is easier to deny than to revoke a license.

Investigators should be watchful for cheating on any examinations by applicants for securities licenses. Because the answers to questions soon become almost common knowledge in the industry, it is advisable to change the questions with regularity, if possible. Jurisdictions that regulate investment advisers separately would find the above applicable to such.

2. UNREGISTERED SECURITIES

The sale of unregistered securities occurs with as much frequency as does the sale of securities by unregistered dealers. Registration files and reference books that would reflect exempt status should be checked before any other investigative steps are pursued. If the securities are found not to be registered, then a determination must be made as to whether the securities should have been registered. Frequently, it is not possible to determine whether an exemption exists without additional investigation as to the number of investors, who they are, their relationship with the promoters, their general sophistication, the size and nature of commissions and other remuneration paid, and whether advertising or solicitation was used. In many jurisdictions, the state does not have the burden of negating an exemption, it being the duty of the issuer or seller to prove the exemption. However, as a practical matter, the state must satisfy itself that no exemption exists and be able to prove it before maintaining any action. Therefore, it is important to gather the facts that will negate any exemption as quickly as possible.

3. TECHNICAL VIOLATIONS

If a sale of securities is made in violation of statutory language but harms no person or company, it is considered a technical violation.

These can easily involve both the sale of unregistered securities and the sale of securities by unregistered dealers as well as violations of other sections of a state's statute. It is generally inadvisable to pursue substantive action against technical violations as jury sympathy will lie with the defendant. An investigation should normally be closed after it is established that only technical violations exist, unless an extremely important question of law is present which must be tested. Frequently, voluntary compliance may be achieved through a rescission offer; in other situations an undertaking may provide an adequate remedy.

4. FRAUD

Violations of securities laws involving fraud are common, as the definition of fraud in the securities area is very broad. Almost all fraud in securities cases involves the making of false representations to purchasers in order to induce them to purchase securities, or the failure to disclose relevant facts to a purchaser which could have influenced his investment decision. Fraud may, for example, involve the principals absconding with the proceeds of the offering. This can be pled as a failure to disclose. Such conduct would also be a violation of Section 101.(1), (2) and (3) of the Uniform Securities Act.

It is important to associate a fraud as closely as possible with the selling process for it is more difficult to prevail if the fraud occurs after the time that the investor buys the securities, as most securities laws are structured around the sale. Particular stress must be placed on establishing the fraud when conducting witness interviews.

In reality, the strength or weakness of a case is determined by the degree and nature of the fraud perpetrated upon investors. Any case which appears to involve fraud deserves attention regardless of the size of the offering or the number of investors. Its rank in the priority list will be determined by how many bigger frauds are ahead of it.

Neither promoters nor their attorneys like to hear the word fraud. It is extremely difficult to obtain consent cease and desist orders if the word fraud is used; but much less difficult if fair, just and equitable language is employed.

5. COMBINATIONS

Many securities cases allege the sale of unregistered securities by unregistered dealers which work a fraud upon purchasers. A good investigation normally produces sufficient evidence to substantiate all of these. It is somewhat rare to find registered securities dealers or registered securities involved in fraud cases. Fraud is more frequently found in a situation where applications for registration of dealers or securities are pending. These situations will

normally be brought to the attention of the investigator by the Securities Registration and Dealer Registration Divisions of the agency.

C. PRIORITIES

It is often difficult to set priorities on investigative matters. Frequently, some investigation is necessary to determine what the priority of a case should be, even though the investigator is too busy working on high priority matters to do the necessary preliminary investigation at that time. Common sense on the part of the investigator in setting priorities for his cases is extremely important. As it is seldom possible to investigate all cases assigned, an investigator who sets improper priorities is generally making unproductive use of his time.

1. LOW PRIORITY

Low Priority cases include those in which only technical violations are believed to exist, in which fraud is not likely or in which there may have been some fraud but all of the investors profited from the investment. There are some exceptions in situations where the potential for abuse is so great that action is warranted even though there are no complainants. Set low priorities in cases if there were offers made in violation of the law but no sales were consummated, and in situations in which the purchasers are believed to be culpable.

2. ROUTINE PRIORITY

There is a tendency in enforcement of securities laws to give greater attention to a case at first until it loses its luster and is set aside for the next new case. This practice is not productive and accomplishes little or no result. To avoid this habit, place most cases into a routine category from the beginning and make no more of them than they merit. Ninety percent of all investigations are routine, and unless the significance of the case is obvious, the investigation should be treated as such.

3. HIGH PRIORITIES

It is essential that investigations be treated as high priority only after careful thought has been given to the matter. There is a tendency to set priorities too quickly and, therefore, to set too many high priority matters, resulting in one partially completed investigation followed by another.

High priority cases are important for one of a variety of reasons. The amount of money involved may be extremely large

or there may be a large number of investors. High priorities also are given to new fad investment schemes which must be dealt with before they cause a scandal. High priorities are also set if there are registered dealers or registered securities involved, because of time limits and not because the subject matter is significant.

If the staff is not large enough to handle high priority matters as well as routine matters, the agency will make little or no progress in meaningful enforcement of its securities law. High priorities are set for those cases where the agency has the opportunity to make a significant contribution to the enforcement of its state's securities law and where the benefit will reach a large number of persons.

4. PARAMOUNT PRIORITY

This category of priority is reserved for situations where the agency itself is under attack in the form of a lawsuit seeking a declaratory judgement, where an agency's order is appealed and mop-up investigation is necessary, or where the assistance of the agency is necessary in helping its attorneys prepare for a court action.

D. IS IT A WILD GOOSE CHASE?

Frequently, an investigation that started out on a shaky lead fails to produce an actionable case. An exemption may be available, or leads may turn out to be inaccurate or non-existent. If the investigator walks into enough blind alleys looking for leads and has become completely frustrated in his attempts to gain information, he should stop further investigation activity and close the case. Agencies tend to be afraid to close a case because something may have been missed, so the investigation drags on until the Statute of Limitations has run. Meanwhile, investigators are writing reports and shuffling papers on inactive cases that should have been closed.

Also, investigators tend not to give up on a case; if the original facts prove to be inaccurate and a violation is not found, they look for others. This generally is unproductive use of investigators' time. Remember that preliminary investigation before opening a formal investigation on a case will diminish the clutter of unactionable cases.

E. WHAT IS THE APPROPRIATE REMEDY?

Determination of the appropriate remedy is a major decision. In some cases, the agency structure determines the remedy; in others, remedies are dictated by a practical consideration of the agency's favorable or unfavorable standing with the state's Attorney General's Office or with other agencies upon which it must rely. All agency members should do everything within their power to maintain good

working relationships with those agencies. Professionalism on the part of staff members is important in maintaining these necessary liaisons.

The three basic remedies are administrative actions, injunctive actions and criminal actions. Frequently, consideration may be given to an administrative or injunctive action followed by criminal action. If the violation occurred in the past, but within the Statute of Limitations, then criminal action probably should be considered. Little can be gained by having a cease and desist hearing or obtaining an injunction against activities which occurred in the distant past, except in the instance where wide publicity of the fraud or inequitable practices would significantly increase the probability of civil suits by investors who would otherwise be unaware that a civil remedy is available to them. In such instances, an administrative hearing with wide publicity may be desirable simply for the purpose of bringing out the facts.

Cease and desist orders can generally be obtained quickly. Some jurisdictions have the ability to issue Ex Parte Cease and Desist Orders, while others require a hearing before entry of an order. Where there are not many disputed facts which make the case complicated, a cease and desist hearing can work almost as well as an injunction in putting a quick stop to illegal activity. An injunction is extremely well suited to stopping the illegal activities of individuals as well as their companies and, coupled with the use of a temporary restraining order, can be obtained promptly. However, in injunctive actions the agency usually depends on the Attorney General, whose opinion of the case may not necessarily parallel that of the agency. Neither injunctive nor cease and desist action should be filed without thorough investigation, as the agency may be called upon promptly to prove its case in an appeal of a cease and desist action or a trial on the merits of an injunctive action.

Absent fraud, there is little chance of maintaining a successful criminal action. The lying, cheating and stealing has to be bad enough to raise the ire of an average juror before a criminal conviction is likely. The possibility of agreed settlements of such cases should not be overlooked. If the principals are caught red-handed, and they are represented by astute counsel, it is often practical to enter an agreed order or an agreed settlement to an injunctive action if it is completely satisfactory to the agency. However, no investigator should consider settling a case simply to expedite the matter.

Frequently, a subject has clearly violated the law but did not intend to do any harm or to profit at the expense of someone else. In most of these instances, the violator is perfectly willing to voluntarily cease and desist his activities, make a rescission offer and to voluntarily comply with securities laws. In fact, voluntary compliance with the laws by the unintentional violator will often be undertaken during the preliminary investigation stage before a formal case is ever opened. Many of these small cases of unintentional

violations of the securities law occur with regard to advertising of securities for sale in the newspaper, or in attempts to raise capital for small businesses. These cases may also include some inadvertent violations by large businesses which are normally not involved in the securities area.

Investigators should be extremely cautious not to assume that all violators of securities laws are crooks. Investigators should always be on their best behavior and treat both the subject who has committed an honest mistake and the fraudulent promoter with courtesy and respect.

IV. OPENING AN INVESTIGATION

An investigation should be opened when a decision is made that an in-depth examination into a matter is necessary. There must be a valid lead to be followed, and the internal record checks should have been completed. A decision must be reached that a probable violation of the Act has occurred and that something constructive can be accomplished by pursuing the matter.

Agencies must keep records, and a formal investigation file into which all material relating to that particular matter can be properly indexed and stored is advantageous. The investigation is usually given the name of the major entity, i.e., the issuer, the name of the dealer or the primary individual involved in the matter. The investigation is then assigned to a specific investigator for action. In some cases, a specific priority is placed on the matter from the beginning. In other cases, it will be up to the investigator to place the appropriate priority upon the matter. The investigator should note the source of information leading to the opening of the investigation, outline the basic facts regarding the matter, name all known principals in the investigation file itself and appropriately index those subjects to the agency's investigation files.

Any document relating to an investigative matter, which has been received by the agency should be incorporated into the investigation file so that all relevant items can be kept in one place. However, if the matter involves a dealer license or securities registration, or if a securities exemption is questioned, it is not advisable to place original records of other divisions in the investigation files; it is preferable to make copies of the needed documents and retain them. Constant vigilance must be maintained to see that all principals and new leads are properly indexed as they come in. The information retrieval system in the Enforcement Division is only as good as the information that is put into it.

It is generally appropriate for only one person within the Enforcement Division to have the authority to open investigations.

Investigators who have received information indicating violations of the Act should request that investigations be opened.

V. THE PRELIMINARY MOVES

Getting an investigation started right is extremely important. A little time spent in planning the appropriate steps in an investigation will reap substantial benefits later.

A. EVALUATION OF WHAT IS KNOWN FROM PRELIMINARY CHECKS

A good deal of information can be discovered about an issuer or dealer as well as many of the principals before any investor or principal in the company (other than a complainant, if any) has been contacted: whether the company has a charter to do business in the state, and if so, whether the charter is active or dead; whether the company has been in business for some time or whether it is a new promotion; whether the incorporators of the company are figureheads, such as the attorneys who assisted in the incorporation of the business, or are active in the business - a quick check of the legal directory of your state or in the Martindale Hubbell Directory for other states will indicate whether the incorporators are all attorneys at the same address or are probably the promoters of the business, or a check of city directories will perhaps reveal the occupation of the promoters and will give some indication of the caliber of persons with whom you will be dealing; and whether or not agency files reflect any history of any of the persons or companies. Are the persons registered dealers or salesmen, is the security registered, do the individuals have a history of previous fraudulent securities promotion? Knowing the answers to these questions will help direct the investigator's next moves. If a complainant is talked to initially, then a determination should be made whether his story implies that sales were made through misrepresentation. Very little experience is needed for the investigator to recognize misrepresentations. Most of the questions with regard to jurisdiction, type of case, priority and possible remedy will normally have answers at this point.

After the general picture is established, it then becomes necessary to really "do something." Does the investigator talk to the principals first or the investors, subpoena bank records or company records? Common sense provides most of the answers. An investigator should never act impulsively. Sellers of securities in fraudulent schemes will frequently hide or run when they become aware that they are under serious investigation, and if he does not proceed properly, the investigator will never see the company's books and records. In some instances, companies and their officers will take offense if they are subpoenaed to produce their records rather than having been approached and merely asked for them. However, unless the issuer

is a substantial entity, it is always advisable to be safe rather than sorry in matters regarding subpoenas. Sometimes the investigator has a list of several investors and will pick one who turns out to be friendly with the promoter; the investigator will wish he were standing at the company's door serving a subpoena, because as soon as he leaves, he knows that the investor will call the promoter. An investigator must be continually on guard not to unduly alarm investors or create a panic among them, especially early in an investigation when the investigation is new and no substantive violation of the law has been established.

Securities investigation is not a science, but an art. Perfection is never possible and can be approached only if investigators are constantly wary and weigh the consequences of every move they make. Successful early case evaluation is largely technique, based upon experience, and cannot be adequately set forth in a manual. Therefore, new investigators are advised to seek the advice of more experienced investigators in matters involving case evaluation.

B. EASY AND QUICK SOURCES OF FURTHER INFORMATION

If little solid information regarding the identity, location and business history of companies is obtainable from an investigator's regular sources, then outside sources of information should be checked.

A good deal of information on a company is available from the Better Business Bureau offices located in the same cities as the company. Investors call their Better Business Bureaus more frequently than they do securities regulatory authorities and the Better Business Bureaus may have had calls from investors regarding the company in which the investigator is interested. The Better Business Bureau normally sends questionnaire forms to new businesses which, though not particularly detailed, contain information regarding the nature of the business, who some of the officers are, the company's location and other general business information.

Dun & Bradstreet has a service which does routine inquiries on companies and their principals. Their report is usually rather bland, however, it has good background information. The Dunn & Bradstreet information is generally not available unless the agency subscribes to the Dunn & Bradstreet Service. If the investigator is interested in general background information only, the Dunn & Bradstreet Service is useful, but, if an in-depth investigation is planned from the beginning, the investigator can likely ascertain the same information from other sources.

If proper liaison can be established, the Retail Credit Bureau is an excellent source of background information on companies and their principals.

The Intelligence Division of the Telephone Company is a a very good source for locating addresses for unlisted telephone

numbers and the name and address of the person who holds a particular telephone number. Telephone toll slips are not maintained for long periods of time, however, if the investigation is proximate in time to the actual promotion, these can provide significant leads, especially if sales are made from a boiler room. Subpoenas for some telephone company information will be required.

If promoters are believed to be drifting around, it is advisable to check with motel managers and places where the subjects have stayed, especially if the investigation begins shortly after the promotion has commenced. Motel managers can often supply the investigator with a list of telephone numbers called by the subjects and will have learned some information regarding the promotion by talking with the promoters.

Building managers can provide useful information.

Electric, gas and other utility companies should not be overlooked in searching for leads as to the whereabouts of subjects.

Banks are good sources of information if proper liaison is first established. Many banks are, or become hostile because subpoenas often require them to expend considerable time in digging up information. However, with proper liaison, the existence of accounts and relative activity of those accounts may be ascertained without the necessity of a subpoena.

Promoters, especially of fraudulent securities, are cunning and crafty. An investigator should never let himself be outsmarted by them. A little time spent reflecting will reveal many sources of information which can be tapped. Persons own automobiles and boats which have to be registered; they have driver's licenses which are recorded; they maintain a wide variety of credit cards and charge accounts. Many promoters of fraudulent securities have judgments against them which may lead to attorneys and other victims. Many promoters of fraudulent securities have girlfriends through whom they may be traced.

C. DECIDING HOW TO PROCEED

After some practice, each investigator will find procedures that work well for him. It is not necessary that every investigator follow the same procedure.

1. WHOM TO TALK TO AND WHEN

Two theories exist. One is to talk to the principals first and get all of the records quickly. Another is to talk to several purchasers first, if they can be located, and get a feeling for the overall facts before confronting the principals. If information leading to the investigation is from a complainant, then talking to purchasers first is virtually automatic and is certainly the most comfortable situation for an investigator. Confrontation of principals, without basic facts on the primary "pitch" and how the promotion is designed is extremely precarious and leaves the investigator groping. This heightens the possibility of the investigator being completely deceived by the promoters. No matter what transpires, the investigator should never submit to questioning by a

promoter or his attorney. To keep silent and act the fool rather than to speak up and prove that you are one, is good advice to an investigator under fire by a promoter's skillful attorney who may learn from the confrontation far more than the investigator. An investigator should remember at all times that it is not his function to give information to promoters or purchasers unless it will benefit his case.

When talking to promoters, it is advisable to give each individual a warning as to his Constitutional right to remain silent and to counsel, even if it is an informal conversation. Once a promoter hires an attorney, he should be consulted before talking to the promoter on subsequent occasions.

One should generally subpoena the company's books and records and fully digest them before talking to the principals "on the record". The investigator will then have a better grasp of the relevant facts and can ask more intelligent questions. Frequently, examination of books and records and conversations with investors are sufficient to resolve how to proceed. In possible criminal cases, the less contact the investigator has with the target of the investigation, the better.

When a subpoena is to be served on a bank, telephone company, etc.(everyone except company principals), talk to an officer at the institution whose records are being subpoenaed in advance of service so that he will be aware that the subpoena is coming and not be unduly surprised. Remember, that you will be going to these institutions repeatedly and that good relations must be maintained for your investigations to work properly. Also, after some dealings with the same person at the institution, it may be possible to obtain limited information without a subpoena and save yourself and the institution a great deal of time. If not properly treated, banks will get tired of honoring requests for records regarding their customers, and the investigator will find himself searching out all of the microfilmed records himself.

If a decision is made to talk to the principals of a company under investigation, it is frequently productive to talk with company employees, especially secretaries in the administrative offices. The boss's secretary will frequently have more specific information about certain details of the business than he does. It is often desirable to question company officials under oath, on the record and back-to-back so that they will not have an opportunity to compare their stories. This is not always practical, and an investigator will learn from experience when formal proceedings are necessary and when they are not.

2. WHAT RECORDS TO LOOK FOR AND WHERE

Books and records are the key to almost every investigation. Hard core fraudulent promoters keep few records, however, even the slyest of them must usually maintain a bank account and issue some sort of an instrument representing the interest sold to investors. Investor's records can also be very skimpy.

a. OBTAINED FROM PURCHASER

The purchaser should have the cancelled check used to pay for the securities purchased. If not the purchaser may have used a cashier's check to make the purchase; he should have a receipt from the issuing bank, which should have a copy of the cashier's check that shows its deposit in the promoter's account. Although certain very sly promoters will cash the check at the investor's bank this practice is rare. The purchaser should also have a receipt of some kind evidencing his purchase. This is usually in the form of a stock certificate, interest in limited partnership, bond, note or debenture. In some instances, the purchaser will also have been given at the time he handed over his check a receipt evidencing the sale. The investor should be asked for all offering brochures, pamphlets, prospectuses and other correspondence which he may have received from the company as well as copies of any correspondence which he sent to the company. If the investor was left with a sample of the company's product, the investigator should examine this. The investor may not know what the investigator is talking about, and therefore, the investigator should ask to examine everything else which was received from the issuer or seller of the securities.

b. OBTAINED FROM THE COMPANY

Company books and records come in all forms. The first thing to examine in a small company is the stub book of issued stock certificates. This should reveal in a detailed fashion the identity of shareholders, the amount of securities held and should also reveal any trading that has occurred. Larger issuers maintain stock ledgers which may be examined after a spot check is made to ascertain that they are substantially accurate. Large companies with transfer agents may not maintain stub books or stock ledgers and have only lists of shareholders. This can compound an investigator's problems.

The company's correspondence and memorandum file should be thoroughly scrutinized, especially as to correspondence with shareholders and prospective shareholders, and memos and notes between company insiders.

The corporate minute books of directors and shareholders' meetings should be examined as well as the corporate charter and by-laws. In smaller companies, these documents will be fragmented or non-existent. Of the above items, the minutes of directors meetings are generally the most useful.

Frequently, in smaller operations, no formal books of accounts exist, in which case, bank statements, deposit slips, checks and other banking items must be examined to determine where

the offering proceeds went. The sophistication of the promoter will affect how cleverly a rake-off of funds is concealed. If bank accounts are used as a major source of information, it is likely that all checks and deposits will have to be scheduled, and this is almost as time consuming as reading microfilm. If books of accounts do exist, make sample checks against bank statements to determine accuracy, then carefully review the books. Investigators should also examine all loan agreements.

If this examination reveals that a company has put all of the capital raised into trying to make the company a success the chances of making a good criminal case are poor. However, other remedies should be vigorously pursued if the public is being harmed.

Most established companies have financial statements, which should also be examined. If a CPA did the financial statements, a subpoena directed to the accountant for his working papers may be advisable.

All advertising material, brochures, pamphlets, advertisements and other offering materials should be examined. This material is especially important in detecting misrepresentations or failures to disclose and for establishing whether a public offering was made. In addition to the stock receipt books and stock ledgers, an examination should be made to determine if there are any pre-organization certificates, subscription agreements, stock reservation orders, debenture registers, bond registers, or sales confirmation slips.

If a security other than corporate stock is involved, it will be necessary to examine other records. If oil and gas interests are involved, it may be necessary to examine oil leases, drilling orders, well logs, production records and similar information. If real estate is being offered, then an examination will have to be made of purchase agreements, escrow agreements, deeds of trust, management contracts; a trip to the courthouse to verify deed records may be necessary.

It is advisable for an investigator to establish forms containing information which he is likely to need in specific types of investigations and to add to them each time a new document is discovered that will prove beneficial in subsequent investigations. Then when an examination is made or a subpoena is requested, the investigator can go through his list and have readily available a list of information which he believes will be necessary to resolve the matter then pending.

c. OBTAINED FROM BANKS

If records cannot be obtained from the company under investigation, then the financial records of the company may be built from bank records. The bank may be located by examination of the purchaser's cancelled check.

In obtaining information from banks, it is best to ask only for the records that you actually believe you will need and

not burden the bank with requests for unnecessary information. Information from banks is critical to the success of many investigations and the Agency's relationship with banks, especially in metropolitan areas, is absolutely essential. Therefore, the investigator must treat the bankers with whom he deals with the utmost respect.

The following is an example form of a subpoena used to obtain bank records. Any or all of the numbered paragraphs can be incorporated to obtain the information sought.

> All books and records in the possession and control of X bank in anywise relating to John Doe, for the period from _____ _____ to _____, including but not limited to the following:
>
> (1) All signature cards reflecting the correct name of each account and revealing the authorized signators and their signatures;
> (2) All account ledgers, ledger cards, statements, ledger sheets, checks and items of deposit and withdrawal;
> (3) All financial statements and all records revealing loans made to such accounts, including, but not limited to, notes, security agreements, or documents describing the security for such loans, and account records revealing repayment of such loans or extension of their maturity dates;
> (4) All records reflecting receipt of or issuance of cashier's checks;
> (5) All stock powers, stock transfer records, signature cards, or contracts relating to such;
> (6) All memoranda and correspondence.

d. OBTAINED FROM BROKER-DEALERS

If your state does broker-dealer examinations on a regular basis, it will have a great deal of expertise in obtaining information from broker-dealers. Non-examining states have almost no expertise in obtaining such records as broker-dealer problems are not routine enforcement matters.

The major broker-dealer enforcement problems include market manipulation, sale of unregistered securities, sale by unregistered persons, churning of accounts, unauthorized trading in accounts, charging excess markups and commissions, and unsound financial condition.

Almost every broker-dealer maintains a document called a daily blotter on which purchases and sales of securities are entered in the order in which they are made. Many also maintain broker-dealer accounts, customer accounts and a general ledger. Large dealers may have more specialized systems. Broker-dealers also keep copies of confirmation slips and the order tickets which substantiate the confirmation slips. Broker-dealers also maintain financial records similar to those of other companies. Individual salesmen of the dealer, also referred to as account executives and registered representatives, frequently will keep a separate book by security and by customer showing all of their trading. From these records, the above-mentioned problem areas can be checked, and improper activity or conduct can be verified and documented.

A new investigator should visit a broker-dealer and be walked through the entire back-office procedure to learn the basics of a brokerage operation.

Broker-dealers should be able to promptly produce for an investigator books or confirmation slips showing all trades by security, by customer and by date. This information will include the full name of the security, the name and address of the customer, the number of shares involved and the price paid, the commission paid or the markup added on to the dealer's original purchase price. Dealers are, of course, entitled to make a profit for their efforts. However, some dealers purchase securities at deep discounts and then sell them to purchasers at prices in excess of the current market price.

Broker-dealers, especially if they have something to hide, will attempt to claim that they do not maintain certain records or that they are currently inaccessible, perhaps being in the hands of the company auditors. Do not be put off by broker-dealers who use these tactics. Chances are they do have the information available, or if not, it will be readily available. Broker-dealers are somewhat vulnerable since they operate via a license granted by the state and cannot afford to be too uncooperative with state investigators. In situations where the dealer is not the target of the investigation, cooperation by the dealer is usually excellent. Most dealers do not, however, call violations of securities laws of which they may be aware to the attention of the securities enforcement agency unless they are suffering an economic loss.

Dealers maintain files of complaints received from customers which should always be examined for violations other than those which occasioned the visit to the dealer's office. Most dealers have procedure manuals which are especially helpful in determining what the office procedure is, and may assist in establishing knowledge on the part of the company employees as to the improper nature of their behavior.

The Securities and Exchange Commission and the National Association of Securities Dealers do broker-dealer inspections on a regular basis and can be of great assistance in obtaining information on broker-dealers. One of the organizations may have recently done a broker-dealer examination and will have information of direct benefit to the investigator or may be about to do an inspection. In this case if only a few items are required to be checked, it may be done for the investigator, or if not a joint inspection may be performed. In any event, if substantial violation of the law is probable, check with the NASD and the SEC before inspecting a broker-dealer also under their jurisdiction.

e. OBTAINED FROM TRANSFER AGENTS

It is rare that information will be required from transfer agents, as entities large enough to require a transfer agent commit substantially fewer violations of securities laws than do small start-up companies. When information is required from a

transfer agent, have the issuer request and obtain the information for you if at all practical. Almost all transfer agent systems are now computerized and the computers are seldom programmed to supply information in a form easily usable by the investigator. In many cases, the investigator must examine an enormous quantity of almost completely undecipherable computer print-out to obtain any meaningful answers.

f. OBTAINED FROM OTHER SOURCES

(1) TELEPHONE COMPANY RECORDS

Toll slips of long distance telephone calls are frequently helpful in fraud investigations and in investigations of sales where a boiler room operation is being used. Telephone companies do not maintain these records for more than six months to a year and a subpoena is normally required in order to obtain them.

(2) ACCOUNTANTS

Accountants' work papers prepared in the course of an audit of a company's records are frequently very useful in situations where the company's financial condition is in question. A subpoena is normally required and a staff C.P.A. should assist in its preparation so that proper terminology will be used.

(3) ATTORNEYS

Attorneys may keep some company records in their possession. These usually consist of the minutes books, contracts, correspondence and perhaps shareholder records. Attorneys may not claim the attorney client privilege as to corporate records. It is a common ploy for attorneys to claim that some of the records are personal, but do not be put off by such tactics and insist that the subpoena be honored in its entirety. If any personal records are found in the corporate records, indicate that you will return them to the attorney promptly.

In some instances, an attorney will claim an attorney client privilege because the entity is not a corporation. This claim of privilege is usually not valid, and there is a line of cases which seems to indicate that the privilege, as to records involving an unincorporated entity, is not available to a person who holds himself out as a business entity to the public.

(4) COURTHOUSE RECORDS

Investigations involving real estate and oil and gas or mining leases may require examination of deed and lease records in the County Clerk's Office at the appropriate County Courthouse.

Judgments against Defendants are also recorded at the Courthouse and may be useful in fraud investigations to ascertain the background and financial ability of the subject. Lien records are useful for the same purpose.

Some counties maintain vehicle ownership information on current license plates issued within that county. This is useful in establishing the identity of a subject if his car license plate number can be ascertained. The state police also frequently maintain this information.

(5) NCIC

In fraud investigations, it is always wise to run the name and description of subjects through the National Crime Information Center to determine if they are wanted elsewhere for other crimes. The National Crime Information Center also maintains information on some stolen securities, and it is always wise to check through NCIC if the case involves stolen securities.

VI. INTERVIEW OF PERSONS

A. GENERAL

In addition to physical evidence, evidence obtained from interviewing witnesses is generally critical to any case. The investigator must develop skills in conducting interviews with witnesses, such as how to ask questions which produce useful answers. It is also extremely important to learn how to listen attentively to what the witness is saying. Techniques that work well with one witness do not work with another, therefore, the investigator must be adaptable and resourceful in developing ways to elicit information.

When an investigator comes in contact with any witness, he must always immediately identify himself and, if the contact is in person as opposed to via telephone, show the proper identification to the person. It is preferable to hand his identification to the person and give him an opportunity to examine it rather than merely "flash the badge." However, be careful to always have possession of the identification by the time the interview is terminated.

An investigator should attempt to make everything he does seem routine. Witnesses are often extremely curious about the nature and extent of what you are doing. If you conduct a thorough investigation and attempt to gather all relevant facts in every case, you can truly say that it is routine.

The investigator, as a gatherer of facts, should be as unemotional as possible in eliciting information and should not act surprised or alarmed at answers given to him. The investigator must be continually vigilant to not disclose confidential information in the course of conducting an interview. If information must be divulged in framing a question, the source

of information should be protected if at all possible. It is frequently helpful, if the witness is reluctant to talk, to inform him that the information he provides will remain confidental and that information given by other witnesses is also confidential.

The investigator must always be courteous and mild mannered even in the face of outrageous insult. Never be baited into showing your temper.

It is generally advisable to ask questions which do not elicit "yes" and "no" answers, unless you are trying to tie someone down to a specific point. The investigator should do little talking and encourage the witness to talk spontaneously. If the investigator can elicit only "yes" and "no" answers, it is extremely likely that he will leave the interview having discovered less than he should have.

While a few quick formalities usually begin any conversation, it behooves the investigator to get straight to the point and elicit the information that he desires. This is professional behavior and will save a considerable amount of the investigator's time. Always allow ample time for an interview. If you are forced to rush in order to make another appointment, it will irritate the person to whom you are talking and you are likely to miss important information.

Remember that your function as an investigator is to gather facts and to separate fact from conclusion and supposition. Therefore, be certain that the answers being given are fact or are clearly identified as supposition. If the person says that he believes that thus and so happened, attempt to pin the person down as to whether or not he knows that it happened. If not, the report should reflect that it is supposition and not fact.

Questions tend to lead to other questions which drift away from the points about which the original inquiries were made. Getting sidetracked is not disadvantageous, but the investigator must be extremely cautious to return to the point of departure and continue his questions after the sidetrack has been followed to its conclusion.

Attempt to avoid interviews of two or more persons at the same time. It is extremely difficult to keep the individuals' stories straight.

The booklet entitled "Suggested Basic Procedures for Securities Investigators", published in 1972 by the North American Securities Administrators' Committee on Investigation and Enforcement Procedures, contains an excellent section on interview of persons as well as other matters, and should be read in conjunction with this manual.

B. PURCHASERS AND COMPLAINANTS

Be thorough in conducting interviews with purchasers and complainants. It is difficult to ask every question that is essential, but one must always attempt to do so. If the interview

leads you to believe that there are some embarrassing questions which must be asked with regard to the relationship between the purchaser and the seller, leave these questions until last, but ask them. It is better to find out early in the investigation that the purchaser and the seller slept together than to be surprised during the trial. However, unless you have reason to believe that the answer to your questions will be "yes", or the witness is a very important one, it is better not to ask such questions as you will unnecessarily alienate the witness.

Let the purchaser, or complainant tell his story in his own words and interrupt only if he gets completely off track. After he has told his story, ask specific questions if they have not already been answered. Basic information which you are sure to need is as follows:

1. Exact name of securities and address of issuer and dealer, if known;

2. Exact date of purchase;

3. Exact amount of purchase;

4. How payment was made;

5. Fullest possible name of seller;

6. Fullest possible address of seller;

7. How the contact was made and any previous relationship between the buyer and the seller;

8. The identity of other persons who have been present when the representations were made;

9. Representations that were made;

10. Location (jurisdiction) at which the transactions occurred;

11. If more than one person made representations, who made which representation, if remembered;

12. Representations which are believed to be false;

13. Copies of all written materials shown to the purchaser if he has them in his possession. If not, ask him to explain what he was shown;

14. Whether the purchaser has a stock certificate or other evidence of the securities purchased, his

check, correspondence from the company and/or the seller, or other;

15. If the complainant will sign an affidavit as to what he has said.

The above list is not meant to be exhaustive as there are numerous other questions which have particular applicability to special situations.

C. PRINCIPALS

Extreme caution must be exercised in interviewing principals under investigation. Administer warnings as a routine matter, unless the principal initiates contact; in this case use judgment as to whether or not to give a warning. If there is any doubt, a warning should be administered. The routine administration of a warning is not generally offensive and only on rare occasions will it cause the subject to refuse to talk to you.

It is preferable to interview principals in your office rather than his if at all possible. Generally, a threatening or intimidating tone or approach will be ineffective and will simply lead to allegations that you are intimidating or harassing the subject. Ask questions about the less controversial areas first and save the real "meaty" questions until later in the interview. If the subject refuses to answer key questions and the proceeding is terminated, at least some useful information may have been obtained.

The principals of many entities under investigation are quite capable of lying, but would prefer to simply evade the question. Most are skillful in distracting the investigator and can end up controlling the interview. An investigator must be alert and refuse to be sidetracked. This requires listening very carefully to the answers and remembering the questions. Frequently, a question must be rephrased numerous times to elicit a clear answer.

D. THIRD PARTIES

It is often necessary to interview persons who are only remotely connected with the investigation, i.e., bankers, landlords, friends of promoters, etc. Keep in mind that these people will be curious why the information is being elicited. It may be necessary to tell the person something about the inquiry before they tell you

anything. The best approach is to identify yourself and indicate that you are making a routine inquiry into the sale of the securities of XYZ Company. Never indicate that the subject of the investigation is violating the law or is in any particular type of trouble, financial or otherwise. If the person is made aware that the inquiry is official and that the information is important to the investigation it is usually possible to obtain the desired information. Do not reveal confidential information from other sources which if made public would be damaging to the company or its image.

As persons with little or no interest in the matter under investigation are frequently busy, get straight to the point after taking care of necessary formalities.

E. ATTORNEYS AND ACCOUNTANTS

Attorneys and accountants must be interviewed with great care. Such persons tend to hedge everything, are generally biased to the viewpoint of their client and wish to conceal any personal involvement in the matter under investigation. Frequently the interview is necessary in order to obtain amplification or explanation of confused records or to gain additional insight into special details or technical matters and is contemporaneous to obtaining the company's records. Be sure that the explanation offered makes sense and is adequate and responsive to your inquiry. "I don't know the answer", is a common response and some tact is necessary in order to secure meaningful answers. Because the attorney or accountant is working in a professional capacity with the corporation do not assume that he does not have a personal involvement in the matter. You should always assume that attorneys are representing their client's interest. Do not be lulled into a feeling that the attorney is really on your side and has the interest of the State and its other citizens at heart.

If the attorney or accountant with whom you are dealing represents a purchaser or other victim in the investigation, it is reasonable to assume that an amicable relationship exists between this attorney or accountant and yourself and that he is attempting to be cooperative.

F. PREPARATION FOR INTERVIEW

Proper preparation for an interview is important, and the investigator should ascertain as many facts as are reasonably available to him prior to conducting the interview. Unless the interview is to be on a matter that will follow a routine format it is advisable to prepare questions in advance. This is especially important in investigations involving aspects of the securities industry which are novel to the investigator. Otherwise, the investigator will neither understand the responses being given nor know what further information to seek in order to conduct an intelligent investigation.

Conversations during an interview tend to drift away from the original topics into other areas as the subject of the interview and the investigator think of new things that they wish to discuss. Let the discussion run its course, while useful information is being acquired, but then return to the point where the organized line of questions terminated and resume with the essential questions. If this procedure is not followed rigorously, the investigator will subsequently determine that there were a number of vital questions which he failed to ask. Considerable time can be saved if the job is done right in the initial contact.

G. TIME AND PLACE OF THE INTERVIEW

It is more convenient for an investigator to interview persons in his office, however, it is often impossible to do so. Witnesses who cannot come to your office can generally be interviewed in their offices during regular working hours if they operate their own business or control their own time. If the witness or investor is a salaried employee, it is frequently impossible or embarrassing for him to be interviewed during working hours; it is generally preferable to interview these persons, in their homes. This, of course, would not hold true for such persons as bank employees who are being contacted with regard to records maintained by the bank.

Appointments reduce the risk of finding persons unavailable or not finding the documents necessary for a meaningful examination. Appointments are beneficial only if arrangement of interviews is not unduly inconvenient to the investigator. The city directory and telephone directory are helpful in locating people at their jobs during the day.

In small and medium-sized towns, an investigator can, in one day, call upon many purchasers and other witnesses "cold", without an appointment. "Cold" contacts are preferable if the investigator is only in town for a day and does not have time to adjust his schedule to the convenience of the purchasers and other necessary witnesses or when it is important to catch the principal or witness unaware that an investigation is in progress. In larger metropolitan areas, "cold" calls will prove to be extremely time consuming and are generally undesirable even when weighed against the disadvantages of arranging appointments.

The promoter is much more likely to be comfortable and on his guard if he is safe in his home environment. Therefore, conduct a principal interview away from his offices, either at your office or perhaps at office space arranged at the local district attorney's office, unless the need to inspect numerous records would make that impractical. Unless it is necessary to talk to the promoter only through his attorney and only after lengthy formalities and delays, the investigator should consider

the "cold" call on the promoter as it is frequently very effective. Information obtained before the promoter has had adequate opportunity to make up a story is generally as close to the truth as the investigator ever gets from such witnesses.

"Cold" call interviews should not be made during the early morning or late evening hours, during lunch hours or after dark unless extremely important. Such calls can be quite inconvenient to the person you wish to interview and can cause undue irritation to the person with whom you wish to speak.

Try to avoid interviews in public places as distractions are a real hindrance. Such interviews generally tend to be short and nonproductive.

In arranging appointments, always allow yourself enough time to conduct a full interview and to reach your next appointment on time. It is better to have a little extra time than to have to terminate interviews early or make excuses for breaking or delaying other appointments. Always attempt to be prompt, but if delayed more than five or ten minutes, call, apologize and inform the person when you will arrive, or schedule another appointment immediately. Plan ahead. An investigator who cannot manage his time is only marginally effective.

H. CONDUCT OF THE INVESTIGATOR

1. INTRODUCTION AND FORMALITIES

When an investigator deals with any member of the public, whether in person or via the telephone, he must always be efficient, courteous, polite and clean spoken. The investigator is the agency's ambassador and he gives the impression the public will have of the agency. Before doing anything or saying anything which might be in the least bit controversial, ask "How will this look in the most unfavorable light?" and "How will this look and sound if I have to take the witness stand and relate this conversation or incident?"

Always attempt to be businesslike. Certain pleasantries are sometimes necessary but never allow an interview to become a social occasion. Politely refuse offers for refreshment. An investigator should never accept gratuities, even small ones, from the public or the subjects of investigation. The investigator must take the agency's image into account at each step of the investigation.

2. CONTROL OF THE INTERVIEW

An investigator must always control a witness interview. He should not allow himself to be bullied, badgered or intimidated and should never submit to interrogation by the witness or the witness' counsel.

An investigator can quickly determine if he is receiving cooperation from a witness. If he is not, it is sometimes better to terminate the interview rather than prolong a fruitless effort. While a forceful, but tactful approach is the best for assuring cooperation, even this sometimes proves to be unproductive.

The investigator may find that he has started an investigation before any purchaser has realized that he has been taken. In such instances, the investigator may find that the purchasers are not cooperative and will react as though he is interfering with the orderly conduct of their affairs. In such instances, little can be done and the investigator will simply have to wait until the victim realizes that he will not receive the rich gains which have been promised.

I. GATHERING THE FACTS

Gathering the facts about a sale of securities or a related securities matter is the main function of a securities investigator. Without all of the basic facts, the who, what, when, where, why and how, there is a gap in the story. Do not presume anything even if the answer seems obvious; rather ask the question and save yourself the embarrassment of later finding out that the answer was not obvious after all.

It is best to follow each series of questions and answers to a logical end. For example, if you ask a purchaser what the seller looked like and he responds that he was 35, short and wore glasses, don't take that for an answer. Ask the witness if he was bald, what color his hair was, if he had any distinguishing marks, etc. If the purchaser relates that the promoter told him hardly anything, it may be necessary to pry, but eventually you may discover that he was told a great deal about the investment.

Gathering facts is hard work, if done properly. If done improperly, the facts gathered are incomplete and reveal little. Witnesses do not know what information you want, and the information they possess can only be obtained by asking the proper questions. Ask a broad question in the area in which you are interested and then follow that question with specific questions not answered in the narrative answer given to your general question. Do not accept a vague and unresponsive answer. If necessary, change the question slightly and ask again. Do this as many times as is necessary to establish that the witness is either not going to answer the question or gives a satisfactory answer.

Always remember to distinguish fact from supposition or hearsay. When asking about an important fact, it is often advisable to ask the witness how he knows that his answer is correct. Many times it is not a fact at all, but merely the witness' belief that the information is correct. However, supposition has an important

part in an investigation as it may lead the investigator to other sources of information to determine whether or not the information is factual.

J. OBTAINING THE PHYSICAL EVIDENCE

When interviewing witnesses, it is usually necessary to obtain physical evidence such as stock certificates, cancelled checks, and correspondence with the company. Make copies of original documents and let the witness retain the originals. Certain minor documents may be noted and not copied at all. If an investigator is unable to state when and from whom he obtained a document or a copy thereof, its evidentiary value is generally lost.

Keep in mind that the chain of evidence must be preserved, and always identify any document taken away from its original source as to: what it is, if it is not clear on its face; from whom it was received and when; and place your initials on the back of the document. All of this information is inconspicuous when placed on the back of a document or a copy of the original and should be recorded automatically. If an original is to be immediately returned to the owner, i.e., witness hands the document to the investigator who has it copied and returns it to him, it is sufficient to identify the copy as being a copy and no identification need be placed on the original document. When a document of potential evidentiary value comes into an investigator's hands, he must ask himself, "If I am under cross-examination on the witness stand, can I swear that I received this document from X as a copy of his original or as the original document?"

Establishing the chain of custody of documents, tape recordings and other physical evidence is often critical at the time of trial.

If a sworn affidavit is to be obtained from a witness, it is preferable to attach copies of the documents as exhibits to the affidavit in which case their authenticity can be proved.

When records obtained from principals and third parties (primarily banks) are voluminous, the investigator must decide whether to identify each document separately, or to somehow bind and number the pages and identify the back of the last document as being "(so many) numbered pages of (such and such documents) obtained from (a person or institution) on (date)."

A document kept in the ordinary course of business may be described in a sworn affidavit to be executed by the custodian of the records. Under this procedure, business records may be made introduced into evidence in many states.

K. NOTE TAKING AND PRESERVATION OF THE INTERVIEW

Each investigator has his own style of taking notes. Whatever the form, they must be readable and must accurately reflect the facts discovered during the course of the interview. Dates, names and places should be written in full and care should be taken to see that the spellings are correct. As quickly as possible after the interview, hopefully before another important interview takes place, the investigator should go over his notes and fill in blank spaces and pencil in additional thoughts before his recollection fades. He should prepare a memorandum of the interview setting out all facts, unless an affidavit relating to those facts is to be prepared immediately.

It is permissible to use a tape recorder at an interview if the witness does not object. Tape recorders make some witnesses somewhat nervous and perhaps more reluctant to speculate on certain aspects of an investigation. Remember, however, that a memorandum or affidavit is likely to be necessary even if a tape recorder is used. A tape recorder is not a substitute for proper note taking, but, rather, is a back-up system. Unless proper notes are taken, a great deal of time will be wasted listening to tape recordings and preparing memorandums from that source.

Important interviews should be conducted by two investigators so that one can keep good notes while the other is taking the lead in questioning. It is frequently impossible to take good notes and listen attentively to persons giving long and technical answers.

L. AFFIDAVITS OF WITNESSES

Affidavits are double-edged swords. If a witness signs and swears to an affidavit, it gives the investigator confidence that he can supply the proof necessary to make his case. However, affidavits are subject to discovery and may be used by the defense in an attempt to trip-up the witness on small details.

Affidavits should be prepared in the witness' own words if possible. Generally, it is preferable to draw the affidavit in a rough form and ask the witness to make all changes that are necessary in order to make the statement correct. As time frequently does not allow this luxury, the investigator should prepare the affidavit as accurately as possible and request that any minor changes be made by the witness in pen and initialed. If the witness makes major changes in the affidavit, it would be advisable to have the affidavit retyped if time permits.

It is difficult to simply ask the witness to prepare his own affidavit as he will have no idea what the form or content should be. Also, it is likely that placing this major burden on the witness will result in his procrastinating or never preparing an affidavit.

If the investigator knows that the witness has an attorney, the investigator may suggest that the witness have his attorney look

at the affidavit prior to its execution. The danger in this is that the attorney may suggest that the witness not execute the document.

Affidavits should be sworn to and executed before a notary public. Therefore, the investigator must be sure that the affidavit is prepared so that the witness swears to the document and does not merely have his signature verified by the notary. Even if an investigator is a notary, it is not advisable for him to notarize the witness' affidavit as such practice tends to raise unnecessary issues as to the impartiality of the notary.

Affidavits should be concise and should contain all of the relevant facts with only enough other language to make them readable. It is not necessary to put everything the witness says in the statement, and matters which have no real bearing on the matter under investigation should not be contained in an affidavit.

M. DETERMINING CREDIBILITY OF WITNESSES

No witness is 100% credible. Each witness is slightly biased and slightly confused as to certain facts. The investigator must sort the facts as reported to him and make a determination as to the accuracy and truthfulness of the story. Interview at least two witnesses as to the specific facts in question when possible, and if two unrelated witnesses tell a substantially identical story, then they substantiate each other and establish their credibility. This technique is most applicable to testimony of purchasers. It is always advisable to interview several purchasers, especially with regard to misrepresentations, to establish if there is some pattern to the misrepresentations made and to substantiate the fact that the misrepresentations have been made.

In determining the credibility of the principals of an investigation, it is frequently impossible to get two separate stories. An investigator should never believe the story of a subject of an investigation unless the truth of the information can be verified from an independent unbiased source which is believed to be reliable. Frequently, the insider's story can be either corroborated or disproved by an examination of records which are not immediately in the possession or control of the subject.

An investigator may frequently find himself in the position of having one purchaser and one seller who tell conflicting stories, and has no readily available method of determining who is lying.

If the witness' truthfulness is in serious doubt in a case of major importance to the agency, it would be prudent to determine if the witness will consent to a lie detector test. While the lie detector test is not admissible evidence, it could be of great benefit to the investigator in determining whether he should proceed further on the matter.

The service of a handwriting or document expert at the state police headquarters can frequently be very helpful. With a surprisingly small specimen of handwriting, the experts are able to

determine whether the document in question was executed by the named individual or whether the instrument was forged.

The credibility of a witness may be tested by the investigator by asking a complicated series of slanted questions, the answers to which are already known. However, most promoters are not easily deceived and have their stories memorized and well rehearsed.

Investigators should always be alert to undue nervousness on the part of a witness which indicates that he may be lying. Such nervousness frequently manifests itself in blushing, fidgeting, avoiding eye contact with the investigator or prolonged pauses before starting the answer to a question. Of course, a witness who has any one or more of these traits may be telling the truth at all times.

VII. EXAMINATION OF RECORDS

A. WHEN

It is preferable to make an examination of company records as quickly as possible after an investigation is commenced. If possible, examine the company records before interviewing any company principals. Frequently, the ability to sustain a case against the principals will rest largely upon what is reflected by the company records. The most important function of an investigator is to properly examine the records of the entity under investigation.

Records can be destroyed, lost and altered. Therefore, in an important investigation, an examination of the records is desirable before the company is aware that there is a problem. Even if a complete examination is not possible at that time, it will discourage possible tampering with the records later. It is important for an investigator to know what kind of records a company is likely to keep so that he will know what to look for. Therefore, if in doubt, the investigator should have a brief discussion with some expert as to what type of records would normally be maintained by the entity on which he is about to serve a subpoena.

Investor records are usually examined during the course of the witness interview unless they are kept in the witness' safe deposit box. The investigator should obtain copies of any documents which are material to the investigation as quickly as they can be made.

If no company records are readily available, it may be necessary to examine the bank records of the company and construct a set of books from such bank statements, checks, deposit slips, notes, etc.

B. WHERE

Assuming the records are acquired pursuant to an instanter subpoena, the only practical place to examine them is the company's

office or an individual's place of business. If the company is a going concern, it is usually not possible to take records away from the office, and important documents must be copied or schedules made reflecting the content of the documents. Before using the business' copying machine, arrangements should be made as to how much, if anything, the company will charge for the copies, and if the cost is excessive, an arrangement should be made to either allow temporary removal of the documents for copying or a rented copying machine brought in. If a company is not functioning, it may be possible to take the company records and reproduce and examine them at the investigator's leisure.

Bank records have usually been reduced to microfilm by the time the investigator wants to examine them. A cooperative bank will take time to make copies of the required documents at their expense. An uncooperative bank may force the investigator to examine the microfilm tapes himself and make the copies. Therefore, maintaining good relations with banks is extremely important.

C. HOW

Investigators with accounting backgrounds have a decided advantage, and those lacking accounting skills should try to obtain basic knowledge in the area as soon as possible.

Be systematic. Determine what is important by making a brief overall review of the records. Try to determine in advance what records should be scheduled, and whether copies of small checks or deposits are necessary. The investigator should then review the most important records first.

In most cases, an investigator has neither the time nor the skill to do a full audit. Therefore, the investigator should concentrate on what he thinks will show him what he needs to know, and should accumulate as much of that information as he possibly can in the shortest possible time. The investigator frequently does not have the time to seek out the minor details of a case. Therefore, the investigator should first find out who the principals are and when and how much they invested, then who the investors are, how much and when they invested and third, where the money went. Improper use of the proceeds from securities sales is an important element in most fraud cases.

Records maintained by bookkeepers and accountants can give a good overview of the company. Accountants' work papers are especially helpful if recent audits have been made. However, remember that the checks, deposit slips, and contracts will be the necessary evidence in the event action is taken, so make copies of those records.

In big investigations an investigator may need one or more assistants to do scheduling and records analysis for him. If

the scheme is complex, it is possible that only a trained accountant can understand it. If the investigator needs help, he should certainly ask for it.

D. PRESERVING THE EVIDENCE

The types of documentary evidence frequently used in securities violation proceedings include schedules of records, copies of original documents, and the documents themselves. Preservation of this evidence is the essence of successful enforcement action.

If schedules of records are prepared rather than making copies of original documents, be absolutely certain that whoever prepares the schedule clearly identifies on each page the information contained therein, its source, the dates on which prepared, and identification of the person preparing it.

When original documents are copied, the investigator should note on the back of each document its nature or contents, when, and from whom it was obtained. The investigator should also initial the notations so that he may be called upon later to identify the document for evidentiary purposes.

If the investigator is taking possession of original documents, identification of these should be made in substantially the same manner as for copies. Be sure to note on the back of each document when and from whom it was obtained. It is mandatory that custody of documents can be traced from original receipt to the time when they are sought to be introduced as evidence.

Documents or copies thereof or schedules prepared from original records cannot be used as evidence, if at the time they are sought to be introduced they cannot be identified. Thus, the system suggested above or another, if found to be equally reliable, must be implemented to preserve evidence which may later be used in a proceeding.

VIII. QUESTIONNAIRES AND FORM LETTERS

A. USE AND ABUSE OF STANDARD AFFIDAVITS AND FORM LETTERS

The use of a standard questionnaire sent to the complaining purchaser and any other known purchasers is a quick and useful way of gathering the initial facts in investigations where the priority is routine or low. If properly structured, these questionnaires ask all of the standard who, what, when, where, why and how questions. Frequently, the questionnaire answers will establish that the matter need be pursued no further, or that an investigation should be formally opened.

Standard questionnaires are also useful in surveying large numbers of investors even after the investigation is well under way. A modified or specialized questionnaire would generally be preferable for this purpose. Questionnaires have limitations. The return rate

on questionnaires is usually somewhat low even when accompanied by a detailed explanatory cover letter and a prepaid return envelope. It is generally necessary to interview the persons submitting the most intelligent responses.

Frequently, a questionnaire will ask for the witness to send copies of relevant documents. If originals are received, be sure to copy them and return the originals by certified mail unless the originals will be used as evidence in the case.

Form letters may be used by an investigator as cover letters for questionnaires or for routine inquiries to agencies from whom numerous requests, all seeking the same basic information, are made. However, the investigator should realize that form letters are impersonal and that if he is seeking information from the public, the impact of the letter will be minimal. Certain language becomes "stock language" in particular types of letters and this cannot be helped. However, if at all possible, send an original letter, not a mimeograph or xerox,with the purchaser's name typed in. This will diminish the recipient's tendency to believe that the matter is of little significance.

B. SPECIALIZED QUESTIONNAIRES AND FORM LETTERS

Modified standard questionnaires can be a useful investigative tool. Using a standard questionnaire as a base, the questions can be tailored to fit a specific type of case under investigation. The hour or two spent drafting the new questionnaire is generally worthwhile, assuming ten or more questionnaires are to be sent. The investigator should then preserve the new form as it may become the base of other specialized questionnaires. The same practice holds true for form letters.

One type of specialized form letter is the "come-hither letter" which informs the recipient that his activity may constitute a sale of securities which could be in violation of the securities laws. It requests him to appear at the investigator's office at a certain date and time to discuss the matter and requests the production of certain documents relative to the matter. It concludes by advising the recipient that his appearance would be voluntary and that he has the right to be represented by counsel, and suggests that he consult his attorney regarding the matter.

Such letters are excellent for gathering facts in routine cases where more than a written response is called for. It is generally desirable in these letters to request that the recipient notify the investigator of his intention to appear or not appear several days prior to the requested appearance date. This will assist the investigator in arranging his own schedule.

IX. PRESERVING AND REPORTING THE EVIDENCE

A. MEMORANDUM OF WITNESS INTERVIEWS

To prepare a memorandum of an interview, the investigator first must have good notes or a tape recording. If no useful

information was obtained during the interview, then the investigator should merely preserve the notes and/or tape recording. If useful information was obtained, it should be preserved through either a complete affidavit obtained from the witness or a detailed memorandum. All significant information should be reported in the memorandum, otherwise the information is unavailable to anyone other than the investigator himself. Only if a proper memorandum has been prepared can another investigator or the investigator's supervisor complete the work or evaluate the significance of what has already been discovered.

A proper memorandum should state the witness' story in a clear narrative form. Names, dates and places must be accurately reported. The full names of subjects and correct spelling of all names must be included; otherwise subsequent identification of the subjects will be difficult if not impossible.

If the investigator has personal feelings about the sincerity, truthfulness or competence of the witness or his story, he may wish to precisely state such at the end of the memorandum along with his thoughts and suggestions about leads which were discovered in the interview. However, discovery, especially in criminal cases is becoming very broad. It is likely that a defendant's attorney will see the entire file before a trial.

A printed form with appropriate blanks can frequently be used successfully to record short memoranda such as telephone interviews. Such forms will frequently save a good deal of the investigator's and his secretary's time.

The investigator should remember to underline in red the names of all subjects in the memorandum whose names should be indexed to the permanent investigative records of the agency.

B. MEMORANDUM OF COMMUNICATIONS WITH ATTORNEYS AND OTHERS

Special care should be taken in handling communications with attorneys. In most instances the communication should be accurately preserved in a memorandum. This is especially important if the motives of the attorney are suspect or the investigator feels that the attorney may attempt to misquote him. Some attorneys go "opinion shopping" in the agency hoping to find someone who, in a weak moment, will speak without knowledge or authority and agree with his position. Without a memorandum of the conversation, it is difficult to substantiate what was actually said to the attorney.

C. SUMMARY REPORTS

An investigator with a substantial work load will soon forget facts in cases that have been pre-empted by more important matters. Therefore, at lease semi-annually, an investigator should review all of his open files and write a summary report which will bring together all the important facts, express the violations which may have occurred, propose actions necessary to resolve the matter and establish as closely as possible the day on which the Statute of Limitations will have run.

Efficient investigators can handle many cases at one time and the summary report will help the investigator properly assess his priorities so as not to lose track of meritorious older cases. The summary memorandum is also an excellent way of keeping supervisors advised of the progress being made on cases.

D. EVIDENCE ENVELOPES

The use of evidence envelopes is good but is not a substitute for physically marking and identifying documents. The evidence envelope is a manila envelope printed so as to provide appropriate blanks for the name and number of the case, the documents inside, from whom the documents were obtained and the date. In theory, if the envelope is sealed, the contents would be identifiable without the necessity for physically marking them. However, so many things occur during the course of an investigation that create a need to open the envelope that it is not useful as a method of segregating and keeping track of the evidence and does not necessarily guarantee its identifiability. Without the use of evidence envelopes or another method of preserving evidence, documents tend to become shuffled together, requiring frequent reorganization and sometimes causing embarrassment to the investigator who is not able to readily produce a document in his possession.

E. IDENTIFICATION OF RECORDS

All physical evidence obtained in an investigation, whether original records or copies, must be identified in such a manner that the investigator can subsequently authenticate its source and when it came into his possession. This subject is examined in detail in Section VII. D. - Preserving the Evidence.

What might at the time seem like a bothersome waste of time can become a matter of crucial importance at a hearing or trial.

F. FILE MAINTENANCE

An investigator is responsible for the organization of his files. No investigator should blandly rely upon file clerks and secretaries to keep his files for him. A frequent review of each file should be made to see that it is being kept in an orderly manner, that information is not misfiled therein and that he is aware of all information in the file. The investigator should mark the face of each letter, memorandum or anything, other than original evidence, (which is marked on the back), to be placed in the file. File clerks should be instructed not to file matters which have not been so marked, but to route the document to the investigator. This practice will prevent matters reaching the file prior to examination by the investigator.

After a file has become more than an inch thick, it should be broken down into elements, such as correspondence, memorandums,

financial records, and witness affidavits, to facilitate orderly examination. A thick file in chronological order is difficult for the investigator to manage and impossible for anyone else to easily digest.

All facts should be reduced to writing and filed in their proper place. Investigators, after a few years on the job, learn that small details are important and feel the frustration of trying to understand and use disorganized or incomplete files left by their predecessors.

X. CONTACTS WITH THE NEWS MEDIA

An investigator should never talk to, or correspond with, the press for any reason unless specifically authorized to do so by a supervisor. Press relations is the function of the agency Administrator and not the investigator. If contacted by the press and asked a question, the only response is to tell the press that they should talk to the person in the agency authorized to speak for it. No matter how great the urge to talk or how great he believes the necessity to do so, the above rule should not be broken.

If press releases with regard to administrative action and/or criminal action are a regular part of the agency's operation, the investigator should draft a press release in advance of its expected need so that the release can be placed in final form and approved by the agency Administrator on the day that the expected action occurs. Releases made several days after the happening of a significant event have little or no news value. If charged with the duty of drafting press releases, the investigator should report facts and not suppositions.

In reporting indictments, the release should never contain any allegations or information not specifically contained within the indictment. To do otherwise is to comment upon the case prior to trial which may subject the agency to unwanted embarrassment. If the agency releases information to the press regarding indictments, the investigator must obtain the permission of the District Attorney or other prosecuting authority prior to releasing any such information. Some District Attorneys prefer not to release information regarding indictments prior to the arrest of the subject.

Press releases with regard to the early stages of an investigation are self-serving, premature and should be avoided. While the investigation may be sensational and quite newsworthy, a reporting of such matters tends to scare witnesses or make them feel they are in the limelight. This can seriously impede an orderly investigation.

XI. CORRESPONDENCE AND ORAL COMMUNICATION TO PERSONS DURING THE COURSE OF AN INQUIRY

An investigator has almost constant contact with the public during the course of an investigation. Therefore, he must constantly maintain a subdued, professional image of himself and the state agency he serves.

The investigator has statutory guidelines within which he must operate. He must be as helpful as possible to those who need it, and be polite but stern with those who violate the law.

An investigator should never commit himself or his agency to any position of which he is not sure. If the investigator is not certain as to the applicability of the law to a specific fact situation, he should profess his indecision.

An investigator should never make promises as to the date by which anything will be accomplished. He should never promise that he will attempt to "do something" beyond stating the matter will be looked into. It is dangerous to say that the matter will be investigated because, to the public, this has sinister connotations. Never speculate with a victim or other witness as to whether or not a violation of the law has occurred. Never give legal advice to a person. If advice is needed, suggest the person consult a private attorney. Do not recommend a specific attorney or law firm. Never reveal confidential information except to a government agency or quasi government agency which is trusted. Any information which is not a public record can be considered as confidential information.

XII. SPECIALIZED INVESTIGATIONS

A. MUNICIPAL SECURITIES

Exempt Municipal Bonds and Government Securities are, for the most part, dealt in by reputable registered dealers. Industrial Revenue Bonds are also exempt securities in many jurisdictions.

Dealers in Municipal Bonds can easily defraud their customers, especially private customers. Banks are the most frequent customers of Municipal Bond dealers and often fall prey to unscrupulous dealers but are seldom willing to admit it.

The primary thing to examine in bond transactions are at what discount the bonds were purchased by the dealer and at what mark-up the bonds were sold. As bonds are interest-bearing securities, the total interest yield should be the customer's primary concern. However, many customers are not knowledgeable in the bond market and are easily deceived.

An unscrupulous dealer may purchase a bond at a deep discount, i.e., 30% of (face value) - and market it at 75% (face value) on the same day. The purchaser thinks he is getting a good deal, buying at 25% below par, little realizing what has happened to him. Such dealers generally market unrated bonds of little-known issuing authorities with much greater risk than highly rated bonds. Also,

such bonds may have extremely long maturities or otherwise are undesirable. For example, the market may be extremely thin in the bonds, making resale difficult.

If accessible to the investigator the "Blue Book" is an excellent source of information on bond prices. The Blue Book can be used for making a comparison of the suspect dealer's price and the market for a bond on a given day to determine if he is charging an excessive mark-up. There is no standard rule as to what mark-up is permissible. However, if the mark-up is substantially greater than 5%, closer examination of the transaction is certainly warranted.

A continual problem facing most jurisdictions is possible violations in that state by bond dealers who have no offices there. Obtaining access to the bond dealer's records thereby becomes much more difficult. However, most jurisdictions where such dealers are located are happy to cooperate in such matters and can provide necessary information.

Some bond dealers are also prone to engage in "switching", a practice in which the customers are encouraged to sell a high-rated bond for a better yeilding but lower-rated bond of perhaps longer maturity.

Industrial Revenue Bonds, sold by a municipality, but to be retired out of revenues from rent or other fees paid by a private industry, should also be closely scrutinized if any complaints are received. While most Industrial Revenue Bonds are quality bonds, they are susceptible to fraudulent abuse by dealers. If the bond dealer is engaged in a conspiracy with the entity which will be responsible for retiring the issue, the conspirators can retain substantially all of the bond proceeds and never commence operations.

B. CHURCH BONDS

As Church Bonds are typically exempt from securities registration requirements, most of the problems in the area involve lack of disclosure, fraud or sales by unregistered broker-dealers. As dealer problems are discussed in other sections, this analysis will center on the different kinds of fraud which occur in this area.

There are two general types of Church Bonds, mortgage and revenue. The mortgage bonds are secured by First or Second mortgages on Church buildings. The revenue bonds are secured by contributions to the Church. Frequently, an unscrupulous promoter or dealer can persuade the leadership of a Church to build facilities which the Church cannot afford, and to pay for such facilities with the proceeds of an issue of Church Bonds. The Church is often financially incapable of meeting the payments of interest and principal for the bonds. The financial burden placed upon the Church may result in a constant refinancing of bonded indebtedness through additional issues. In more extreme cases, the Church will be unable to pay even the interest on the debt.

The purchasers of Church Bonds are frequently unsophisticated, elderly persons who deserve the protection of the securities laws. Many purchasers of Church Bonds have religious or benevolent motives in addition to thinking that Church Bonds are safe investments and generally have little other investment expertise. Complainants are difficult to find. Further, because the bondholders generally do not know each other, it is difficult for them to know what course of action to follow, even if they determine that some action is necessary.

Little help can be expected from a Church in any Church Bond investigation. In cases where the Church is seeking funds, it is normally desperate for financing and may feel that it has a good deal even if excessive commissions and other charges are paid. In other cases, the Church is in the position of a defaulting debtor, in which case it will certainly be on the defensive. In still other cases, there is a possibility that the minister or a church officer, is misappropriating or stealing either the proceeds of the bond issue or the sinking fund payments. When complaints from bondholders are received, the investigator will probably learn that there has been a default in the payment of interest, the payment of principal, payments to a mandatory sinking fund, a failure to construct the facility which was to be security for the bonds, or a combination of these. If the Church members become aware of these financial troubles, they may stop attending and the Church could simply disappear, resulting in a substantial loss to the investors without much hope of recourse. In the alternative, the Church members may engage in the unsound practice of attempting to refinance the debt through a large additional issue, or finance the principal or interest payments through a series of smaller issues.

Bond Dealers who exploit Churches by convincing them to make bond issues they cannot afford should be investigated with great care. If the proposal by the bond dealer includes an arrangement for the construction of the Church facility there is great potential for abuse when the entire package is to be handled by one company. Close examination should be made of those situations in which the Church Bond dealer also acts as trustee or paying agent for interest and principal. In these situations, the dealer could either abscond with the funds or hold the sinking fund payments in one large unsegregated account and invest any excess funds in government securities for his own benefit rather than for the benefit of the Churches for whom he acts as fiduciary. An investigator may become aware of Church Bond problems in any one of three circumstances; the initial sale, the default in payment of principal or interest, and the refinancing through additional issues.

In the initial issue situation, the investigator will find that the prospectuses used in the sale of the bonds are generally grossly inadequate and make virtually no disclosure. Unless the prospectus is generally in conformity with the guidelines promulgated by the Committee on Church, Institutional and Municipal Financing of the North American Securities Administrators Association, it may be presumed that inadequate disclosure is made. Every effort should be made on the part of the investigative staff to encourage full disclosure in church bond issues. In initial issues, it is important for the investigator to ascertain:

1. What are the average weekly contributions each year for the last five years? Is the figure increasing or decreasing?

2. What is the total church membership in terms of family units? Is the figure increasing or decreasing?

3. What is the total church budget, not including necessary sinking fund payments?

Allowing a pad, and taking into consideration the growth trend of the congregation, if there is an overwhelming presumption that the church will not be able to service its bond indebtedness, the issue should not be made. If the issue can be prevented, action to do so should be taken.

If there are investor complaints for non-payment of principal or interest, the investigator will frequently find that several years have lapsed between the time of the sale and the first default. In fact, one or more refinancing efforts may have occurred prior to the problem arising. In such cases, effective action is difficult unless a refinancing effort is then underway, as the Statute of Limitations will frequently bar any meaningful action. The investigator may also learn in this situation that the church keeps very poor records and frequently does not know with any certainty, who the bondholders are. This can, at times, be the cause for the non-payment of principal or interest. The investigator will notice that default frequently occurs in issues which have large balloon payments. A balloon payment amortization schedule is one in which only a small portion of the entire bond indebtedness is to be paid over the life of the bond issue with substantial portion coming due at the final maturity date.

In these circumstances, the investigator may discover that a refinancing will not enable a church to retire its indebtedness. This determination should be made on the same basis as for the initial issue, that is, an analysis of the growth trend of the congregation and contributions.

When the investigator determines that remedial action is necessary, the issuance of a cease and desist order prohibiting any further sale of the church's securities, or license revocation hearing directed to the church bond dealer involved in the sale of the bonds, or both would be appropriate. In reaching his determination, the investigator must weigh the policy of protection of public investor as against the legitimate need of churches to raise capital.

C. REAL ESTATE SYNDICATIONS

Most real estate syndications which become subjects of investigation are structured as limited partnerships or "joint ventures" and are sold pursuant to a claimed limited offering exemption.

As a general rule, there is inadequate disclosure made in such offerings. The usual offering sheet reveals little more than where the land is and the amount of the original payment an investor must make. Most of these investigations concern raw land syndications.

Frequent abuses in raw land syndications are:

1. The promoter does not disclose substantial mark-ups. A promoter may purchase land for $4,000 an acre and immediately syndicate the property for $10,000 an acre. An examination of deed records and sales contracts is frequently necessary in order to establish mark-ups.

2. The promoter may use straw men and dummy sales to inflate the price of the land. Also, a common practice is for the promoter to transfer the property from one syndicate to another, each time pyramiding the price of the land to the new syndicate.

3. The syndicator may own or control an "acquisition company" which finds the property for the syndicator and makes the acquisition and then sells the property to the partnership at a mark-up which could have otherwise been avoided.

4. Syndicators of numerous projects frequently commingle funds from several limited partnerships to such an extent that they, in effect, become one single offering.

5. Salesmen of real estate syndications frequently receive substantial commissions and, in some cases, almost all of the original money raised will be expended for administrative overhead of the syndicator with practically nothing remaining for a down payment on the land itself.

6. Some syndicators purchase one tract of land and split the tract into two or more separate tracts, forming a limited partnership to purchase each tract. The purpose in doing this is to keep the size of each purchaser's investment down to a reasonable amount and still stay below the maximum number of investors set by the limited offering exemption. Some promoters sell interests which are units in a tract which is

itself a fractional undivided interest in larger tracts. The use of this tactic by the syndicator, makes it simple to prove that all of the separate offerings should be integrated into one offering for purposes of counting purchasers, and disallowance of the small offering exemption.

7. Some syndicators charge management fees for managing the property which are clearly excessive. If the securities law under which the violation falls has within it a maximum offering expense limitation and the fees and expenses are in excess of that amount, it is simple to establish that the offering would not be fair, just and equitable. If the fees and expenses are below the maximum amount but are in excess of the industry average, then the investigator might conclude that the management fees are excessive and not fair, just and equitable. However, the answer will be much less clear-cut and more difficult to reach.

8. Some syndicators sell property which is subject to flooding or is otherwise unsuited to development. The U. S. Corp of Engineers and, in some cases, local authorities will have floodplain records which should be checked if the possibility of flooding is thought to be a problem. If the flooding problem is believed to be chronic, local area residents can provide helpful information.

The biggest problem to be faced in real estate syndication investigation is that purchasers are not usually unhappy. As a syndication usually has a long pay-out period, purchasers do not realize that they have been had until years after the original sale. In some cases the purchaser may never realize that he has been dealt with unfairly because it may be possible to sell the property at a profit. Therefore, the investigator can expect little help from investors unless they become alarmed. As an example, they may not have been advised of the size of the yearly payments which they must make or they may have been told that the property would be sold within six to twelve months and the property was not sold.

Most real estate syndicators are unknowledgeable of the application of securities laws to their transactions. Some will attempt to register as securities dealers but will continue to sell unregistered securities. Some will register as dealers and then continue selling through unregistered salesmen. The attorneys which represent real estate syndicators frequently have no experience with securities law and are incapable of advising their client adequately.

The investigator will find in other real estate syndication cases that the syndicator is aware of the requirements of securities

laws and realizes that what he is selling should be registered. However, the syndicator believes that the problem of registration is a burden he cannot afford and he simply takes a chance hoping that his activities will not come under the scrutiny of the securities regulatory authorities.

D. EXOTIC SECURITIES

When the stock market falls into a slump, an investigator can expect an upsurge in new and novel ideas for raising capital from the public. Most such schemes fall into the category of investment contracts, evidences of indebtedness or an interest in the capital, property, assets, profits or earnings of a company. The investigator should never assume that all securities that are not stocks and bonds are investment contracts, as other approaches are viable.

In many instances, the investor is merely investing in an enterprise where his money is used to pay off prior investors in what is referred to as a "Ponzi scheme."

The investigator should not assume that merely because no fraud can be uncovered that the exotic offering is not a security.

Pyramid marketing schemes are securities in most jurisdictions. The pyramid scheme involves a plan of business whereby an investor places money into an operation primarily to purchase the right to recruit other investors from whose investment he will receive a share and will also receive a share of investments made by investors recruited by the investors which he recruited. Pyramid schemes are usually masked behind a marketing scheme which frequently will involve cosmetics or cleaning agent products.

There are numerous other exotic securities in existence and new ones being invented by promoters everyday. Any time an investigator is confronted with an exotic security, he must first prove that the thing being offered is a security. Frequently, there are few or no precedents, but a need for regulation. In those cases, the investigator must proceed with great caution and with the willingness of his agency to take a chance that it will lose in court. It is advisable to fight to expose the fraud even if this means losing on the technical issue of whether a security is involved.

In all exotic securities cases, an investigator must look beneath the promoter's "story" and chart the actual transaction. Most exotic securities do not appear to be securities on their face and an investigator can be easily fooled. The investigator must not ever take the promoter's word for anything. He must attack the problem with a positive attitude. Find out what the promoter actually does with the investors' money and what the procedures are at every step of every transaction of the promoter and his agents. The investigator should have a chart showing the flow of every paper and of every oral communication between the time an investor first learns of the deal and the time his account is closed. Only after the investigator finds a security within the definition in his State law, can he proceed. Finding the security is by far the toughest job. After that problem is resolved, the investigation will follow standard investigative procedures.

XIII. WHETHER TO CLOSE THE CASE OR CONDUCT A FULL INVESTIGATION

A. WHAT RESOLUTION YOU CAN EXPECT TO OBTAIN

An investigator must be a realist. He must attempt to subdue his emotional involvement and analyze the case based upon the law and the facts. Not all cases which the investigator has investigated are worth pursuing to a conclusion where formal action is taken.

If the violation uncovered is limited to the sale of unregistered securities without any fraud, and the sales have already ceased and are not likely to continue, it is meaningless to pursue the matter. Even if the jurisdiction has summary cease and desist powers, the investigator must realize that a hearing on such orders is allowed and should assume that any action which he takes or recommends will be vigorously opposed by the respondent.

In license cases involving pending applications, it is foolish to seek to deny a license on grounds which prior agency precedents held to be insufficient, regardless of how objectionable the applicant may seem to the investigator.

Little can be accomplished by pursuing cases where only one purchaser out of many is found to be unhappy even if the investigator is reasonably certain that the investor's story is correct. Such cases should be pursued only if the investigator has clear physical evidence documenting the violation.

The investigator must be cautious not to become involved in protracted investigations of seemingly important matters where the facts cannot be established with clarity. The cases to pursue are those where solid facts exist which can be proven to show clearly and convincingly that violations of the securities laws exist and have caused substantial harm to the public or which, if not immediately abated, will result in substantial harm to the public. Prevention or elimination of harm to the public is the only meaningful resolution to any case. The investigator must not forget his job's purpose.

B. HOW IMPORTANT IS THE CASE ?

The importance of a case is measured by the degree of harm done or to be done to the public by the promoter and by the chances of achieving a favorable resolution. The investigator must constantly weigh the relative importance of each case so as to avoid wasting time investigating relatively unimportant matters. Clearly, nothing can be accomplished by keeping cases active that, because of other priorities, will never be pursued.

The priority of a case must be considered, not only in its individual ranking among all of his open cases, but its ranking in a series of cases involving the same general subject matter. As an example, assume that in the oil and gas securities investigations of an investigator, millions of dollars have been lost by investors in a giant fraud. Intensive investigation ensues and in the course of such investigation there are ten or twelve companies known to be engaged in the particular fraudulent plan of business. The investigator may obtain injunctions against four or five of the major companies and under this pressure all of the other companies cease business and are completely abandoned. Criminal cases are then brought against the promoters of two or three primary companies. Criminal action may be warranted against the principals of all twelve of the companies involved but the investigator must weigh the benefits to be derived against the time it would take in light of his entire work load.

C. WHEN TO MAKE THE DECISION

There is a delicate balance between closing a case too soon and not closing it soon enough. Any case closed, before the investigator has established the basic facts, is closed too soon unless the Statute of Limitations has run. The basic who, what, when, where, why and how must be known before a decision as to the merits of a case can be made. The point at which the facts indicate that further investigation will be unproductive, or unwarranted because of higher priority matters, is the time to assign a low priority to the investigation or to close it. Investigations which are closed, or are not pursued prior to establishing basic facts, are not low priority cases; they are uninvestigated cases with priority unknown.

A good securities investigator can make initial decisions quickly, conduct a preliminary investigation with a minimum of time and effort and make a decision whether a case should be fully investigated or closed. An investigator who cannot routinely conduct preliminary investigations without dropping or setting aside other demanding active investigations is not making proper use of his time.

If an agency administrator becomes alarmed by a matter, he may insist on a lengthy and laborious investigation which quickly reveals to the investigator that the suspicion of great harm to the public and massive fraud is without basis. The investigator should attempt to impress this fact upon the administrator and try to prevent a massive undertaking which leaves other meritorious cases abandoned. The massive investigation, while stimulating in the beginning, is generally unproductive. Intensive and well-planned investigation by one or two investigators can frequently accomplish the same result and at fraction of the cost in man hours.

The securities investigator has great responsibility and power. He must never become blase or casual about his job or so engrossed in the day to day details of the job that he forgets its

overall significance. One flippant remark, one report prepared where a question wasn't asked and the investigator supposed the answer and set it down as fact, one decision to drop a case without doing an adequate preliminary investigation, can have profound effects upon the lives of many persons with whom the investigator does not come into contact. The investigator will frequently discover that he does not do the right thing in every situation. However, well calculated actions, which prove to be incorrect, are preferable to doing nothing. An investigator is confronted by, creates and operates in situations of controversy and tension. He should attempt to control the turmoil for he cannot eliminate it. The investigator must constantly strive to learn more about the areas in which he deals. He will never know enough.

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