



PROGRAM MATERIALS

Program #1939

April 14, 2009

The Implications of the Crisis on Wall Street

**Copyright © 2009 by Thomas O. Gorman, Esq.; Frank C.
Razzano, Esq. All Rights Reserved.
Licensed to Celesq®, Inc.**

Celesq® AttorneysEd Center
www.celesq.com

6421 Congress Avenue, Suite 100, Boca Raton, FL 33487
Phone 561-241-1919 Fax 561-241-1969

DOJ, THE SEC AND THE MARKET CRISIS

Thomas O. Gorman
Porter Wright
www.secactions.com

Frank Razzano
Pepper Hamilton, LLP

April 14, 2009

PART I

The Criminal Implications of The Crisis on Wall Street

What is Criminal Securities Fraud v. Civil Securities Fraud?

A. WILLFULNESS (Section 32 of '34 Act and § 24 of '33 Act)

1. Voluntary conduct?
2. Reckless conduct?
3. Evil or purposeful?
4. Knew conduct is unlawful?
 - a. Ratzlof v. United States, 510 U.S. 135 (1994)
5. Willful blindness?
 - a. United States v. King, 351 F. 3d 859, 866-67 (8th Cir. 2003)
6. No knowledge provisions
 - a. U.S. v. Lilley, 291 F. Supp. 989, 992-93 (S. D. Tx. 1968)

B. 2nd & 9th CIRCUITS - RECKLESSNESS

1. U.S. v. Peltz, 433 F. 2d 48 (2nd Cir. 1970)
2. U.S. v. Tarallo, 380 F. 3d 1174 (9th Cir. 2004)

C. PRACTICAL

1. Discretion: Can prosecutor obtain conviction?
2. In fact, easier to plead criminal v. civil case
 - a. Civil: PSLRA
 - b. Criminal: Indictment alleged in statutory language sufficient

HOW HAS THAT DISCRETION BEEN EXERCISED TO DATE: PENDING PROSECUTIONS & INVESTIGATIONS

A. ARS Market

1. Indictments / Parallel / SEC Proceeding

a. Julian Tzolov and Eric Butler, former Credit Suisse Securities Brokers, LLC

- Indicted for conspiracy, securities and wire fraud for scheming to obtain higher sales commissions by selling \$1B in auction rate securities backed by mortgages to customers, who placed orders for ARS backed by student loans.

PENDING PROSECUTIONS & INVESTIGATIONS (continued)

2. Reported Targets

a. Lehman

- **Dumping auction rate securities into customer accounts as the market unraveled**
- **Using client funds to buy auction rate securities to prop up the market**
- **Last spring, S.E.C. received evidence of insider trading at Lehman**
- **Lehman's Product Management Group routinely received research reports before they were made public. Senator Grassley has written Mary Shapiro to determine if S.E.C. followed up**

b. UBS

- **Possible insider trading by David Shulman, the firm's head of fixed income, and others, including David Aufhauser, UBS's General Counsel, for selling his holdings in auction rate securities ahead of the collapse of the market. Aufhauer resigned and agreed to pay \$6.5M in order to settle charges with NYAG**

PENDING PROSECUTIONS & INVESTIGATIONS (continued)

B. Mortgage Backed Securities

1. Mark Turkcan, President Of First Mortgage Bank in St. Louis, indicted for:

- Covering up losses from purchase and sale of mortgage backed securities.**

2. Operation Malicious Mortgage

- Operation Malicious Mortgage resulted in 144 mortgage fraud cases in which 406 defendants charged through June, 2008.**

PENDING PROSECUTIONS & INVESTIGATIONS (continued)

- 3. Ralph Cioffi and Matthew Tanmin, senior managers at Bear Stearns indicted**
 - Conspiracy, securities and wire fraud in connection with marketing two funds as low risk strategy, backed by a pool of debt securities such as mortgages, when knowing the funds were in grave condition and risk of collapse**
 - Cioffi also charged with insider trading**

PENDING PROSECUTIONS & INVESTIGATIONS (continued)

- 4. Reported investigations of Fannie and Freddie Mac, AIG, Lehman and Washington Mutual**
 - **Accounting misstatements**
 - **FBI Director Robert Mueller has promised to “pursue these cases as far up the corporate chain as necessary to ensure those responsible receive the justice they deserve.”**

5. S.E.C. Subprime Working Group – approximately 100 enforcement staff working with SROs, DOJ, Treasury, Federal Reserve and other state and federal regulators. Focused upon 1) subprime lenders; 2) investment banks and other large financial institutions; 3) catch-all group including those who securitized and sold tranches of subprime debt, credit rating agencies.*

* Testimony of Elise B. Walter, Commissioner of S.E.C. before U.S. House of Representatives, Committee on Financial Services, March 20, 2009.

- 6. S.E.C. Enforcement's Rumors and Market Manipulation Working Group – false rumors used in combination with shorting. Working with FINRA, NYAG and USAO, SDNY***
- 7. Hedge Fund Working Group – Ponzi schemes; lack of due diligence by feeder funds; and, exercise of redemption right (some investors favored over others).***
- 8. ARS Group – S.E.C., FINRA and state regulators looking at whether investors misled about market risk.***

* Testimony of Elise B. Walter, Commissioner of S.E.C. before U.S. House of Representatives, Committee on Financial Services, March 20, 2009

PENDING PROSECUTIONS & INVESTIGATIONS (continued)

C. The Madoff Mess

1. Its Magnitude

- a. In 1980 the Joint Economic Committee of Congress estimated that the short term direct dollar cost of white-collar crime was roughly \$44B.**
- b. In 1999, David A. Anderson in “The Aggregate Burden of Crime,” 42 J.L. & Econ. 611, 636-8 (1999), estimated \$36B annual loss for mail fraud.**
- c. Madoff estimated loss is \$50B.**

WHAT FUTURE HOLDS: ONE OF THE NEW ADMINISTRATION'S PRIORITIES - WHITE COLLAR CRIME

- A. The Perception that White Collar Crime has not been vigorously prosecuted**
 - 1. Syracuse University survey of securities fraud prosecutions**
 - a. 133 – last fiscal year**
 - b. 513 – in fiscal 2002**
 - c. 437 – in fiscal 2000**
 - 2. Pequot Capital**

ONE OF THE NEW ADMINISTRATION'S PRIORITIES: WHITE COLLAR CRIME

B. The Amazing Admission of Former Chairman Christopher Cox regarding S.E.C. Enforcement

- 1. SEC knew and didn't adequately respond to Madoff**
- 2. SEC Opening/Closing Memoranda in Madoff**
 - 1. Opening – investigating Ponzi scheme**
 - 2. Closing – non mention of Ponzi scheme**
- 3. Stanford International Bank**
 - a. Previous violations/red flags missed**
 - Net capital**
 - FINRA**

NEW ADMINISTRATION WILL DEMAND A REFOCUSING OF THE DOJ'S AND SEC ENFORCEMENT EFFORTS

C. New Initiatives

- 1. 2,000 open investigations into mortgage fraud and 566 corporate fraud investigations, of which 43 involved matters related to current financial crisis, according to FBI Deputy Director John Pistole in testimony on 03/20/19***
- 2. Rita Glavin, head of DOJ Criminal Division, studying a nationwide mortgage fraud taskforce rejected by AG Mukasey**

D. What Will Happen?

- 1. Clean house at the SEC**
 - Linda Thompson resigned**

***WSJ, 03/20/09**

NEW ADMINISTRATION WILL DEMAND A REFOCUSING OF THE DOJ'S AND SEC ENFORCEMENT EFFORTS

2. Vigorous enforcement

- Not limited to small “pump & dumps”**
- Concentrating on investment banking; conflicts of interest on the street; the role of “gatekeepers.”**
- Gatekeepers – according to Noel Barofsky (TARP Special IG), “[t]hey have the most to lose, they’re the most likely to flip, and they make the best examples.”**

3. Regulation of hedge funds

- Probably will be regulated by Investment Management Division of SEC.**

4. Regulation of credit default swaps and derivatives.

NEW ADMINISTRATION WILL DEMAND A REFOCUSING OF THE DOJ'S AND SEC ENFORCEMENT EFFORTS

5. Investigation of Hedge Funds

- a. Is Madoff the tip of an iceberg?
 - i. 10,000 hedge funds
 - ii. \$2T in assets
 - iii. 20 to 50% trading
 - iv. Already seen others
 - » *U.S. v. Forte* - \$50M
 - » *U.S. v. Steinger* - \$1.25M
 - » Stanford Financial - \$8B – sale of certificates of deposit by R. Allen Stanford and two colleagues, working through firms in Texas and Caribbean

NEW ADMINISTRATION WILL DEMAND A REFOCUSING OF THE DOJ'S AND SEC ENFORCEMENT EFFORTS

- » **S.E.C. v. Nicholson (S.D.N.Y.)** – Investors who sought to redeem shares in Westgate Absolute Return Fund, LP managed by Westgate Capital Management, found their checks returned for insufficient funds. James M. Nicholson, President and general partner of Westgate arrested.
- » **S.E.C. v. North Hills Management (S.D.N.Y.)** – Mark Bloom of North Hill Management arrested for raising \$30 M which was to be placed in a group of hedge funds. In fact, \$13 M misappropriated and half of funds put into a commodities trading pool which paid Bloom a \$1.6M referral agreement.
- » **S.E.C. v. Billion Coupons, Inc. (D.Haw.)** - CEO Marvin Cooper allegedly operated a Ponzi scheme, claiming to be involved in FOREX trading.

NEW ADMINISTRATION WILL DEMAND A REFOCUSING OF THE DOJ'S AND SEC ENFORCEMENT EFFORTS

- » **S.E.C. v. W.G. Trading (S.D.N.Y.)** – Paul Greenwood and Stephen Walsh charged criminally by USAO and sued civilly by CFTC and S.E.C. for raising \$668M from investors for investment in an enhanced equity index strategy. In fact, they misappropriated the money.
- » **S.E.C. v. Lawton (D.Minn.)** – John Lawton and his fund Paramount Partners, L.P. alleged that customers invested \$10.8M based on annual returns of 6.5% to 19%. The S.E.C. froze assets, which are estimated at \$2M.

» **S.E.C. v. Sunwest Management Co. (D. Ore.)** – Sunwest which managed 320 retirement facilities in 34 states raised \$300M by offering tenancy-in-common interests in specific retirement homes, that allegedly generated a 10% annual return. However, Sunwest was a single integrated enterprise and comingled all funds. As the economy weakened, Sunwest operated as a Ponzi scheme using money raised in new offerings to pay the 10% return to older investors.

- » **S.E.C. v. Locke Capital Management, Inc. – S.E.C. charged Leila Jenkins and Locke Capital Management with a securities fraud spanning six years by making up a supposed billion dollar client based in Switzerland to lure real investors. Additionally, Locke deceived clients about the number, identity and role of its employees. The S.E.C. worked with the U.K. FSA, the Swiss Financial Market Supervisory Authority and Spain’s Comision Nacional Del Mercado De Valores in connection with this matter.**

- » **U.S. v. Friehling (S.D.N.Y.) – U.S. Attorney’s Office and S.E.C. charge Madoff’s outside auditors.**

- » **S.E.C. v. Hu (N.D.Cal.)** – Albert K. Hu, a hedge fund manager charged with misappropriating investor funds by transferring them to foreign banks. Hu arrested in Hong Kong.

- » **S.E.C. v. The Nutmeg Group (N.D. Ill.)** – The Nutmeg Group, an investment adviser to 15 unregistered investment pools, owner and manager Randall Goulding and CCO David Goulding charged with misappropriating client assets, misrepresentation and failure to comply with custodial obligations.

- » **S.E.C. v. Millennium Bank (N.D. Tx.)** – Defendants raised \$68M from 375 investors who were misled into believing they were investing in CDs of Millennium Bank licensed in St. Vincent and the Grenadine. Actually, it was a Ponzi scheme.

- » **S.E.C. v. Dime Financial Group, LLC (W.D. Wash.)** – John H. Min allegedly misappropriated \$1.4M of investor money. He targeted churches, church members and senior citizens.

- » **S.E.C. v. Edward T. Stein Associates, Ltd., et al. (S.D.N.Y.)** – Edward T. Stein through accounts at his investment funds sold \$55 million to 80 investors in a Ponzi scheme. The USAO in the E.D.N.Y. also announced criminal charges against Stein.

NEW ADMINISTRATION WILL DEMAND A REFOCUSING OF THE DOJ'S AND SEC ENFORCEMENT EFFORTS

- E. Fraud Enforcement and Recovery Act of 2009, S.386, proposed by Senators Leahy, Grassley and Kaufmann**
- Authorizes \$165M to hire fraud prosecutors and investigators at DOJ for fiscal years 2010 and 2011, including \$75M in 2010 and \$65M in 2011 for the FBI; \$50M for U.S. Attorneys' offices; \$20M for the Criminal Division of DOJ; \$15M for the Civil Division of DOJ; and \$5M for the Tax Division of DOJ. It also authorizes \$120M for 2010 and 2011 for investigators and analysts at U.S. Postal Inspection Service and OIG at HUD. It authorizes \$20M for 2010 and 2011 for the Secret Service of the Department of Homeland Security.**
 - Amend 18 U.S.C. § 20 and add Section 27 to include mortgage lending business in definition of "financial institution," so that bank fraud statute passed in mist of S&L crisis will cover mortgage lenders.**

NEW ADMINISTRATION WILL DEMAND A REFOCUSING OF THE DOJ'S AND SEC ENFORCEMENT EFFORTS

- **Amend 18 U.S.C. § 1014 to add “mortgage lending business”**
- **Amend 18 U.S.C. § 1031, major fraud against U.S., to protect funds expended under TARP and economic stimulus package.**
- **Amend securities fraud statute, 18 U.S.C. § 1348, passed as part of SOX to include commodities fraud.**
 - **“any commodity for future delivery, or any option on a commodity for future delivery”**
- **Legislatively overrule Supreme Court decision in *Santos v. U.S.*, holding that proceeds under money laundering statute 18 U.S.C. § 1956 is limited to profits.**
 - **Proceeds means “any property derived from or obtained or retained, directly or indirectly, through some form of unlawful activity, including the gross receipts of such activity”.**
- **Amend Qui Tam statute.**

F. The Omnibus Appropriations Act of 2009

- **Increases Securities and Exchange Commission budget by \$37 million to enhance enforcement, capital markets oversight and investor protection activities; Commodities futures Trading Commission budget by \$35 million; and, Federal Trade Commission budget by \$15 million through September 30th. Public Law No. 111-008 (3/11/09).**

G. Budget

- **Under the President's Budget, S.E.C. would receive 13% increase in funding over previous fiscal year.**

WHO WILL THEY PROSECUTE?

A. Probably not the entities

1. Government is not interested in forcing more financial institutions into bankruptcy and liquidation

B. Kinder and Gentler Approach:

Change in policy at the DOJ on corporate cooperation in light of *U.S. v. Klein*.

- Senator Arlen Specter – third try: S.445 – would prohibit federal prosecutors and investigators from requesting or conditioning charging decisions on an organization's reasonable assertion of A-C privilege or decision to pay attorney's fees.

HOW WILL THEY PROSECUTE?

C. Focus on Individuals

1. Will avoid complex technical issues

2. Focus

- **Disclosure and misrepresentations**
 - **Financial Statement and Manipulation**
 - » **Subprime exposure**
 - » **Intentional misrepresentation regarding mispricing of securities**
 - » **Loan quality**
 - » **Credit risk exposure**
 - » **Mortgage delinquency**
 - » **Default rates**
 - » **Prediction of future performance**

- **Accounting Fraud**
 - **Loan Loss Reserves**
 - **Valuation of Assets**
 - **Timing and Amount of Write-Downs**
- **Insider Trading**
 - **Abuse of Rule 10b-5-1 trading programs***

* New Century Financial Corp. under investigation for abusing plans. Vikas Bajaj & Julie Creswell, Authorities Investigating Big Lender, N.Y. Times, March 3, 2007 at C1.

- **International Cases**

- FSA in England – 12 count indictment against stockbroker, Malcolm Calvert
- FSA estimates that 25% of all takeover deals are preceded by suspicious trading
- HK S.E.C. – Vickey Hung, an employee of Sino Gulf Holding, Ltd. sold 180,000 shares prior to announcement of negative news. Pled and received 6 month suspended sentence.

- **The Cover-up Obstruction**

- Martha Stewart
- Scooter Libby

HOW WILL THEY PROSECUTE? (continued)

3. Investment Bankers

- Conspiracy
- Recklessness
- Willful Blindness

HOW WILL GOVERNMENT INVESTIGATE: INVESTIGATIVE TECHNIQUES

A. Not like SEC

B. Blue Collar Techniques

1. Search warrants

- **Coordinated internationally**
- **Document Control**
- **Attorney-Client Privilege**
- **Employee Interviews**

INVESTIGATIVE TECHNIQUES

(continued)

2. Electronic surveillance

- **Turn co-conspirator and wire up**

3. Whistleblowers

4. “Jumping on the bus” and trading up

- **Testimony is a commodity**

5. Ambush interview

CONSEQUENCES OF PARALLEL SEC, CFTC AND BANKING INVESTIGATIONS AND PROCEEDINGS

- A. Denies the putative target the refuge of the Fifth**
- B. Perjury, false statement and obstruction**

SENTENCING

- A. 2B1.1 – loss resulting from client’s activities and reasonably foreseeable acts of others in furtherance of jointly undertaken criminal activity**
- B. Loss Causation**
 - Court must consider factors other than fraud that caused decline in price**

**GIVEN THE RISKS
WHAT DO YOU DO?**

COMPLIANCE

IS COMPLIANCE SYSTEM REQUIRED?

A. Duty of Board to establish and maintain system of internal controls

1. Fiduciary Duty – Caremark International Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996)
2. SOX
3. Federal Government Contractor Regulations

B. Negates Intent? – U.S. v. Hilton Corp., 467 F.2d 1000 (9th Cir. 1972)

C. Federal Sentencing Guidelines for Corporations

- Reduces culpability score
 - Occurred despite effective compliance program
 - No high level individuals participated
 - No unreasonable delay

ADVANTAGES OF COMPLIANCE

- A. Reduces frequency of violations among senior level personnel**
- B. Helps to detect problems while small**
- C. Program which is enforced, monitored and audited by high level management employees may be persuasive in determining whether to indict an entity**

WHAT SHOULD COMPLIANCE PROGRAMS INCLUDE?

A. Policy Statement

1. Written codes of conduct and ethics that define what is prohibited
 - Reasonably designed, implemented and enforced so that it is generally effective in preventing and detecting criminal contact
2. Statement should articulate corporate values, policies and procedures
3. Explain how to identify and report violations
4. Outline due diligence process for hiring employees and engaging suppliers and consultants

B. Management Level Supervision of Program

- Specific individuals within organization delegated day-to-day operational responsibility for compliance and ethics

C. Education and Training

- Periodic training
- Certification that training received and policies being complied with

D. Enforce the program

- Help lines
- Pre-retention & post-retention oversight
- Monitoring and auditing
 - Internal audit of internal control procedures
 - Insure books and records accurately reflect transactions
 - Periodic board or management review
- Periodically evaluate
 - Independent audits of system
 - Focus on “red flags”
- Appropriate disciplinary measures
 - Restitution and remediation

PART II

The SEC And The Market Crisis: Its Impact

INTRODUCTION

- The Market Crisis has spawned three key responses from the SEC
 - Intervention in the markets
 - Enforcement investigations
 - Calls for legislative reform
- In addition there are other calls for reform from government, the private sector and the international community
- Collectively these efforts are likely to have a impact on issuers, directors, officers and general counsels

INTRODUCTION

- To examine the potential impact of the market crisis in this regard four points will be analyzed:
 - Market interventions
 - The scope of current investigations
 - Key legislative reform proposals
 - Analysis and conclusions

INTERVENTION IN THE MARKETS

Overview: The SEC has focused on short selling and fair value accounting

- *Short selling:* In August 2008 the SEC imposed a ban on short selling followed by additional disclosure requirements keyed to preventing naked short selling
 - In 2007 the SEC had dropped the uptick rule, a 1930's era rule designed to curb short selling

INTERVENTION IN THE MARKET

- *Short selling (cont)*
 - The ban has its roots in the Bear Stearns debacle. In July 2008 the share price of Bear Stearns dropped from \$50 to \$10 in one week as the company and the SEC sought to reassure the markets
 - Many believed that the company was the victim of a “bear raid”
 - At the same time Treasury was discussing propping up Freddie Mac and Fanny Mae
 - Regulators were concerned about the viability of financial institutions
 - The SEC is investigating trading in the shares of Bear Stearns and Lehman Brothers

INTERVENTION IN THE MARKET

- *Short selling (cont)*
 - The SEC expanded its ban in August and it continued through October.
 - Other regulators in the UK, Germany, Australia and Japan followed, imposing longer bans
 - The SEC's intervention raised a storm of criticism
 - Many called for the return of the uptick rule
 - Congressman Edward Markey questioned the approval by the SEC of the repeal of NYSE Rule 80A, the so-called "collar rule"

INTERVENTION IN THE MARKET

- *Short selling (cont)*
 - The ban then SEC Chairman Cox later lamented the ban as his most egregious error, claiming Secretary Paulson and Fed Chairman Bernanke pressured him
 - A report by the SEC Inspector General suggested that Corp Fin's failure to timely review Bear Stearns filings deprived investors of key information, contributing to the rumors. "SEC's Oversight of Bear Stearns and Related Entities," Report No. 446, Sept. 25, 2008
 - Now short selling is being blamed for pushing down the price of GE because of GE Capital which has opaque disclosure. See Joe Nocea, NYT, March 7, 2009

INTERVENTION IN THE MARKET

- *Short selling (cont)*

- On April 8 the SEC announced that it would seek comment on proposed rules regarding short selling.
<http://www.sec.gov/news/press/2009/2009-76.htm>

There will be two alternatives, each with variations

- A market-wide approach with two variations
 - Proposed modified uptick rule is based on a market-wide short sale price test based on a national best bid
 - Proposed uptick rule based on a market wide short sale price based on the last price or tick

INTERVENTION IN THE MARKET

- *Fair value accounting* centers on SFAS 157. The standard requires that the value of certain assets such as mortgage backed securities be adjusted to market rather than carried at historic cost
 - During the market crisis financial institutions have had to write down the value of their mortgage backed securities portfolios, creating huge losses
 - Critics of the standard argue it has caused market instability

INTERVENTION IN THE MARKET

- *Fair value accounting (cont)*
 - Regulators are reviewing the criteria used to value assets under the standard
 - Sept. 16, 2008: The International Accounting Standards Board Expert Advisory Panel issued a draft documents titled “Measuring and disclosing the fair value of financial instruments in markets that are no longer active”
 - Sept. 30, 2008 the SEC’s Office of the Chief Accountant and the FASB issued interim guidance on the following subjects:
 - The use of management’s internal assumptions in the absence of a market
 - How to use market quotes when assessing the mix of information available
 - Consideration of disorderly transactions
 - Transactions in an inactive market and value
 - Factors to consider in assessing whether an investment is other than temporarily impaired

INTERVENTION IN THE MARKET

- *Fair value accounting (cont)*
 - Section 133 of the Emergency Economic Stabilization Act directed the SEC to prepare a report which was completed early this year. The recommendations include:
 - SFAS No. 157 should be improved but not suspended
 - Additional measures should be taken to improve the application and practice
 - The accounting for financial asset impairments should be readdressed
 - Further guidance is needed to foster the use of sound judgment in this area
 - Accounting standards should continue to be established to meet the needs of investors
 - There is a need to simplify the accounting for investments in financial assets

INTERVENTION IN THE MARKET

- *Fair value accounting (cont)*
 - April 2, 2009: The FASB issued additional guidance on use of the standard when there is a lack of a readily available market. Summary of Board Decisions, April 2, 2009 Meeting at www.fasb.org/actions/sbd040209pf.html
 - Directs the staff to prepare a final draft of FAS 157-e
 - Entity must determine if market is active or inactive
 - If the market is inactive must consider if transactions were orderly
 - If the market is inactive and the transactions not orderly entity must look to other factors for value such as management's judgment about projected cash flow
 - April 2009: HR 1909 was introduced, titled: To direct the Securities and Exchange Commission to suspend the application of mark-to-market accounting

INTERVENTION IN THE MARKET

- *Auditing*
 - The PCAOB issued a Staff Audit Practice Alert on Audit Considerations in the Current Economic Environment
 - The Alert focuses on six areas of increased concern
 - These include fair value measurements, accounting estimates, the adequacy of disclosures and considerations regarding the ability of an enterprise to continue as a going concern
 - See *also* Marc Panucci, SEC Associate Chief Accountant, Office of the Chief Accountant, Remarks Before the 2008 AICPA National Conference on Current SEC and PCAOB Developments, Dec. 8, s008, www.sec.gov/news/speech/2008/spch120808mp.htm (raising concerns for management and the auditor re the market crisis)
 - This may result in additional audit scrutiny

CURRENT INVESTIGATIONS

Overview: The SEC has over 50 open investigations related to the market crisis. Few cases have been brought. More will be brought and these inquiries may impact legislative proposals

- *Areas of inquiry:* There are four key areas
 - The Subprime Working Group: Formed in March 2007, 100 staff members are assigned. The group coordinates with the USAO. Key areas are:
 - accounting: use of loan reserves and asset valuation
 - disclosure: keyed to loan quality, credit risk, mortgage delinquency, default rates and exposure to the subprime market
 - Insider trading
 - Trading in credit default swaps

CURRENT INVESTIGATIONS

- *Areas of inquiry (cont)*
 - Large financial institutions: This group is focused on
 - Issues regarding the timing and amount of write-offs
 - False disclosure regarding subprime exposure or concentration, financial condition, future financial performance and the valuation of assets
 - The possible intentional mispricing of securities and the knowing underwriting of securities based on collateral likely to default
 - Related internal control questions
 - False representations made to retail customers to induce them to purchase securities such as mortgage backed investments
 - Market manipulation and trading issues

CURRENT INVESTIGATIONS

- *Areas of inquiry (cont)*
 - Rumors and Markets Manipulation group: This group is focused on the spreading of false rumors in conjunction with short selling. It coordinates with FINRA, NYSE, USAO and NYAG
 - Hedge Fund Working Group: There are “dozens” of hedge fund related investigations. They focus on whether the lack of transparency is used to conceal Ponzi schemes or other misconduct by “fund of funds” and “feeder funds” or insiders gaining preference over investors when redemptions are restricted

CURRENT INVESTIGATIONS

- *Areas of inquiry (cont)*

- Other investigations. There are other market related investigations including:

- Bear Stearns and Lehman Brothers: These focus on the circumstances and trading surrounding the collapse of these Wall Street Banks. In part they are reviewing possible insider trading.
- Auction rate securities: Investigations in this area have resulted in settlements or settlements in principle with a number of financial institutions (see below). The actions focus on the representations made to investors.

CURRENT INVESTIGATIONS

- *Cases brought to date:* A small number of enforcement actions have been brought to date including:
 - *SEC v. Cioffi*, Civil Action No. 08-2457 (E.D.N.Y. June 19, 2008). Action against Ralph Cioffi and Matthew Tannin, two former portfolio managers at Bear Stearns. It alleges that the defendants fraudulently misled investors about the financial state of two large hedge funds of the investment bank and their exposure to the subprime market. Parallel criminal charges have been filed.

CURRENT INVESTIGATIONS

- *Cases brought to date (cont)*
 - *SEC v. Tzolov*, Case No. 08 Civ. 699 (S.D.N.Y. Sept. 3, 2008). Case alleges two brokers made more than \$1 billion in unauthorized purchases of subprime related auction rate securities after telling customers the securities would be backed by student loans. Criminal charges have been filed.
 - *SEC v. Ainsworth*, Case No. EDVC 08-1350 (C.D. Cal. Oct. 3, 2008). Action against 5 LA brokers who convinced customers to refinance into subprime mortgages and take the equity from their home to make unsuitable investments.

CURRENT INVESTIGATIONS

- *Cases brought to date (cont)*
 - *SEC v. Berliner*, Civil Action No. 08-cv-3050 (S.D.N.Y. Filed April 24, 2009) is the first ever case based on a short seller circulating false rumors. The defendant consented to an injunction and disgorgement.
 - *SEC v. Nicholson*, Civil Action No. 09-civ-1748 (S.D.N.Y. Feb. 25, 2009) alleges that James Nicholson and his company, Westgate Capital Management, defrauded investors by misrepresenting the returns and assets of 11 unregistered hedge funds under their management.

CURRENT INVESTIGATIONS

- *Cases brought to date (cont)*
 - *SEC v. WG Trading Investors, LP*, Civil Action No. 09-1750 (S.D.N.Y. Feb. 25, 2009). The complaint alleges that defendants Paul Greenwood and Stephen Walsh and their related entities misled investors by telling them their funds would be invested through a stock index arbitrage strategy when in fact defendants took large parts of the money,
 - *SEC v. North Hills Mgt. LLC*, Civil Action No. 09-1741 (S.D.N.Y. Feb. 25, 2009) is an action against Mark Bloom and his firm which alleges he raised about \$30 million from investors claiming that it would be invested in a diverse group of hedge funds when in fact much of the money was diverted to his personal use.

CURRENT INVESTIGATIONS

- *Cases brought to date (cont)*
 - *SEC v. Madoff*, Civil Action NO. 08 Civ. 10791 (S.D.N.Y. Dec. 11, 2008) is the case filed against disgraced Wall Street financier Bernard Madoff based on what is claimed to be the largest Ponzi scheme in history. The action is partially settled.
 - *SEC v. Stanford International Bank*, Case No. 3-09-cv-209 (S.D. TX. Feb 17, 2009) is an action brought against Robert Allen Stanford and his related group of companies including an Antigua based bank. It is alleged to be a \$9 billion Ponzi scheme.

CURRENT INVESTIGATIONS

- *Cases brought to date (cont)*
 - Ponzi scheme cases: The SEC has brought a number of these cases in recent months. In the last two years the Commission has filed 75 Ponzi scheme cases.
 - Auction rate securities. Three cases have been brought and settled while in several others there are agreements in principle. In each case the defendant agreed to repurchase ARS from retail customers and, for institutional investors either use best efforts to bring liquidity to the market or in some cases repurchase the securities after the purchases from retail customers:
 - *SEC v. Citigroup Global Markets, Inc.*, Civil Action No. 08 civ 10753 (S.D.N.Y. Dec. 11, 2005)
 - *SEC v. UBS Securities LLC*, Civil Action No. 08 civ 10754 (S.D.N.Y Dec. 11, 2008)
 - *SEC v. Wachovia Securities LLC*, Civil Action No. 09 CV 743 (N.D.Ill. Feb. 5, 2009)
 - Agreements in principles have been entered into with Merrill Lynch, Bank of America and RBS Capital Markets Corp.

CALLS FOR REFORM

Overview: The market crisis has resulted in a number of proposals for reform. These range from retooling the entire financial regulatory landscape to giving individual agencies additional tools. They include:

- *Financial Regulator Reform Act of 2008.* Introduced in the Senate Nov. 2008. Key provisions would:
 - Give the CFTC authority over CDS
 - Give the Fed authority over investment bank holding companies
 - Require the SEC, in consultation with the Fed and the CFTC to issue rules regarding the designation of a clearing house for CDS and prevent fraudulent practices in that market
 - Create the Commission on Financial Regulatory Reform to study the current market structure and report to the President and Congress in six months

CALLS FOR REFORM

- *The Financial Oversight Commission*, introduced in the House of Rep. Nov. 2008. This bill creates a Commission to study and report on the causes of the current market crisis.
- *The Supplemental Anti-Fraud Enforcement Markets Act (“SAFE”)*, S. 331 introduced January 2009. This bill would provide the FBI with \$80 million to hire 500 new agents in its white collar crime division. The SEC would receive up to \$20 million to hire 100 new enforcement officials. DOJ would be given \$10 million for 50 new U.S. Attorneys

CALLS FOR REFORM

- S-2484, March 2009: This bill would authorize additional FBI field agents to investigate financial crime. The bill, pending before the Judiciary Committee, would authorize \$150 million for each fiscal year from 2010 to 2014 to fund approximately 1,000 additional FBI field agents to investigate financial fraud.
- HR 1909, April 2009: This bill would require the SEC to suspend fair value accounting.

OTHER ISSUES

Overview: Four other matters tied to the market crisis may influence the direction of SEC enforcement and regulation: Credit rating regulation; the New Century report; the IG reports; and high profile scandals.

- *Credit rating regulation:* In July 2008 the SEC published a staff report based on its examination of three credit rating agencies which were key in the subprime residential mortgage-backed securities and collateralized debt obligations markets. *Summary of Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies.* Key points include:
 - Some rating agencies struggled with growth in the market
 - Relevant rating criteria were not always followed
 - None of the rating agencies had specific written procedures
 - In some cases the agencies failed to follow their internal procedures
 - There are significant conflicts
- The SEC has issued proposed rules keyed to the report. See, e.g., Release No. 33-8940; 34-58071 (July 2008).
- See also *The Role of Credit Rating Agencies in Structured Finance Markets* (ISOCO April 2008).

OTHER ISSUES

- *The New Century Report*: After subprime mortgage lender New Century tumbled into bankruptcy its trustee conducted an internal investigation. See, e.g., *In re New Century TRS Holdings, Inc.*, 07-10416 (U.S. Bank. D. Del.). Key points include:
 - The report details how the lender significantly expanded its loan portfolio from about \$14 billion in 2002 to \$60 billion in 2006
 - The expansion was based on making increasingly risky loans and exceptions to company underwriting guidelines. Loans in many instances were given to people who could barely afford the “teaser rates.”
 - Seven improper accounting practices are detailed in the report including significantly undervaluing the repurchase reserve. These practices turned losses into gains and resulted in the payment of bonuses to executives based on false regulatory filings,

OTHER ISSUES

- *SEC Inspector General Report: SEC Oversight of Bear Stearns and Related Entities*, Report No. 446-A, Sept. 25, 2008. The report is highly critical of the SEC's voluntary CSE program which supervised investment bank holding companies on a voluntary basis and the staff's work re Bear Stearns. Key points include:

OTHER ISSUES

- *IG Report (cont)*
 - The report states that “it is undisputable that the CSE program failed to carry out its mission in the oversight of Bear Stearns”
 - Program requirements were inadequate – Bear Stearns complied but failed
 - Div. T&M was aware of numerous red flags re Bear Stearns including shortcomings regarding its risk management in mortgage-backed securities but took no action
 - Bear Stearns complied with the capital and liquidity requirements but still collapsed
 - Corp Fin failed to conduct a timely review of Bear Stearns’ most recent 10-K “depriving investors of material information that they could have used to make well-informed investment decisions. The information could have been potentially beneficial to dispel the rumors that led to Bear Stearns’ “collapse.”

OTHER ISSUES

- *Scandal:* The SEC and particularly the enforcement division has been mired in scandals, undermining its mission
 - *Madoff:* Congressional hearings and public accounts have detailed repeated missed opportunities to discover this scam sooner
 - The testimony demonstrated that despite a virtual road map the division failed in earlier investigations to discover the fraud
 - The stigma was heightened by the then Chairman distancing himself from the failures, blaming the staff. The staff amplified the failures by invoking privilege when asked to testify about past investigative efforts by congress.
 - The SEC's IG is conducting a wide ranging investigation

OTHER ISSUES

- *Scandal (cont)*
 - *Pequot Capital*: This scandal began in 2007 with a whistleblower complaint filed by a former SEC enforcement staff attorney. It centers on questions keyed to favoritism based on personal contacts which may have thwarted an insider trading investigation
 - A Senate report was highly critical of the SEC staff performance and calls for reform. Minority Staff of S. Comm. On Finance, 110th Cong., 1st Sess. The Firing of an SEC Attorney and the Investigation of Pequot Capital Management (S. Prt. 110-28 Aug. 2007)
 - Recently the SEC reopened this investigation and the USAO opened a criminal inquiry, both based on the same subject matter as the earlier, closed investigation

ANALYSIS AND CONCLUSIONS

The way forward

- *A New Beginning:* The SEC has a new Chairman, Mary Shapiro, who has promised to rejuvenate the enforcement division. Initial steps include:
 - A new General Counsel
 - A new Director of Enforcement
 - Retention of a firm to review how enforcement handles tips and other leads
 - Reversal of the “pilot project” re corporate penalties
 - Streamlined process to obtain a formal order
 - Reconsideration of the uptick rule

ANALYSIS AND CONCLUSIONS

The way forward (cont)

- *New Authority:* Key pending bills include those calling for more resources for the FBI, USAO and the SEC. Increased resources is consistent with the repeated statements of the new SEC chairman to congress

ANALYSIS AND CONCLUSIONS

The Way Forward (cont)

- *Regulatory overhaul:* There have been repeated calls for regulatory overhaul. Some call for sweeping reform while others focus on giving regulators new tools.
 - Proposals have been put out by the Treasury Department
 - Various SEC officials have requested specific authority such as over CDS and investment bank holding companies

ANALYSIS AND CONCLUSIONS

The Way Forward – regulatory reform (cont)

- A key blue print was offered by Treasury Secretary Tim Geithner. Testimony before the House Financial Services Committee, March 26, 2009, www.treas.gov/press/release/tg71.htm. Key points include:
 - Establishing a single entity with responsibility for systemic stability over major institutions and critical payment and settlement systems
 - Establishing and enforcing more conservative capital requirements
 - Requiring leveraged private investment funds to register with the SEC
 - Establishing a comprehensive framework for oversight, protections and disclosures for OTC derivatives
 - The SEC should develop strong requirements for money market funds to reduce the risk of rapid capital withdrawals
 - Establish a strong resolution mechanism that gives the government tools to protect the financial system and the broader economy from the potential failure of large complex financial institutions.
- These points should be considered in conjunction with those from the recent G-20 meetings. See, e.g., *Declaration on Strengthening the Financial System* -- London, 2 April 2009.

ANALYSIS AND CONCLUSIONS

The Way Forward – regulatory reform (cont)

- Under the Treasury plan the SEC remains an independent agency and would:
 - Hedge funds: be given authority to require registration and probably net capital and record keeping requirements
 - Net Capital: Will probably be directed to supplement existing requirements and may obtain additional authority. New regulations may also focus on the cash flow section of MD&A
 - Money market funds. The SEC would be directed to strengthen the capital base for these funds. See, e.g., Speech of Andrew J. Donahue, Keynote Address at PLI Investment Management Institute 2009, April 2, 2009, www.sec.gov/speech/2009/spch40209ajd.htm (IM is undertaking a review of these regulations)
 - Executive compensation: The SEC will review and enhance regulation in this area perhaps with substantive limitations

ANALYSIS AND CONCLUSIONS

The way forward – regulatory reforms (cont)

- *Other reforms:* Recent events suggest that other reforms may include:
 - Enforcement: Ms. Schapiro has promised a rejuvenated program and brought in a new director. The forthcoming report of the IG will in probability have key recommendations
 - Corporation finance: The IG's report was highly critical of the division which can be expected to revamp the timing and manner in which it reviews filings
 - The uptick rule: Some form of short sale regulation will be adopted beginning with proposals which will be published shortly
 - Fair value accounting: There is significant clamor for further revisions in this area
 - Derivatives: Treasury's plan calls for a fundamentally redrawing the OTC derivatives market. This may include adding oversight in the mortgage backed securities market and other similar markets such as ARS. It is unclear which agency will have oversight but the SEC should be involved here.
 - Credit rating agencies: In view of their central role in the markets, additional regulation may be forthcoming here.

ANALYSIS AND CONCLUSIONS

The Way Forward (cont)

- Enforcement investigations
 - The directive from the PCAOB on audit risk may increase auditor scrutiny, lengthen audits and increase cost
 - The SEC's large inventory of investigations may expand over time and the scope of existing inquiries may broaden
 - Cases brought to date are probably not representative of those which will be filed

ANALYSIS AND CONCLUSIONS

The Way Forward –Investigations (cont)

- The subprime working group can be expected to continue its focus on accounting and disclosure issues focusing on loan quality, reserves and internal control issues
- The rumors and market manipulation group can be expected to continue to concentrate on the trading markets. Key here may be control cases such as *In the matter of Merrill, Lynch, Pierce, Fenner & Smith*, Adm. Proc. File No. 3-13407 (March 11, 2009)(settlement keyed to new procedures to control non-public information)
- The Hedge Fund Group can be expected to continue its focus on adherence to investment policies and the treatment of investors in contrast to insiders. The work of the group can be expected to be instrumental in developing rules for hedge fund regulation

ANALYSIS AND CONCLUSIONS

The Way Forward (cont)

- *End Note:* The market crisis can be expected to result in rejuvenated enforcement and enhanced regulation
 - Enhanced enforcement keyed to financial statement and disclosure issues
 - New regulation in previously unregulated areas such as hedge funds and derivatives
 - New scrutiny on risk, capitalization, cash flow and executive compensation
- *Preparation:* The SEC can be expected to play a key role. Those under the jurisdiction of the agency would do well to carefully review their controls and disclosures in these areas