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REPORT

SEC ENFORCEMENT

Trends in SEC Enforcement 2009

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The Securities and Exchange Commission ("SEC" or "the Commission") is at a crossroads. Its future is uncertain. Once the guardian of the nation's capital markets, known as an efficient regulator with a highly respected enforcement program, the Commission is now the subject of much criticism and is mired in scandal.

The on-going market crisis presents challenges of unknown magnitude for the troubled agency. The SEC has, at times, responded with what some have called bold steps, while at other times, it seemed to simply be a spectator. While some have suggested that this resulted only from a temporary lack of leadership, the scandals that continue to unfold belie this notion. As the crisis continues, the pressure on the agency has increased. Calls for reform range from giving the Commission additional resources and authority, to having it disappear into other agencies.

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Now, a new Chairman has promised to rejuvenate the SEC. Ms. Schapiro is rapidly assembling a new team and has taken steps to move the agency forward. New rule making proposals have been made and others promised. Enforcement reportedly is being reorganized, streamlined and invested with a new tone at the top.

Ms. Schapiro's efforts, coupled with the blueprint for reform offered by the Treasury Department which may give the agency more authority and the on-going work of the Enforcement Division, offer a glimpse of the way forward. The grant of additional authority could fill in gaps in the SEC's authority. In addition, the Enforcement Division reportedly has four task forces conducting dozens of investigations related to the market crisis.

Determining the direction of SEC enforcement is critical to those who come within the jurisdiction of the agency. Regulated entities, public companies, directors, officers and general counsels charged with advising their companies and executives all need to understand the future direction of the program.

To assess the likely path of SEC enforcement, five key points will be examined:

1. The SEC, the market crisis and calls for reform;

2. Significant recent policy initiatives which may influence future actions;

3. Primary areas of emphasis in 2008 which can be expected to give direction to future enforcement efforts including:

   a. The market crisis investigations and actions;

b. Insider trading;
c. Financial fraud;
d. Foreign Corrupt Practice Act (''FCPA''); and
e. Option backdating.
4. Significant recent legal rulings; and
5. Analysis and conclusions.

I. THE SEC, THE MARKET CRISIS AND CALLS FOR REFORM The market crisis and the repeated calls to rewrite the regulatory landscape make projecting the future direction of SEC enforcement hazardous. Some of the calls for reform are rooted in the current market crisis. Others stem from scandals that have tarnished the reputation of the SEC. An agency that until recently was largely unknown on Main Street U.S.A. is now unfortunately being recognized, not for its past successes, but for its failure to protect investors — its fundamental mission.

Examination of the enforcement program begins with a brief look at recent statistics. Last year, the SEC filed 671 cases, a record number.[1] This is the first increase in recent years. While this is significant, many critics note that the number is inflated by defaults and similar actions. Other critics point to recently published NERA statistics which demonstrate that the number of cases settled in 2008 declined to one of the lowest levels in years.[2] In the first quarter of 2009, however, settlements have increased compared to the prior quarter and to the same quarter one year earlier.[3]

Other statistics further cloud the view. A recent study published by Syracuse University based on Department of Justice (''DOJ'' or ''the Department'') data found that the number of securities fraud prosecutions declined significantly in 2008.[4] At the same time, the FBI reports that it is overburdened, with 530 corporate fraud investigations underway. These cases focus on financial fraud and insider trading.[5] While the vitality of SEC enforcement is not measured by the number of criminal cases brought, since those are exclusively in the purview of the Department of Justice, the numbers raise significant questions. This is particularly true since the SEC and the Department closely coordinate and often conduct parallel investigations and actions.

Collectively, these statistics raise more questions than they answer. No clear trend emerges from them. On the one hand, they clearly do not depict a vibrant enforcement program. At the same time, they also do not suggest one that is dysfunctional. The lack of a clear trend, however, might suggest a program in search of direction, supporting calls for reform.

Beyond the statistics, the current market crisis has spawned repeated calls for the reform of securities regulation as well as banking and other financial regulators.[6] Many have criticized the SEC's performance during the current crisis as lackluster, at best. A report from the SEC's Inspector General, for instance, is highly critical of the agency's performance during the demise of Bear Stearns.[7] That same report also criticized the agency's now-defunct program of voluntary supervision over investment bank holding companies.[8]

When the SEC did react to the market crisis, not only was it criticized, but perhaps worse, the agency second-guessed itself. In September 2008, the Commission initiated a ban on short trading in the shares of certain financial institutions.[9] Regulators around the globe instituted similar bans which lasted far longer than the modest few week embargo imposed by the SEC.[10] Yet after the SEC's ban ended, then-Chairman Cox claimed it was the biggest mistake of his tenure, undertaken only because of pressure from the Secretary of the Treasury and the Chairman of the Federal Reserve.[11] Attempting to shift blame for controversial actions suggests a rudderless agency, not a strong regulator.

Scandals in the enforcement division belie any notion that difficulties at the agency stem solely from a temporary lack of leadership. The *Pequot Capital* debacle is the scandal that will not die. The scandal was initiated

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[1] Press Release, Securities and Exchange Commission, SEC Announces Fiscal 2008 Enforcement Results (Oct. 22, 2008), *available at* http://www.sec.gov/news/press/2008/2008-254.htm.

[2] Jan Larsen, Dr. Elaine Buckberg, and Dr. Baruch Lev, *SEC Settlements Trends: 1Q09 Update* at 3 (Apr. 9, 2009), *available at* http://www.nera.com/image/PUB_Settlements_Update_0409.pdf.

[3] *Id.* at 2.

[4] Eric Lichtblau, *Federal Cases of Stock Fraud Drop Sharply*, N.Y. Times, Dec. 24, 2008, *available at* http://www.nytimes.com/2008/12/25/business/25fraud.html.

[5] *The Need for Increased Fraud Enforcement in the Wake of the Economic Downturn: Hearing Before the S. Comm. on the Judiciary*, 111th Cong. (2009) (statement of John Pistole, Deputy Director, Federal Bureau of Investigation).

[6] *See, e.g.*, Letter from Timothy Geithner Secretary, Department of Treasury, to Senator Harry Reid, et al. (May 13, 2009), *available at* http://www.financialstability.gov/docs/OTCletter.pdf; Luis Aguilar, Commissioner, Securities and Exchange Commission, Empowering the Markets Watchdog to Effect Real Results, Remarks Before the North American Securities Administrators Association's Winter Enforcement Conference (Jan. 10, 2009), *available at* http://222.sec.gv/news/speech/2009/spch011009laa.htm; Press Release, U.S. Department of the Treasury, Treasury Releases Blueprint for Stronger Regulatory Structure (Mar. 31, 2008), *available at* http://www.treas.gov/press/releases/hp896.htm (calling for the merger of the SEC and CFTC); Paul S. Atkins and Bradley J. Bondi, Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program, 13 Fordham J. Corp. & Fin. L. 367 (2008).

[7] Securities and Exchange Commission, Office of the Inspector General, Report No. 446-A, SEC's Oversight of Bear Stearns and Related Entities (Sep. 25, 2008), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf (''Bear Stearns Report'').

[8] *Id.* at 17-18, 34-35, 48.

[9] Emergency Order Pursuant to Section 12(k) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 34-58592 (Sep. 18, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58592.pdf.

[10] *See, e.g.,* Press Release, Ontario Securities Commission, OSC Issues Temporary Order Prohibiting Short Selling of Certain Financial Sector Issuers (Sep. 19, 2008), *available at* http://www.osc.gov.on.ca/Media/NewsReleases/2008/nr_20080919_osc-issue-temp-order.jsp; Press Release, United Kingdom Financial Services Authority, FSA statement on short positions in financial stocks (Sep. 19, 2008), *available at* http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml; William Launder, *BaFin: Extends Naked Short-Selling Ban To May 31*, Wall St. J., Mar. 30, 2009, *available at http://online.wsj.com/article/BT-CO-20090330-708180.html*.

[11] Amit R. Paley and David S. Hilzenrath, *SEC Chief Defends His Restraint*, Washington Post, Dec. 24, 2008, at A01, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/12/23/AR2008122302765.html (''Cox said the biggest mistake of his tenure was agreeing in September to an extraordinary three-week ban on short selling of financial company stocks.'').

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by a former SEC staff member turned whistleblower. Congressional hearings probed claims of undue influence and favoritism in an insider trading investigation of a hedge fund, where the testimony of a prominent witness was not taken for reasons which are far from clear. A Senate report was highly critical of the SEC's performance.[12] Just as the scandal seemed to be fading from view, reports surfaced that a criminal insider trading investigation is underway, as well as an SEC inquiry, both focused on the same allegations that were involved in the initial botched inquiry.[13]

The *Madoff* case only stoked the fires of scandal surrounding the agency and raised critical questions of basic competence as well as favoritism.[14] Here, the SEC had opportunities to discover at an earlier time what appears to be the Ponzi scheme fraud of the ages. At one point, the agency was even given a road map to the fraud — but lost its way.[15] The impact of this failure was intensified by the surprising comments of then SEC Chairman Cox, who yet again sought to distance himself from controversy, this time by blaming the staff.[16] Apparently heeding the comments of their leader, the entire senior staff of the agency completed the dismal portrait painted of the agency for the public by refusing to respond to questions from a Congressional oversight committee about the SEC's failed investigative efforts.[17]

Through it all the enforcement staff reportedly has been hard at work on over 50 active market related investigations. These investigations are being run by four key working groups: the subprime working group; the large financial institutions group; the rumors and market manipulation group; and the hedge fund working group. Each group has a particular focus. Overall, key issues being examined include those relating to the use of loan loss reserves and the valuation of assets, disclosure regarding asset and loan quality, the timing of write downs, false disclosure regarding market exposure, internal control issues, market manipulation and insider trading. These investigations have been ongoing for months and in all probability will expand over time.[18]

Scandal, a lackluster image and the continuing market crisis spawned calls form reform as new SEC Chairman Mary Schapiro took office. The new chairman has attempted to seize the moment, taking office with a vow to reform the agency and rejuvenate the enforcement program. Ms. Schapiro has moved swiftly, beginning with the creation of her team which includes a new general counsel, enforcement director and head of Corporation Finance. She has also moved quickly to streamline enforcement operations, dropping the ''pilot program'' of former Chairman Cox, which required the question of a corporate penalty to be submitted to the Commission prior to staff settlement negotiations, and facilitated the process for obtaining a formal order of investigation.[19] Her enforcement director is reportedly establishing a new ''tone at the top'' of the division and is assessing reforms focused on streamlining the division's operations. At the same time, Ms. Schapiro and the Commission have put out new rule proposals including those which would govern short sales[20] while promising more proposals on topics ranging from credit reporting agencies to executive compensation.[21] The new chairman has also signaled a return to the roots of the agency with the creation of a new Investor Advisory Committee.[22]

Even as Ms. Schapiro attempts to move the SEC forward with a focus on improving internal operations and additional investor protection rules, a new scandal has emerged which could derail her efforts. Now the FBI and DOJ are probing the conduct of two Enforcement

[12] Minority Staff of S. Comm. on Finance, 110th Cong. 1st Sess., S. Rep. 110-28, The Firing of an SEC Attorney and the Investigation of Pequot Capital Management at 46 (2007).

[13] Kara Scannell, *SEC Reopens Probe of Trading at Pequot*, Wall St. J., Jan. 8, 2009, at C5; Scot J. Paltrow, *Criminal Probe in Pequot Case*, Conde Nast Portfolio, Feb. 12, 2009, *available athttp://www.portfolio.com/news-markets/national-news/portfolio/2009/02/12/Criminal-Probe-in-Pequot-Case*.

[14] On December 11, 2008, the Commission filed its enforcement action against former NASD President Bernard Madoff, who is alleged to have run the largest Ponzi scheme in history. *SEC v. Madoff,* No. 08-10791 (S.D.N.Y. filed Dec. 11, 2008). The U.S. Attorney's Office for the Southern District of New York filed criminal charges on the same day. *United States v. Madoff*, No. 08-2735 (S.D.N.Y. filed Dec. 11, 2008). The SEC has partially settled its action. Defendant Bernard L. Madoff Consents to Partial Judgment Imposing Permanent Injunction and Continuing Other Relief, Release No. 20889 (Feb. 9, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr20889.htm. On March 12, 2009, Mr. Madoff pled guilty to charges of securities fraud, investment advisor fraud, mail fraud, wire fraud, money laundering, false statements, perjury, among others. *See also U.S. Gen. Accounting Office, Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement 2* (2009) (''GAO Report'') (depicting the Enforcement Division internal processes as cumbersome and impeding the work flow of the division).

[15] *Assessing the Madoff Ponzi Scheme and Regulatory Failures Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 111th Cong. (Jan. 27, 2009) (statement of Harry Markopolos); *Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (Jan. 27, 2009) (statement of Dr. Henry A. Backe, Jr).

[16] Press Release, Securities and Exchange Commission, Statement Regarding Madoff Investigation (Dec. 16, 2008), *available at* http://www.sec.gov/news/press/2008/2008-297.htm.

[17] *Assessing the Madoff Ponzi Scheme and Regulatory Failures Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing of the H. Comm. on Financial Services*, 111th Cong. (2009) (statement of Rep. Gary Ackerman).

[18] Various commissioners and staff members have referenced these inquiries in Congressional testimony and speeches. The recent Congressional testimony of Commissioner Elisse Walter provides a comprehensive summary of the investigations and lists the cases brought to date. *Federal and State Enforcement of Financial Consumer and Investor Protection Laws Before the H. Comm. on Financial Services*, 111th Cong. (2009) (statement of Commissioner Elisse B. Walter).

[19] Mary L. Schapiro, Chairman, Securities and Exchange Commission, Address to Practising Law Institute's ''SEC Speaks in 2009'' Program (Feb. 6, 2009), *available athttp://www.sec.gov/news/speech/2009/spch020609mls.htm*.

[20] Press Release, SEC Seeks Comments on Short Sale Price Test and Circuit Breaker Restrictions (Apr. 8, 2009), *available at* http://www.sec.gov/news/press/2009/2009-76.htm.

[21] SECActions.com, http://www.secactions.com/?p=1170 (Jun. 4, 2009).

[22] Press Release, SEC Announces Creation of Investor Advisory Committee (Jun. 3, 2009), *available at* http://www.sec.gov/news/press/2009/2009-126.htm.

Division attorneys for possible insider trading. Regardless of the outcome of those inquiries, however, the real issue for the Commission is the SEC Inspector General Report which is the predicate for the probe. That report claims that the SEC has virtually no internal procedures governing securities trading by staff members.[23] The continuing lack of internal procedures and controls at the agency — a difficulty that has been the subject of earlier reports — is more than an embarrassment for an agency charged with monitoring compliance of such controls for others.[24] This will only continue to undermine confidence by the markets and investors in the ability of the agency to perform its mission.[25]

The new market reform proposal offered by Treasury however will, if adopted, give the SEC the chance Ms. Schapiro has sought — an opportunity to again be a premier market regulator — with enhanced authority and a larger budget. Under Treasury's blueprint for market reform the SEC would have a key role, beginning with membership in the Financial Services Oversight Counsel (''FSOC''). That group, which includes the chairman of key financial regulators, is designed to assure proper coordination among regulators to avoid the ''too big too fail'' syndrome which caused the government to put billions into various public companies virtually nationalizing them in some instances.[26]

Treasury's White Paper would also enhance the SEC's regulatory authority. The Commission would be granted authority over hedge fund advisors and certain derivatives. Hedge fund advisors would be required to register with the SEC[27] while commodity pools registered with the Commodity Futures Trading Commission (''CFTC'') would remain under the jurisdiction of that agency.[28] The purpose of the new authority is to assess whether any of the funds pose a threat to the stability of the financial markets. This goal would be achieved by requiring the advisors to register and report information about their operations.[29]

The SEC, along with the CFTC, would be given authority over OTC derivatives within their respective jurisdictions. Under the plan there would be, for derivatives, a ''robust regulation regime . . . [of] conservative capital requirements . . . business conduct standards, reporting requirements, and conservative requirements relating to initial margins on counterparty credit exposures. Counterparty risks associated with customized bilateral OTC derivatives transactions that should not be accepted by a CCP would be addressed by this robust regime covering derivative dealers.''[30] The SEC would also be given authority to require reporting by issuers of asset backed securities.[31]

Under the Treasury White Paper, the SEC would also have expanded authority to promote transparency in investor disclosures as well as new tools to increase fairness for investors by ''establishing a fiduciary duty for broker-dealers offering investment advice and harmonizing the regulation of investment advisers and broker-dealers''[32] — issues the Commission has already started to examine.[33]

The SEC is also directed in the White Paper to continue with initiatives it presently has underway. These include plans to strengthen the regulatory framework for money market funds, add transparency and standardization to the securitization markets and increasing regulations of credit rating agencies.[34] Likewise, the SEC and the Financial Industry Regulatory Authority (''FINRA'') would expand the Trade Reporting and

[23] Office of the Inspector General, Report of Investigation: Case No. OIG-481, Employees' Securities Transactions Raise Suspicions of Insider Trading and Create Appearances of Impropriety; Violations of Financial Reporting Requirements; and Lack of SEC Employee Securities Transactions Compliance System at 27 (Mar. 3, 2009) *available athttp://online.wsj.com/public/resources/documents/20090514LettertoSEC.pdf*; *Insider Trading Probe at SEC*, Wall St. J., May 16, 2009, at 1, *available at* http://online.wsj.com/article/SB124241028545124563.html.

[24] *Id*. *See also* Press Release, European Union, Financial Services: Commission Proposes Stronger Financial Supervision in Europe (May 27, 2009), *available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/836&format=HTML&aged=0&language=EN&guiLanguage=en*; *see also* Media Release, International Organization of Securities Commissions, IOSCO Finalises Policy Responses to the Financial Crisis, 11 June 2009, Tel Aviv, *available at http://www.mondovisione.com/index.cfm?section=news&action=detail&id=83182*.

[25] There are other potential difficulties on the horizon for the embattled agency. For example, recently Ms. Schapiro received a letter from Senator Grassley inquiring as to whether the SEC followed-up on information given to the Enforcement Division last year implicating Lehman Brothers in insider trading. Letter from Senator Charles Grassley to Mary Schapiro, Chairman, Securities and Exchange Commission (May 14, 2009), *available at http://grassley.senate.gov/private/upload/2009-05-14-Letter-to-SEC.pdf*. An inadequate response to this inquiry could trigger more difficulties for the SEC.

[26] U.S. Department of the Treasury, Report, Financial Regulatory Reform — A New Foundation: Rebuilding Financial Supervision and Regulation (June 17 2009), *available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf* (''Treasury White Paper'').

[27] *Id.* at 85.

[28] *Id.* at 50.

[29] *Id.*

[30] *Id.* at 48.

[31] *Id.* at 6. Ms. Schapiro and CFTC Chairman Gary Gensler recently testified before Congress in support of this proposal. *Over-the-Counter Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks Before the S. Comm. on Banking, Housing, and Urban Affairs,* 111th Cong. (2009) (statements of Mary Schapiro and Gary Gensler). *See also Regulatory Reform and the Derivatives Markets Before the S. Comm. on Agriculture,* 111th Cong. (2009) (statement of Gary Gensler); *but see* Gretchen Morgenson and Don van Natta Jr., In Crisis, Banks Dig In For Fight Against Rules, NYTimes, June 1, 2009, at 1.

[32] Treasury White Paper, at 15. *See also* White Paper at 70-75 (SEC should be given additional authority to promote transparency; standards on primary liability harmonized; establish fiduciary duty for broker-dealers offering investment advice; harmonize certain sanctions; and expand whistleblower protections).

[33] Elisse B. Walter, Commissioner, Securities and Exchange Commission, Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?, Address to Mutual Fund Directors Forum Ninth Annual Policy Conference (May 5, 2009), *available at http://www.sec.gov/news/speech/2009/spch050509ebw.htm*.

[34] Treasury White Paper at 12, 13, 87. Luis Aguilar, Commissioner, Securities and Exchange Commission, Address to NASAA Members and the SEC — United in the Public Interest and Making Investors a Priority (Apr. 28, 2009), *available at* http://www.sec.gov/news/speech/2009/spch042809laa.htm; Mary Schapiro, Chairman, Securities and Exchange Commission, Address at the Statement at SEC Roundtable on Credit Rating Agencies (Apr. 15, 2009), *available at* http://www.sec.gov/news/speech/2009/spch041509mls.htm.

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Compliance Engine to include asset-backed securities under the Treasury proposal.[35]

Finally, the SEC and the CFTC would be required under the proposal to work together to harmonize regulation under their respective statutes. To facilitate this goal, the two agencies would prepare a report to Congress by September 30, 2009 that ''identifies all existing conflicts in statutes and regulations with respect to similar types of financial instruments . . . .'' [36] The report is to include appropriate recommendations.

If the proposals in the Treasury White Paper are enacted the SEC will have been given a new lease on life and enhanced authority. Likewise its new Chairman will have been given an opportunity to move the embattled agency past its current difficulties and restore it to its prior status as the protector of the investor and watch dog of the capital markets.[37]

Regardless of the precise path of regulatory reform, however, the current case loads of the SEC Enforcement Division and the FBI, coupled with increasing funding for law enforcement suggest significant future enforcement activity. As those investigations continue and resources are added along with perhaps enhanced regulation, it seems clear that the inquiries will broaden and ripen into civil and criminal enforcement actions.

II. SIGNIFICANT POLICY INITIATIVES Two significant policy initiatives in 2008 will clearly impact future SEC enforcement efforts. The first is the publication of the SEC's Enforcement Manual.[38] The second concerns cooperation guidelines which, while published by the Department of Justice, influence the standards at the SEC.[39]

The publication of the Enforcement Manual is a significant step toward improving the transparency of the Enforcement Division. While the Department of Justice has long published a manual which details its policies, the SEC did not have any comparable compendium until last year.

The Manual details the internal policies and procedures of the division. Many of these policies are written as internal directives to division investigators, memorializing procedures that experienced practitioners will recognize, such as those for producing documents and taking testimony.[40]

Other sections, such as those discussing the Wells process, cooperation and parallel proceedings contain significant policy statements. In discussing the Wells process, the Manual suggests that in certain instances the division may make the factual material from the underlying investigation available. The Manual lists three factors which should be considered in assessing whether this policy should be followed:

- Whether access would be a way for the staff and the recipient of the Wells notice to gauge the strength of the case;
- Whether the prospective defendant has asserted the Fifth Amendment; and
- The stage of other portions of the investigation.[41]

The section on cooperation appears to amplify, or at least clarify, existing policy. Prior to the publication of the Manual, cooperation was governed by the standards in the SEC's 2001 *Seaboard* Release.[42] While that Release still governs, the Manual makes two statements not found in *Seaboard*. First, it flatly states that SEC attorneys cannot ask for waivers of the attorney client privilege or the work product doctrine.[43] This is in line with new Department of Justice guidelines. Second, while the Manual echoes *Seaboard* by stressing that cooperation is a function of producing all the facts, it also states that if a company declines to waive privilege to earn cooperation credit, it still must produce the facts.[44] This view is consistent with the SEC's position that the underlying facts are not privileged.[45]

The section of the Manual regarding parallel proceedings is also significant, reflecting one of the key legal rulings of 2008 regarding investigations.[46] It directs division investigators to ensure that SEC investigations are independent of those conducted by the Department of Justice, as well as other regulators. On the critical question of how to respond to inquiries from counsel for a witness about the prospect of parallel proceedings,

[35] Treasury White Paper at 45-46.

[36] *Id. at* 50.

[37] *Id. at* 2-9.

[38] The Manual is available at *http://www.sec.gov/divisions/enforce/enforcementmanual.pdf*.

[39] Another key policy development is the publication by the Department of Justice of its guidelines on monitors. Memorandum from Craig S. Morford, U.S. Dept. of Justice, Selection and Use of Monitors in Defense Prosecution Agreements and Non-Prosecution Agreements with Corporation (Mar. 7 2008), *available at* http://www.usdoj.gov/criminal/fraud/docs/dag-030708.pdf. While this memorandum applies to criminal prosecutions, many SEC cases are settled in conjunction with a parallel criminal case. This is particularly true in FCPA cases. *See, e.g., SEC v. York International,* No. 07-01750 (D. D.C. filed Oct. 1, 2007); *U.S. v. York International Corp.,* No. 07-01750 (D.D.C. filed Oct. 1, 2007) (monitor is part of settlement). Accordingly, the standards will impact SEC cases.

[40] Some of the procedures appear to be efforts to improve the operations of the division. For example, sections on the production of documents contain a discussion about the preference for electronic productions and detail the preferred formats. Enforcement Manual, Section 3.2.6.2 Form of Production at 53. The Manual suggests that division attorneys should require producing parties to adhere to these requirements. The authority of the staff to impose these requirements beyond perhaps the usual bully pulpit is questionable at best.

[41] *See* Paul S. Atkins and Brandley J. Bondi, Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program, 13 FORDHAM J. CORP. & FIN. L. 367 (2008).

[42] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (Oct. 23, 2001) (''Seaboard Release'').

[43] SEC Enforcement Manual, Section 4.3, at 99.

[44] *Id*. The Commission may also be moving toward giving better guidance in its press releases regarding what acts receive credit in the charging process. *See SEC v. UnitedHealth Group, Inc.,* No. 08-6455 (D. Minn. Filed Dec. 22, 2008). *See* Section III E.

[45] SEC Enforcement Manual, Section 4.3, at 98. At the same time, producing the underlying facts which are typically gathered by a company through an internal investigation may result in a waiver of privilege. *See, e.g., U.S. v. The Williams Companies, Inc.*, No. 08-5203 (D.C. Cir. Apr. 17, 2009) (producing material to government in response to a grand jury subpoena with an understand that there was no waiver of privilege resulted in a waiver of work product protection). *See also U.S. v. Reyes*, No. 06-cr-0556 (N.D. Cal. Aug. 27, 2007) and *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007) (privilege re internal investigation conducted under the direction of special committee waived when shared with entire board).

[46] SEC Enforcement Manual, Section 5.2.1, at 110.

it directs Commission investigators to rely on Form 1662, the SEC's standard set of warnings which notes that there may be parallel inquiries. The Manual provides, however, that if authorized by the U.S. Attorney's Office conducting a parallel inquiry, the staff may disclose that fact. At least in certain instances, this directive offers the prospect that a witness may learn about a parallel inquiry.[47]

Portions of the cooperation standards in the Manual seem to echo, at least in part, the new standards published in 2008 by the Department of Justice.[48] Those standards were issued in response to the decision in *Stein*[49] which held portions of the earlier standards unconstitutional, and under threats by Congress to pass legislation.[50] The new standards contain two significant provisions. First, like the SEC Enforcement Manual, the new standards flatly prohibit Department attorneys from requesting what is called ''core'' attorney client privilege material. While this term is not defined, it apparently does not cover attorney client communications regarding internal corporate investigations.[51]

Second, like the Enforcement Manual, cooperation is defined in terms of producing all the relevant facts.[52] To avoid the question of privilege waivers which is typically presented when a company is considering producing all of the relevant facts from an internal investigation,[53] the new Department policy suggests that non-lawyers be used to collect the facts during the investigation. This, of course, eliminates the question of privilege waivers. At the same time, it seems to contrast with the SEC's position and perhaps highlights the difficulty here as to whether factual material from the internal investigation can be produced without privilege waivers.[54]

III. SIGNIFICANT CASES Key areas of emphasis for the division in 2008 and, in all probability, continuing into the future include its market crisis investigations, insider trading, financial fraud and the FCPA. While the Commission also brought cases focused on auction rate securities tied to the market crisis, these cases are not likely to be a critical enforcement focus in the future. Likewise while a number of option backdating cases were brought last year and more will undoubtedly be filed in the future, those cases are essentially a resolution of current inventory, rather than a key enforcement priority going forward.

A. Market Crisis Investigations And Cases Commission officials have repeatedly stated that the agency is devoting a significant amount of resources to enforcement investigations related to the current market crisis.[55] At this point, there appears to be at least 50 open investigations in this area. Many of these investigations have been going-on for months and some have as many as 100 members of the staff involved. In some instances, the work of these investigations has apparently been hindered by a lack of uniform record keeping systems and requirements.[56] Nevertheless, in view of the critical nature of these inquiries, the amount of resources being devoted to them and the attention focused on them, it seems clear that not only will they continue and perhaps expand, but that a significant number of enforcement actions will be brought as a result. These investigations may also impact requests for additional legislative authority.

1. The Investigations. Generally, the investigations are being handled by three major staff working groups: 1) the subprime working group; 2) the rumors and market manipulation working group; and 3) the hedge fund working group. There also appear to be other market crisis related investigations being conducted by the Enforcement Division.

The subprime working group was formed in March 2007 and reportedly involves about 100 members of the enforcement staff. The work of this group, which is being coordinated with the U.S. Attorneys' Office, is focused on subprime lenders and large financial institutions.

The investigations concerning subprime lenders are focused on accounting questions, disclosure issues and insider trading. The accounting questions center on issues involving the use of loan loss reserves and the valuation of assets. The disclosure questions are keyed to the nature of the disclosures made regarding loan quality, credit risk and the exposure to the subprime market. Other issues concern the disclosures made regarding mortgage delinquency and default rates as well

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[47] SEC Enforcement Manual, Section 5.2.1, at 110, fn. 9.

[48] The new standards were issued as a chapter to the U.S. Attorney's Manual. U.S. Dep't of Justice, Executive Office for U.S. Attorneys, United States Attorneys' Manual, tit. 9, ch. 28 (Aug. 28, 2008), *available at* http://www.usdoj.gov/opa/documents/corp-charging-guidelines.pdf (''DOJ Standards''). This contrasts with prior practice in which the standards were incorporated in a memorandum prepared by the then Deputy Attorney General. *See, e.g.*, Memorandum from Paul J. McNulty, Deputy Att'y Gen., U.S. Dep't of Justice, Re: Principals of Federal Prosecution of Business Organizations (Dec. 12, 2006), *available at* http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf.

[49] *U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006), *reaff'd*, 495 F. Supp. 2d 390 (S.D.N.Y. 2007), *aff'd*, 541 F.3d 130 (2nd Cir. 2008).

[50] The Attorney Client Privilege Protection Act of 2008, S. 3217, 110th Cong. (2008) (The proposed legislation, which passed the House, would bar government attorneys from seeking waivers).

[51] SEC Enforcement Manual, Section 4.3, at 98; *see also* DOJ Standards at Section 9-28.710 at 9 (providing that core privilege does not include attorney client conversations about the internal investigation).

[52] *SEC v. UnitedHealth Group, Inc.*, No. 08-6455 (D. Minn. filed Dec. 22, 2008) (cooperation credit given for: 1) conducting an internal investigation; 2) disclosing the findings and conclusions of that inquiry in a Form 8-K; 3) sharing the facts uncovered with the government; and 4) adopting extensive remedial actions.).

[53] *U.S. v. The Williams Companies, Inc.*, No. 08-5203 (D.C. Cir. April 17, 2009).

[54] Thomas O. Gorman, New DOJ Cooperation Principles: Substituting the Culture of Avoidance for the Culture of Waiver, 22 Bloomberg Law R. 1 (Sept. 29, 2008).

[55] *Federal and State Enforcement of Financial Consumer and Investor Protection Laws Before the H. Comm. on Financial Services*, 111th Cong. (2009) (statement of Commissioner Elisse B. Walter); *Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2008) (statement of Christopher Cox, Chairman, Securities and Exchange Commission).

[56] *To Review the Role of Credit Derivatives in the U.S. Economy Before the H. Comm. on Agriculture*, 110th Cong. (2008) (statement of Erik R. Sirri, Director of Division of Trading and Markets, Securities Exchange Commission).

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as projections concerning financial performance in view of subprime exposure. There are also questions regarding insider trading and the trading in credit default swaps.

Issues being analyzed by the large financial institutions branch of this group include: the timing and amount of write-downs and the related disclosures; false disclosure regarding subprime exposure or concentration; financial condition; future financial performance; and the valuation of assets. Other issues focus on the possible intentional mispricing of securities and the knowing underwriting of securities based on collateral likely to default and related internal control questions. Questions involving false representations made to retail customers to induce them to purchase securities such as mortgage-backed investments and market manipulation are also being analyzed.

The rumors and market manipulation group is focused on the spreading of false rumors in conjunction with short selling. The group is coordinating with FINRA and the NYSE regarding member firms as well as the New York Attorney General's office and the U.S. Attorney's Office for the Southern District of New York.

The hedge fund working group is reported to have ''dozens'' of hedge fund related investigations. These inquiries are focusing on questions regarding whether the lack of transparency has been used to conceal a Ponzi scheme or other misconduct by ''funds of funds'' and ''feeder funds'' and if the managers failed to exercise due diligence. Other hedge fund related investigations are considering issues regarding the large number of liquidations and the suspension of redemption rights. In these cases, a key question under inquiry is whether the adviser favored their interest or those of selected persons over those of investors.

Enforcement has a number of other market related investigations underway which include:

- Bear Stearns and Lehman Brothers: These investigations are analyzing the circumstances and the trading surrounding the collapse of the two Wall Street investment banks. They focus in part on questions regarding insider trading that may have occurred as the institutions collapsed.

- Auction rate securities: The auction rate securities (''ARS'') market crashed in February 2008. Prior to that date, a number of banks and brokers sold ARS as essentially cash equivalents. When the market crashed, purchasers of the securities were unable to liquidate their holdings. The SEC, the Attorney General of New York and other state attorney generals have actively investigated the sales practices for ARS. Those investigations have resulted in final settlements with UBS, Citigroup Capital Markets, Wachovia, Banc of America Securities, RBC Capital Markets Corp., and Deutsche Bank Securities, Inc. An agreement in principle has been reached with Merrill Lynch. While the settlements tend to be similar, they are not identical.[57]

2. Enforcement Actions. A number of enforcement actions have been brought to date by the SEC which are related to the current market crisis. Five significant cases, aside from the ARS actions, are *Mozilo*,[58] *Rorech*,[59] *Reserve Management*,[60] *Cioffi*, [61]and *Berliner*.[62]

SEC v. Mozilo centers on events at former sub-prime lending giant, Countrywide Financial Corporation. Named as defendants are Angelo Mozilo, former CEO of the company, and his two top lieutenants, David Sambol, former COO and Eric Sieracki, former CFO. The complaint, which alleges fraud by all defendants and insider trading by Mr. Mozilo, is based on claims that the defendants concealed the high risk nature of the loan portfolio at the company with claims that its lending was no riskier than that of other lenders. [63]

SEC v. Rorech is the first insider trading case based on trading in credit default swaps. The defendants are two market professionals. All of the trading took place in the accounts of the trader's employer. The action is consistent with the SEC's view that it has antifraud — but not regulatory authority — over certain credit default swaps.[64]

SEC v. Reserve Management Company is an action against the principals of the Reserve Primary Fund, the first money market fund to ''break the buck.'' The complaint centers on claims that the defendants failed to provide material information to Primary Fund's investors, board and rating agencies following the bankruptcy of Lehman Brothers on September 15, 2009 at a time when the Fund had a substantial portfolio of Lehman debt securities and when it was experiencing overwhelming redemption demands.[65]

SEC v. Cioffi, is an action against Ralph Cioffi and Matthew Tannin, two former portfolio managers at Bear Stearns. It alleges that they fraudulently misled investors about the financial state of two large hedge funds of the investment bank and the exposure of those funds to the subprime market. Parallel criminal charges have been filed.[66]

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[57] SEC Lit. Rel. No. 21066 (June 3, 2009); Press Release, Securities and Exchange Commission, SEC Enforcement Division Announces Preliminary Settlement With Merrill Lynch to Help Auction Rate Securities Investors (Aug. 22, 2008), *available at* http://www.sec.gov/news/press/2008/2008-181.htm. FINRA is also actively investigating in this area. FINRA Investor News, Investor Alert: Auction Rate Securities: What Happens When Auctions Fail (May 5, 2008) *available at* http://www.finra.org/Investors/Subscriptions/InvestorNews/P038422.

[58] *SEC v. Mozilo*, No. 09-03994 (C.D. Cal. Filed June 4, 2009).

[59] *SEC v. Rorech*, No. 09-4329 (S.D.N.Y. filed May 5, 2009).

[60] *SEC v. Reserve Management Company, Inc.*, No. 09 CV 4346 (S.D.N.Y. Filed May 5, 2009).

[61] *SEC v. Cioffi*, No. 08-2457 (E.D.N.Y. filed June 19, 2008).

[62] *SEC v. Berliner*, No. 08-3859 (S.D.N.Y. filed April 24, 2008).

[63] SEC Files Securities Fraud Charges Against Former Countrywide Executives, Litigation Release No. 21068 (Jun. 4, 2009), *available at http://www.sec.gov/litigation/litreleases/2009/lr21068.htm*.

[64] *To Review the Role of Credit Derivatives in the U.S. Economy Before the H. Comm. on Agriculture*, 110th Cong. (2008) (statement of Erik R. Sirri, Director of Division of Trading and Markets, Securities Exchange Commission).

[65] Recently, the Commission has brought a number of significant actions regarding investment funds and their advisers. *See, e.g., In the Matter of Evergreen Investment Management Company, LLC*, Adm. Proc. File No. 3-13507 (June 8, 2009) (proceeding centered on incorrect pricing of securities) and *In the Matter of New York Life Investment Management LLC*, Adm. Proc. File No. 3-013487 (Filed May 27, 2009) (action centered on adviser fees).

[66] SEC Charges Two Former Bear Stearns Hedge Fund Portfolio Managers with Securities Fraud, Lit. Release No.

SEC v. Berliner is the first case of its kind brought by the Commission. In this settled action, the SEC claimed that Paul Berliner, a Wall Street trader, circulated false rumors through instant messages about a pending deal between Blackstone Group and Alliance Data Systems (''ADS''), claiming that the price under negotiation was much lower than the actual price so that he could short ADS shares. Mr. Berliner consented to the entry of a permanent injunction and order requiring that he disgorge his trading profits.[67]

The SEC brought a fraud action against the former chairman and CEO of the company as well as its former executive vice president and CFO and the former controller. The former chairman settled by consenting to the entry of a permanent injunction and agreeing to pay disgorgement and a civil penalty. The other two defendants are litigating the action.[68]

The Commission has also settled a number of cases related to the crash of the auction rate securities markets. The SEC's settlement with Wachovia is typical of the resolutions reached in these cases. *SEC v. Wachovia Securities, LLC.*, No. 09-743 (N.D. Ill. filed Feb. 5, 2009).[69] Key terms of that settlement require the defendant to repurchase ARS in two phases. First, Wachovia will purchase the securities from essentially small investors — individuals, not-for-profits, religious organization and others with account values up to $10 million. Second, Wachovia will purchase ARS from all other holders. Wachovia also agreed to lend customers the full par value of their ARS pending the buy back with interest rates set so that customers will have not have negative carry on their loans. Eligible customers who incurred consequential damages from the illiquidity of the market can participate in a special FINRA arbitration.[70]

B. The Foreign Corrupt Practice Act The SEC, typically in conjunction with the Department of Justice, and at times other regulators in this country and around the globe, continues to focus on FCPA enforcement. In the last few years, the SEC and DOJ have brought increasing numbers of cases. At the beginning of 2009, there were over 100 open FCPA investigations.

The cases stem from two primary sources. Many are the result of self reporting, often based on pre-merger due diligence.[71] Others are based on the U.N. Oil For Food Program.[72]

20625 (Jun. 19, 2008), *available at http://www.sec.gov/litigation/litreleases/2008/lr20625.htm*.

[67] SEC Charges Wall Street Trader With Fraud For Spreading False Rumor, Lit. Release No. 20537 (Apr. 24, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20537.htm. *See also, SEC v. Strauss*, No. 09-4150 (S.D.N.Y. filed April 28, 2009), a settled financial fraud case which may typify future enforcement actions in this area. Here, American Home Mortgage Investment Corp. reported profits every quarter following its IPO in 1999. By 2006, the company had originated billions of dollars of mortgages. While the company enjoyed a reputation for being successful and profitable, by the first quarter of 2007 it began experiencing loses as its portfolio of loans for sale tripled. Although additions were made to the loan loss reserve, they were not sufficient, as company documents demonstrated. As a result, the company reported a profit rather than a loss. The false quarterly financial statements which resulted from these transactions were later used in connection with a placement of the company's stock to Citibank.

[68] Other market crisis related cases brought to date include: *SEC v. Tzolov*, No. 08-7699 (S.D.N.Y. filed Sept. 3, 2008) (Two brokers are alleged to have made more than $1 billion in unauthorized purchases of subprime related auction rate securities. The brokers told customers that the securities were backed by guaranteed student loans which was allegedly false. Parallel criminal charges have been filed); *SEC v. Ainsworth*, No. 08-1350 (C.D. Cal. filed Oct. 3, 2008) (Action against five LA based brokers who are alleged to have convinced their customers to refinance their homes with subprime mortgages they could not afford so that cash could be taken out of their homes to purchase unsuitable securities); *SEC v. Nicholson*, No. 09-1748 (S.D.N.Y. filed Feb. 25, 2009) (Action alleges that James Nicholson and his company Westgate Capital Management, defrauded investors by misrepresenting the returns and assets of 11 unregistered hedge funds under management. The case is pending); *SEC v. WG Trading Investors, LP*, No. 09-1750 (S.D.N.Y. filed Feb. 25, 2009) (Action brought against Paul Greenwood and Stephen Walsh and their related entities, WG Trading Investors, an unregistered investment vehicle, WG Trading Company, a registered broker dealer, and Westridge Capital Management, Inc., a registered investment adviser. The complaint alleges that the two individual defendants misled and defrauded investors by telling them that their funds would be invested using a stock index arbitrage strategy when in fact large portions of the money were diverted to their own use); *SEC v. North Hills Management LLC*, No. 09-1746 (S.D.N.Y. filed Feb. 25, 2009) (Action against Mark Bloom and his firm North Hills Management LLC. The complaint alleges that Mr. Bloom raised about $30 million from 40-50 investors over a period of several years, claiming that the money would be invested in a diverse group of hedge funds. In fact, much of it was diverted to Mr. Bloom's personal use).

[69] *See* Press Release, Securities and Exchange Commission, SEC Finalizes ARS Settlement To Provide $7 billion in Liquidity to Wachovia Investors (Feb. 5, 2009), *available at* http://www.sec.gov/news/press/2009/2009-17.htm (collecting materials and links to other ARS settlements). The SEC also brought a number of investment fraud and Ponzi scheme cases which relate to the market crisis. The two largest are *SEC v. Madoff*, No. 08-19791 (S.D.N.Y. filed Dec. 11, 2008) and *SEC v. Stanford International Bank, Inc.*, No. 09-298 (N.D. Tex. filed Feb. 17, 2009). The former is reputed to be the largest Ponzi scheme in history, while the latter may be the second largest according to some reports. Mr. Madoff has pled guilty to related criminal charges. Mr. Madoff has been sentenced to 150 years in prison. Mr. Stanford is contesting the SEC's claims. As the market crisis continues to unfold it is likely that similar cases will be brought. *See U.S. v. Stanford*, 09 cr 342 (S.D. Tex. filed June 18, 2009).

[70] Three additional settlements which are similar to earlier ARS settlements are: *SEC v. Banc of America Securities LLC*, Civil Action No. 09-CIV-5170 (S.D.N.Y. June 3, 2009); *SEC v. RBC Capital Markets Corp.*, Civil Action No. 09-5172 (S.D.N.Y. June 3, 2009); and *SEC v. Deutsche Bank Securities, Inc.*, No. 09-CIV-5174 (S.D.N.Y. June 3, 2009). *See also SEC v. UBS Securities LLC*, No. 08-10754 (S.D.N.Y. filed Dec. 11, 2008) (similar terms); *SEC v. Citigroup Global Markets, Inc.*, No. 08-10753 (S.D.N.Y. filed Dec. 11, 2008) (similar but for large institutional holders Citi is only required to use is best efforts to bring liquidity to the markets).

[71] *See, e.g.*, Sun Microsystems, Inc., Quarterly Report (Form 10-Q), at 40 (May 8, 2009) (disclosing possible FCPA violations discovered during an internal inquiry).

[72] A report prepared on the U.N. Oil For Food Program (''OFFP'') is the predicate for a number of recent FCPA cases. The report concluded that Iraq manipulated the program to dispense contracts based on political preferences and obtain illicit payments. According to the report, prepared by a committee led by Paul Volcker, 2,253 companies paid over $1.8 billion in illicit income to the Iraqi government. Independent Inquiry Committee into the United Nations Oil-For-Food Programme, Manipulation of the Oil-For-Food Programme by the Iraq Re-

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Regulators have been aggressive in bringing actions. This is reflected in the increasing large amounts paid in settlement. It is also reflected in the often expansive manner in which the statutes are applied.

Last year Siemens A.G. paid the largest amount in history to settle an FCPA case, eclipsing a record set in 2007.[73] In the *Siemens*[74] settlement, DOJ, the SEC and the Munich Public Prosecutor's office were collectively paid $1.6 billion in fines, penalties and disgorgement to conclude an FCPA case involving Siemens AG and its subsidiaries. The case was settled with multiple guilty pleas. U.S. authorities received about half of the amount paid by Siemens.

The charges were based on violations in Latin America and the Middle East involving the following transactions:

- *Middle East:* From 2000 to 2002, four Siemens subsidiaries — Siemens Turkey, Siemens France, Osram Middle East and Gas Turbine — were awarded 42 contracts valued at more than $80 million with the Ministries of Electricity and Oil of Iraq under the U.N. Oil For Food Program. These contracts were secured by paying over $1.7 million in kickbacks to the Iraq government. The company made $38 million in profits. As with other OFFP cases, the contract price was inflated prior to the submission of the agreement to the U.N. for approval.[75] The payments were improperly recorded on the books and records of the company.

- *Argentina:* Beginning in September 1998 and continuing through 2007, Siemens Argentina made over $31 million in corrupt payments to various Argentine officials. These payments were improperly recorded in the books and records as ''consulting fees,'' ''legal fees'' and other types of legitimate payments. They were made to obtain favorable business treatment in connection with a $1 billion national identity card project.

- *Venezuela:* Siemens Venezuela made corrupt payments beginning in October 2001. The subsidiary made over $18 million in payments to various Venezuelan officials to obtain favorable treatment in connection with two major metropolitan mass transit projects. The payments were not properly recorded.

- *Bangladesh:* Siemens Bangladesh admitted that from May 2001 to August 2006 it made corrupt payments of over $5.3 million. The payments were made to obtain favorable treatment during the bidding process on a mobile telephone project.

The settlements are based on extensive cooperation by the company. To resolve the actions with each regulator:[76]

- *DOJ*: Siemens AG pled guilty to one count of failure to maintain internal controls and one count of books and records violations; Siemens S.A. Argentina pled guilty to one count of conspiracy to violate the books and records provisions of the FCPA; and Siemens Bangladesh Limited and Siemens S.A. Venezuela pled guilty to one count of conspiracy to violate the anti-bribery and books and records provisions.

- *Munich Public Prosecutor's Office*: Siemens AG agreed to pay about $569 million which includes disgorgement.

- *SEC*: Siemens consented to the entry of a permanent injunction prohibiting future violations of the anti-bribery and books and records provisions and to pay disgorgement of $350 million, which does not include the payment under the Munich agreement.

The DOJ and the SEC set another record with their settlement of FCPA cases against Kellogg Brown & Root, LLC, a former subsidiary of Halliburton. These cases were resolved with the largest combined settlement paid by U.S. companies in an FCPA case.[77] The actions were based on a conspiracy involving KBR and its joint venture partners to pay bribes to Nigerian government officials in connection with the award of four contracts between 1995 and 2004. The contracts were valued at over $6 billion. The company paid over $182 million in bribes to two agents.

To resolve the case with the DOJ, KBR pled guilty to conspiracy to violate the FCPA and agreed to pay a fine of $402 million and to retain a monitor. The company settled with the SEC by consenting to an injunction prohibiting future violations of the anti-bribery, records, and internal control provisions of the securities laws, and from aiding and abetting violations of those sections and agreeing to pay disgorgement of $177 million.[78]

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gime (Oct. 27, 2005), *available at* http://www.iic-offp.org/documents/IIC%20Final%20Report%2027Oct2005.pdf. Typically these cases focus on either the oil side or the humanitarian side of the program. Frequently, the cases are joint settlements involving the SEC and DOJ. *See, e.g., SEC v. Textron Inc*., No. 07-01505 (D.D.C. filed Aug. 23, 2007); Press Release, U.S. Department of Justice, Textron Inc. Agrees to $1.15 Million Fine in Connection with Payment of $600,000 in Kickbacks by its French Subsidiaries under the United Nations Oil for Food Program (Aug. 23, 2007), *available at www.usdoj.gov/opa/pr/2007/August/07 crm 646.html*; *SEC v. York International Corporation,* No. 07-01750 (D.D.C. filed Oct. 1, 2007); *U.S. v. York International Corp.*, No. 07-01750 (D.D.C. filed Oct. 1, 2007); Press Release, U.S. Department of Justice, Justice Department Agrees to Defer Prosecution of York International Corporation in Connection With Payment of Kickbacks Under the U.N. Oil For Food Program (Oct. 1, 2007), *available at* www.usdoj.gov/opa/pr2007/October/07 crm 783.html.

[73] The record set by the settlement with *Siemens* eclipsed the one set the year before. *U.S. v. Vetco Gray Controls, Inc. et al.,* No. 07-004 (S.D. Tex. filed Feb. 6, 2007); *U.S. v. Aibel Group Ltd.*, No. 07-005 (S.D. Tex. Filed Feb. 6, 2007); http://www.usdoj.gov/opa/pr/2007/February/07_crm_075.html (largest criminal FCPA fine); *U.S. v. Baker Hughes, Inc.*, No. 07-130 (S.D. Tex. Filed April 11, 2007); *U.S. v. Baker Hughes Services Int., Inc.*, No. 07-129 (S.D. Tex. Filed April 11, 2007); *SEC v. Baker Hughes Inc.*, No. 07-1408 (S. D. Tex. filed April 26, 2007); Litigation Release No. 20094 (April 26, 2007) (largest joint DOJ and SEC FCPA settlement at the time).

[74] *U.S. v. Siemens, Aktiengesellschaft,* No. 08-367 (D.D.C. filed Dec. 15, 2008); *SEC v. Siemens Aktiengesellschaft,* No. 08-02167 (D.D.C. filed Dec. 15, 2008).

[75] *See, e.g., SEC v. York International Corporation,* No. 07-01750 (D.D.C. filed Oct. 1, 2007); *U.S. v. York International Corp.,* No. 07-01750 (D.D.C. filed Oct. 1, 2007); *SEC v. Ingersoll-Rand Co. Ltd.*, No. 07-01955 (D.D.C. filed Oct. 31, 2007); *SEC. v. Chevron Corp.,* No. 07-10299 (S.D.N.Y. filed Nov. 14, 2007).

[76] *See also U.S. v. All Assets,* No. 09-00021 (D.D.C. filed Jan. 8, 2009) (forfeiture action to confiscate nearly $3 million in bank accounts in Singapore related to the corrupt payments made by a Siemens subsidiary).

[77] *U.S. v. Kellogg Brown & Root LLC*, No. 09-00071 (S.D. Tex filed Feb 6, 2009); *SEC v. Halliburton Co.,* No. 09-399 (S.D. Tex. filed Feb. 11, 2009).

[78] Press Release, Securities and Exchange Commission, SEC Charges KBR and Halliburton for FCPA Violations (Feb.

Another significant case brought last year is *In the Matter of Faro Technologies, Inc*.[79] Here, the DOJ brought criminal charges, and the SEC filed a civil administrative proceeding, focusing on bribes paid by a Faro subsidiary in China. In this matter, an official at the China subsidiary requested permission to do business the ''Chinese way,'' that is, by paying bribes. The employee was instructed not to pay bribes. Later, supervisors from the parent company circulated an article about bribes paid in China to various employees including those in the China subsidiary as a reminder of what not to do. Nevertheless, the employees paid bribes to government officials.

To resolve the matter with the Department of Justice, the company entered into a non-prosecution agreement and agreed to pay a $1.1 million fine. The case was resolved with the SEC by agreeing to the entry of a cease and desist order and adopting a compliance program.

Examples of other FCPA cases brought last year include the following:

- *SEC v. ITT Corp.*[80] Here, the Chinese subsidiary of ITT Corp. is alleged to have made $200,000 in illegal payments in connection with the sale of water pumps yielding $4 million in sales and $1 million in profits. To settle the case, the company consented to the entry of a permanent injunction prohibiting future violations of the Exchange Act's books and records and internal controls provisions and to the entry of an order requiring it to pay $1 million in disgorgement, along with prejudgment interest and a fine of $250,000.

- *SEC v. Fiat, S.p.A*:[81] In this case, subsidiaries of Fiat made corrupt payments in connection with the U.N. Oil For Food Program. To settle with the DOJ, two subsidiaries entered guilty pleas to conspiracy counts and agreed to pay a $7 million fine. To resolve the action with the SEC the company consented to the entry of a permanent injunction prohibiting future violations of the Exchange Act's books and records and internal controls provisions and to the payment of $5.3 million in disgorgement and a civil penalty of $3.6 million..

- *SEC v. Willbros Group, Inc.*[82] The FCPA action here is based on schemes in Nigeria and Bolivia to pay bribes and create false documents to conceal that fact. To settle, the company consented to the entry of a permanent injunction prohibiting future violations of the FCPA anti-bribery and books and records and internal controls provisions. In addition, the company agreed to the entry of an order requiring it to pay a civil penalty of $8.9 million, plus prejudgment interest of $1.4 million. The company settled with the Department of Justice by entering into deferred prosecution agreement, agreeing to the appointment of a monitor and undertaking to pay a $22 million penalty.

Finally, a key focus of FCPA enforcement is individuals. Both the SEC and DOJ have brought a number of cases against individuals involved in FCPA violations.[83]

C. Insider Trading Insider trading has long been a high priority of SEC enforcement. Last year, the number of insider trading cases brought by the agency increased by about 25%, according to SEC statistics.[84]

In addition to the statistics, the emphasis on insider trading is reflected in the new market surveillance approach created last year, as well as the often aggressive manner in which cases were brought against a wide variety of defendants. In August 2008, NYSE Regulation and FINRA, under the supervision of the SEC, entered into an agreement under which the two self regulatory organizations will supervise 11 current insider trading programs on various exchanges. It is designed to enhance detection of possible insider trading.

Under the new approach, NYSE Regulation will be responsible for the detection of insider trading for New York Stock Exchange and NYSE Acra listed securities. FINRA will be responsible for American Stock Exchange and NASDAQ listed securities. Participants in this arrangement include the American, Boston, CBOE, Chicago, International, NASDAQ, National, New York, NYSE Acra, and the Philadelphia Exchanges. Appropriate cases will be referred to the SEC for further inquiry. The new arrangement replaces a system under which each exchange conducted its own investigation.[85]

At year end 2008, NYSE Regulation statistics suggest that there may be an increase in insider trading and a change in those involved. Last year, the organization referred 146 suspected insider trading case to the SEC, a slight increase over the prior year.[86]

More significantly, however, the composition of the cases seems to have changed. In 2007 about 72% of its referrals for further investigation involved hedge funds. In 2008, only about half of the cases involved hedge funds while the other 50% involved insiders, a significant increase over 2007. These statistics may reflect in part the dynamics of the marketplace with hedge fund trading declining because of the market crisis. At the same time, the rise may suggest an increase in insider trading by corporate insiders.[87]

11, 2009), *available at http://www.sec.gov/news/press/2009/2009-23.htm*.

[79] *In the Matter of Faro Technologies, Inc.*, Release No. 57933, Adm. File No. 3-13059 (June 5, 2008).

[80] *SEC v. ITT Corp*, No. 09-00272 (D.D.C. filed Feb. 11, 2009).

[81] *SEC v. Fiat, S.p.A.*, No. 08-02211 (D.D.C. filed Dec. 22, 2008); *see also U.S. v. Iveco S.p.A.*, No. 08-377 (D.D.C. filed Dec. 22, 2008); *U.S. v. CNH Italia S.p.A.*, No. 08-378 (D.D.C. Dec. 22, 2008).

[82] *SEC v. Willbros Group, Inc.*, No. 08-01494 (S.D. Tex. May 14, 2008); Press Release, Department of Justice, Willbros Group Inc. Enters Deferred Prosecution Agreement and Agrees to Pay $22 Million Penalty for FCPA Violations (May 14, 2008), *available at http://www.usdoj.gov/opa/pr/2008/May/08-crm-417.html*.

[83] A good example of this trend is the cases involving three executives of ITXC Corp. The cases involved the alleged payment of $266,000 in bribes to foreign officials of state and foreign owned telecommunications carriers in Nigeria, Rwanda and Senegal. *SEC v. Ott,* No. 06-4195 (D.N.J. filed Sep. 6, 2006); *SEC v. Amoako,* Civil Action No. 05-4284 (D.N.J. filed Sep. 1, 2005); *U.S. v. Young*, No. 07-609 (D.N.J. filed Jul. 25, 2007); *U.S. v. Ott,* No. 07-608 (D.N.J. filed Jul. 25, 2007); *U.S. v. Amoako,* No. 05-1122 (D.N.J. filed Jun. 28, 2006).

[84] *See* SEC Press Release, Oct. 22, 2008.

[85] SEC Announces Proposed Plan to Enhance Insider Trading Surveillance and Detection (Aug. 13, 2008), *available at http://www.sec.gov/news/press/2008/2008-174.htm*.

[86] SEC Actions, http://www.secactions.com/?p=760 (Jan. 23, 2009).

[87] A new paper suggests that there is a leakage of insider trading information within brokerages by market makers, a practice called piggybacking. Christopher C. Geczy and Jinghau Yan, *Who are the Beneficiaries When Insiders Trade? An Examination of Piggybacking in the Brokerage Industry* (Jan. 2009), published in Knowledge@Wharton.

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The aggressive posture of the SEC in this area is reflected in the cases it has litigated. In *SEC v. Talbot,* No. 06-55561 (9th Cir. June 30, 2008), the Commission won a significant court victory regarding the nature of the breach of duty which is required to sustain an insider trading charge. The SEC brought an insider trading action against Thomas Talbot, a director of Fidelity National Financial for trading in the shares of LendingTree at a time when his company owned 10% of that company and before LendingTree announced a merger.

LendingTree was in negotiations to be acquired. The CEO of that company told a vice president of Fidelity about the proposed transaction and requested that the information be kept confidential. The Fidelity vice president later told his CEO who, in turn told the board at a regular meeting attended by Mr. Talbot. There was no request that the information be kept confidential. One director at the meeting stated, however, that this was inside information. Mr. Talbot later purchased shares of LendingTree before the public announcement.

The district court dismissed the SEC's complaint, concluding that the Commission failed to establish a breach of duty. The court held that there was no continuous chain of fiduciary relationships from Mr. Talbot to the source of the information. The Ninth Circuit reversed, finding that a continuous chain is not necessary, just a breach of duty. Here, Mr. Talbot breached a duty to his company, the circuit court concluded, by trading on the information. Mr. Talbot latter settled the case.[88]

The breach of duty issue is also central to the SEC's claims in *SEC v. Dorozhko,* No. 07-9606 (S.D.N.Y. filed Oct. 29, 2007, decided Jan. 8, 2008). In this case, the Commission's complaint was brought against Mr. Dorozhko, a Ukrainian resident. The complaint claimed he hacked into a company's computer files and stole inside information which was later used to trade.

The district judge dismissed the SEC's complaint, concluding that there was no deception. Absent deception, which typically flows from a breach of duty in an insider trading case, there is no violation of Section 10(b). The SEC's appeal of this action is pending before the Second Circuit. That court did extend an asset freeze order the Commission obtained prior to the dismissal of its action.[89]

The SEC also took an aggressive posture in *SEC v. Patton,* No. 02-2564 (E.D.N.Y. filed Apr. 30, 2002), one of the few insider trading cases tried to a jury. There, the Commission prevailed in a case against downstream tippee Constantine Stamoulis after criminal charges against him were dismissed.

The SEC's complaint centers on alleged insider trading in the securities of WLR Foods, Inc. prior to the September 2000 announcement that the company was being acquired by Pilgrim's Pride Corporation. The 14 defendants include Eric Patton, the former Director of Manufacturing for the Turkey division of the company, his brother Steve Patton, his registered representative Michael Nicolaou and several others. Mr. Stamoulis was allegedly tipped by his business partner, John Tsiforis, who the complaint claimed, was tipped by his friend Michael Nicolaou, who had been tipped by Steven Patton.

Criminal insider trading charges were brought against Eric and Steve Patton, Mr. Stamoulis and others. Three defendants pled guilty. The criminal charges against Mr. Stamoulis were dismissed. Following the verdict in the SEC's case, however, the court enjoined Mr. Stamoulis from future violations of the antifraud provisions and directed him to disgorge his trading profits and pay prejudgment interest as well as a fine equal to three times his gain.[90]

In other cases, however, the SEC's aggressive posture resulted in losses. In *SEC v. Mangan,* No. 06-531 (W.D.N.C. filed Dec. 28, 2006), the Commission had Section 5 and insider trading claims dismissed.

In this case, the SEC's complaint claimed that defendant John Mangan, a registered representative and hedge fund operator, engaged in the sale of unregistered securities and insider trading in connection with a PIPE offering. According to the complaint, Mr. Mangan agreed to participate in a PIPE offering and just prior to its announcement sold the underlying shares short. Later he used the shares from the resale registration to cover his short position. The court rejected the SEC's claim that this constituted a violation of Section 5 because at the time of the short sale the shares used to cover were not registered. The court also rejected the claim that this constituted insider trading.[91]

Similarly, in *SEC v. Boutraille Corp.,* No. 05-9300 (S.D.N.Y. filed Nov. 4, 2005), the Commission dismissed an insider trading case after initially obtaining a freeze order over about $3 million in assets. The initial complaint, apparently predicated on a suspicious trading pattern, was brought against unknown purchasers of call options in the common stock of Placer Dome, Inc. In October 31, 2005, Barrick Gold Corp, a Canadian based gold mining company, announced an offer to purchase Placer Dome, also a Canadian based gold mining company.

Prior to the announcement of the deal, the SEC claimed that unknown purchasers, while in possession of inside information and through overseas brokers, bought over 10,000 call options for Placer stock. At the time, over 5,000 of the options were out of the money and set to expire in November, within weeks of the purchases. The account had what the SEC claims was $1.9 million in illegal profits.

[88] Mr. Talbot consented to the entry of a permanent injunction prohibiting future violations of the antifraud provisions of the Exchange Act. He also agreed to pay disgorgement of $67,881, prejudgment interest of $26,916, and a civil penalty of $135,762. Former Director of Fidelity National Financial Settles SEC Insider Trading Case, Lit Release No. 21004 (Apr. 16, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21004.htm.

[89] *SEC v. Dorozhko,* No. 08-0201 (2nd Cir. filed Jan. 11, 2008).

[90] Lit. Release No. 20630 (Jun. 26, 2008).

[91] This is one of three cases in litigation on these issues. In each, the SEC charged fund managers with violating Section 5 and insider trading based on short sales at or just prior to the announcement of a PIPE offering where the short sale would be later covered with shares from the resale registration statement. *See also SEC v. Lyon,* No. 06-14338 (S.D.N.Y. filed Dec. 12, 2006) (Section 5 claim dismissed but summary judgment denied on insider trading claim) and *SEC v. Berlacher*, Civil Action No. 07-cv-3800 (E.D. Pa. Sept. 13, 2007); *but see U.S. v. Shane,* Case No. 06-00772 (S.D.N.Y. filed Sept. 12, 2006) (fund manager entered into deferred prosecution agreement) and *SEC v. Shane,* No. 05-4772 (S.D.N.Y. filed May 18, 2005) (fund manager settled with SEC and NASD).

Subsequently, the complaint was amended to name Boutraille Corporation, Trinity Partners Ltd. and John C. Fraleigh as defendants. After years of litigation, however, the SEC was forced to dismiss the case. [92]

Two significant cases, settled in part in 2008, are the News Corp/Dow Jones case and the *Guttenberg* case, the latter of which is viewed by many as the most significant insider trading case brought in years.

SEC v. Kan King Wong, No. 07-3628 (S.D.N.Y. filed May 8, 2007) is an example of an insider trading case brought very quickly and in which the SEC obtained a significant settlement. The case centers on trading in advance of the May 1, 2007 public announcement of News Corp's bid for Dow Jones. The initial complaint was filed seven days after the merger announcement. It named as defendants Kan King Wong and his wife Charlotte Ka On Wong Leung, both residents of Hong Kong. The complaint claimed the couple purchased 415,000 shares through a Merrill Lynch Hong Kong account before the announcement. When the husband ordered the sale, that account had $8.1 million in profits from the increase in the share price following the announcement of the deal.

At the time of the settlement, the SEC amended the complaint. The amendment claimed that News Corp. board member David Li told his close friend Michael Leung about the deal. Mr. Leung told his daughter and son-in-law — the original defendants. Messrs. Li and Leung were added as defendants in the amended complaint which claims that Mr. Leung traded through the account of his daughter and son-in-law with their assistance.

In the settlement, each defendant consented to the entry of an order enjoining them from future violations of Section 10(b) and Rule 10b-5. In addition, Mr. Li was ordered to pay an $8.1 million civil penalty; Mr. Leung was ordered to pay $8.1 million in disgorgement plus pre-judgment interest and an $8.1 million penalty; and K. K. Wong was required to pay $40,000 in disgorgement plus prejudgment interest and a $40,000 civil penalty.

U.S. v. Guttenberg, 07-00141 (S.D.N.Y. filed Feb. 26, 2007) and *SEC v. Guttenberg,* No. 07-1774 (S.D.N.Y. filed March 1, 2007) were also partially settled last year. The 10 criminal cases charged 13 individuals, while the SEC named 14 individuals as defendants in a single case. The defendants were primarily Wall Street insiders.

The claims involved two overlapping schemes. The primary scheme is based on allegations that Mr. Guttenberg furnished others with information from his employer about up coming UBS recommendations on stocks prior to the announcement date. A second scheme centered on information obtained by a Morgan Stanley attorney who furnished others with inside information regarding upcoming deals.

The criminal cases were resolved with each defendant pleading guilty. Not all of the defendants in the SEC case have settled.

Many of the insider trading cases brought in 2007 involved trading in advance of a corporate event such as a merger or an earnings release. Others had international aspects which made detection and discovery of the acts more difficult.

An example of an insider trading case based on a merger where the SEC took an aggressive position is *SEC v. Tedder,* No. 08-1013 (N.D. Tex. filed June 17, 2008). Here, the SEC, based in part on the facts from a corporate internal investigation, claims that defendants Tedder and Carr, both employees of Aviall, Inc., traded in advance of the acquisition of their company by The Boeing Company.

In its complaint, the SEC details a series of events which it alleges gave the two employees inside information. Those events include extending a trading blackout, an executive tour at the company by Boeing executives, repeated closed door meetings by the in-house counsel and an e-mail inadvertently sent by the company CEO to 122 employees about a conference call involving due diligence and rumors. The case is in litigation.

SEC v. One or More Unknown Purchasers of the Call Options for the Common Stock of DRS Technologies, Inc., No. 08-6609 (S.D.N.Y. filed July 25, 2008) is an example of an insider trading case with international aspects. The complaint is based on trading in call options on two take over stocks through an account at UBS AG in Zurich, Switzerland. The first instance involved a proposed transaction between Schneider Electric SA and American Power Conversion Corporation. According to the SEC's complaint, Schneider sent a letter to American Power in September 2006 expressing interest in acquiring the company. Shortly after the letter, an unknown purchaser bought 2,830 American Power out of the money call options. After the deal was announced, the share price of American Power rose 26%. Subsequently, the options were liquidated for a profit of about $1.7 million.

The second instance of alleged insider trading involved a proposed transaction in which Finmeccanica S.p.A. would acquire DRS Technologies, Inc. The complaint alleges that prior to an announcement by Finmeccanica on May 12, 2008 that it would acquire DRS for $5.2 billion, the unknown purchaser bought 1,820 DRS call options that were out of the money and due to expire shortly for over $456,200. After a *Wall Street Journal* article reporting the merger negotiations, the unknown purchaser liquidated all the options, yielding a profit of about $1.6 million. This case is in litigation.

The SEC also brought insider trading cases against a wide variety of defendants including directors, audit committee members, in-house counsel, auditors and others. For example:

- *Director and outside counsel: SEC v. Boshell,* No. 08-3292 (N.D. Ill. April 28, 2008) is a settled insider trading case which named as defendants a board member who learned about a potential acquisition at a board meeting and an attorney with an outside law firm doing due diligence on the deal.
- *Audit committee member: SEC v. Gad,* No. 07-8385 (S.D.N.Y. Sept. 27, 2007) is an insider trading case brought against an audit committee member who is alleged to have tipped his close friend after learning there would be an earnings short fall. The case settled last year. *See also SEC v. Erickson,* No. 07-0254 (N.D. Tex. filed Feb. 7, 2007) (action against an audit committee

[92] *See also SEC v. Anton, III,* Civil Action No. 06-2274 (E.D. Pa. Decided April 23, 2009) in which the court after trial found against the SEC and in favor of a former corporate officer alleged to have illegally tipped an individual. In part the court found that there was no personal benefit. The tippee had previously settled. *SEC v. Johnson,* Civil Action No. 05-CV-4780 (E.D.Pa. Sept. 7, 2005).

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member who allegedly participated in negotiations regarding the acquisition of his company and then traded. The case settled last year).

■ *General counsel: SEC v. Heron,* No. 07-01542 (E.D. Pa. filed April 18, 2007). After litigating, this action settled last year. The defendant is the former general counsel of the company who is alleged to have repeatedly traded on inside information about his company. Mr. Heron was convicted on criminal securities fraud charges in a parallel criminal case. *United States v. Heron*, No. 08-1061, 2009 U.S. App. LEXIS 7093 (3rd Cir. Apr. 2, 2009) (The Third Circuit reversed the district court grant in part of a post guilty verdict motion for acquittal).

■ *Outside auditors: SEC v. Raben,* No. 08-0250 (N.D. Cal. filed Jan. 15, 2008) is a settled insider trading case brought against two former PricewaterhouseCoopers auditors for trading in advance of pending deals of audit clients.

■ *Securities professionals: SEC v. Stephanou,* No. 09-325 (S.D.N.Y. filed Feb. 5, 2009) is an insider trading case brought against two securities professionals and a hedge fund manager. The complaint alleges that the defendants traded in advance of pending deals. The case is in litigation. *See also SEC v. Devlin,* No. 08- 1101 (S.D.N.Y. filed Dec. 18, 2008) (insider trading case against securities and legal professionals and their friends and clients which alleges illegal trading on a series of deals. This case is in litigation.)

■ *Public figures: SEC v. Cuban,* No. 08-2050 (N.D. Tex. filed Nov. 17, 2008). This insider trading action was brought against Mark Cuban, the owner of the Dallas Mavericks, HDNet and Landmark Theaters. The case is based on a PIPE offering made by Mamma.com, Inc. According to the SEC, in 2004 when the company was planning the offering Mr. Cuban, its largest known shareholder, was contacted several times about the proposed offering. Before information about the transaction was provided to him, Mr. Cuban agreed to maintain its confidentiality. Mr. Cuban was reportedly upset by the offering because it would dilute his interest. He declined to participate. Shortly before the public announcement Mr. Cuban sold his entire stake in the company, avoiding what the SEC claims was potentially a $750,000 loss. The case is in litigation.

In view of the aggressive posture of insider trading enforcement, all companies should consider implementing and/or updating their compliance procedures. Brokerage firms are required under the securities laws to have insider trading compliance procedures. Non-regulated entities are not required to have these procedures. The SEC, however, recently stressed the importance of having insider trading compliance procedures. In *Retirement System of Alabama,* the SEC resolved an insider trading investigation against an Alabama state pension fund by issuing an Exchange Act Section 21(a) report of investigation rather than bringing an enforcement action.[93] The system agreed to adopt insider trading procedures in the future as part of the resolution of the investigation.

The Commission's emphasis on adequate procedures was also evident in *In the Matter of Merrill Lynch, Pierce, Fenner & Smith,* Exchange Act Release No. 59555, Adm. Proc File No. 3-13407 (Filed Jan. 30, 2009). This settled administrative proceeding was based on claims that the brokerage firm failed to maintain adequate controls over certain material non-public order flow information broadcast internally over a ''squawk box.'' A key part of the settlement was a revision and revamping of the firm's internal procedures to ensure proper control over material non-public information.

D. Financial Fraud Financial fraud has long been an enforcement priority and will clearly be a critical area as the market crisis investigations move forward. Issuer cases in this key area were clearly impacted by the now terminated ''pilot program'' regarding penalties.[94] At the same time, the Commission did bring a number of financial fraud cases. While most of the cases were settled, a few were litigated and were tried to verdict.

The SEC's financial fraud cases increasingly have international aspects. One example of this trend is the *Manterfield* litigation in which the Commission recently prevailed in an action brought in the U.K. In *SEC v. Manterfield,* Claim No. HQ08x00798 (High Court of Justice, Queens Bench, Royal Courts of Justice, Feb. 29, 2008), the SEC obtained the dismissal of an appeal by Glenn Manterfield, a UK citizen, of an assets freeze order the Commission obtained over his U.K. assets in the High Court of Justice in London on May 16, 2008.

The initial SEC enforcement action began in the U.S. against Lydia Capital, LLC, a registered investment advisor based in Boston, and its two principals, Glenn Manterfield and Evan Anderson. *SEC v. Lydia Capital, LLC,* No. 07-10712 (D. Mass. filed April 12, 2007). The complaint claimed that defendants engaged in a scheme to defraud more than 60 investors who had put over $34 million in Lydia Capital Alternatives Investment Fund LP, an unregistered hedge fund managed by Lydia. Defendants had materially overstated, and in some instances fabricated, the Fund's performance according to the SEC.

On April 12, 2007, the SEC obtained a temporary restraining order that froze the assets of the defendants. On February 29, 2008, the Commission filed the UK action to freeze about $1 million in assets. That request was granted and later, after an evidentiary hearing, extended until the conclusion of the U.S. enforcement action. Mr. Manterfield attempted to have that order overturned in his unsuccessful appeal. The case is currently in litigation.

SEC v. Zurich Financial Services, No. 08-10760 (S.D.N.Y. filed Dec. 11, 2008) and *In the Matter of SCOR Holdings (Switzerland) Ltd. formerly known as Converium Holdings AG,* File No. 3-13307 (filed Dec. 11, 2008) are two additional examples of international financial fraud cases. Zurich is a Swiss based reinsurance company. Its shares are traded on the SWX Swiss Exchange and its ADRs are quoted on the Over-the-Counter Bulletin Board and in the Pink Sheets. Converium was organized under the laws of Switzerland by Zurich in 2001. It initially operated as a subsidiary. In March 2001, Zurich spun off Converium and, following an IPO, it was no longer affiliated with Zurich. Its shares and ADRs were registered with the SEC for trad-

[93] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The Retirement Systems of Alabama, Exchange Act Release No. 57446 (March 6, 2008), *available at* http://www.sec.gov/litigation/investreport/34-57446.htm,

[94] *GAO Report, supra* note 15, at 7.

ing. Later, the company was acquired by SCOR SE, a French reinsurer.

The SEC claimed that beginning in 1999, and before the IPO, Zurich developed three sham reinsurance transactions, resulting in falsified financial statements for Converium that were used in its IPO. Those transactions were crafted to make it appear risk transfered to third-party reinsurers when in fact no actual risk was insured outside the Zurich group of companies. The financial statements, which were used in the IPO, were false and materially misleading. Converium understated its pre-tax loss by about 57% or $100 million in 2000 and by 1% or about $3 million in 2001.

To settle the case, both Zurich and Converium consented to the entry of cease and desist orders. In addition, in the civil action, Zurich agreed to pay a $25 million civil penalty. The SEC acknowledged the cooperation of each company.

Few Commission enforcement actions go to trial. Perhaps even fewer financial fraud cases are tried. In 2008, however, four financial fraud cases were tried. The Commission prevailed in two. In a third, the SEC lost, while another was dismissed after years of litigation. The SEC prevailed in *SEC v. Miller*, No. 04-1655 (N.D. Ga. filed June 14, 2004). Here, the jury returned a verdict in favor of the Commission, concluding that John Miller, the former president, CEO and COB of Master Graphics, Inc., violated the antifraud and books and records provisions of the securities laws.

The SEC claimed that Mr. Miller devised and implemented a scheme to inflate income to meet Wall Street expectations. Specifically, the company reclassified rent and salary expense that had been paid to division presidents in the first quarter to assets on the balance sheets. As a result, Master Graphic's net income was over stated by 628%, 46% and 10% in the first, second and third quarters respectively in its 1999 filings.

Previously, the CFO and Chief Accounting Officer had settled with the Commission. *See In the Matter of Henson*, Release No. 33-8425 (May 19, 2004); *In the Matter of Fair*, Release No. 33-8424 (May 19, 2004); *SEC v. Henson*, Lit. Release No. 18733A (Jul. 14, 2004).[95]

The Commission also prevailed in *SEC v. Stanard*, No. 06-7736 (S.D.N.Y. filed Sept. 27, 2006). There, the court found in favor of the SEC and against James N. Stanard, former CEO of RenaissanceRe Holdings, Ltd., following a six day trial.

The Commission's complaint alleged that Mr. Stanard participated in a financial fraud to smooth RenRe's earnings by engaging in a round trip sham transaction. Specifically, the company purported to assign a discount of $50 million of its recoverables to Inter-Ocean Reinsurance Company, Ltd. for $30 million in cash, a net transfer to the company of $20 million. RenRe booked income of $30 million at the time the agreements were executed. The second contract appeared to be a reinsurance agreement with Inter-Ocean. In fact, it lacked any substance. The agreement was used to refund the $20 million paid under the first agreement to RenRe at a later date.

As a result of this transaction, the company materially understated income in 2001 and materially overstated income in 2002, at which time it made a so-called claim under the sham agreement and received the $20 million payment Inter-Ocean had held all along for RenRe. Previously, the SEC settled with the company and two other defendants.[96]

In contrast, the SEC lost at trial in *SEC v. Goldsworthy*, No. 06-10012 (D. Mass. filed Jan. 4, 2006). The court rejected most of the claims brought against former Applix, Inc. CEO Alan Goldsworthy and former CFO Walter T. Hilger following a four week jury trial. While the court rejected claims of intentional fraud, it did find negligent fraud.

The complaint claimed that Messrs. Goldsworthy and Hilger and another engaged in two separate schemes to inflate revenue. The first involved the premature recognition of about $890,000 in revenue for the fiscal year ended December 31, 2001. The second concerned improperly reported revenue of about $341,000 for a transaction with a German customer.

Based on the findings of the jury, the court concluded that defendants had violated Section 17(a)(3) of the Securities Act and Rule 13b2-1. It rejected SEC claims that there were violations of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) along with Rules 10b-5, 12b-20, 13a-1, 12a-11, 12a-13 and 13b-2-1. The company previously settled. *See In the Matter of Applix, Inc.*, Adm. Proc. File No. 3-12138 (Jan. 4, 2006).

Finally, after years of litigation, the SEC dismissed all claims against former AOL executive John Tuli in *SEC v. Johnson*, No. 05-00036 (D.D.C. filed Jan. 10, 2005). According to the complaint, Mr. Tuli participated in a scheme to falsify the books and records of a Las Vegas-based internet company by repeatedly confirming, or causing others to confirm, to the outside auditors of the company that services had been had been completed and accepted by AOL. Those audit confirmations were alleged to be false. Mr. Tuli had previously been acquitted following a three month jury trial on criminal charges based on similar allegations.[97]

Other cases reflect the increasing role of derivatives in the market. For example, in *SEC v. Lee*, No. 08- 9961 (S.D.N.Y. filed Nov. 18, 2008), the SEC brought an action based on a fraudulent scheme keyed to derivatives. It named as defendants, David Lee, a former commodity option trader at a subsidiary of Bank of Montreal, and Kevin Cassidy, Edward O'Connor and Scott Connor, all former employees of Optionable, a commodity brokerage whose shares are quoted on the OTC Bulletin Board.

The complaint alleges a scheme which victimized the shareholder of the bank and the brokerage firm as well as the New York Mercantile Exchange. According to the SEC, the bank's shareholders were defrauded in a ''u-turn'' scheme. In that scheme, when Mr. Lee could not obtain market prices for trading positions in natural

[95] *See also SEC v. Conaway*, Case No. 05-40263 (E.D.Mich. filed Aug. 23, 2005) where a jury returned a verdict in favor of the SEC in June 2009 and against the former Kmart CEO Charles Conaway in a financial fraud case. The action centered on false and misleading statements in the MD&A section of a Form 10-Q filing and related statements in an investor call about events which preceded the bankruptcy filing of the company in January 2002.

[96] Reinsurer Settles Accounting Fraud Case Involving Sham Reinsurance Transaction, Lit. Release No. 19989 (Feb. 6, 2007).

[97] *United States v. Benyo*, et al., No. 05-12 (E.D. Va. Jan. 9, 2008).

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gas options, he inserted prices or marks which were verified by the Optionable defendants. As a result, the financial statements were falsified.

The shareholders of Optionable were also victims, the SEC alleged. The periodic reports of this company were false. Those reports touted the ''synergistic benefits of the derivatives valuation services'' that the company provided to multiple brokerage clients, but failed to disclose that the primary client was Bank of Montréal and that the services provided were fraudulent.

The third victim, the Commission alleged, was the New York Mercantile Exchange. Optionable sold the exchange over $10 million of its shares based on its periodic reports. Those reports were materially false.

Mr. Lee has pleaded guilty to federal and state criminal charges. Mr. Cassidy is under indictment. Mr. Lee also consented to the issuance of a Consent Order of Prohibition with the Federal Reserve Board.[98]

Frequently, financial fraud cases are years old, raising questions as to whether they should have been brought in the first place — particularly at a time when the Commission has scarce resources. *SEC v. Prudential Financial, Inc.*, No. 08-3916 (D.N.J. Aug. 6, 2008) is an example of such an action. This settled action[99] alleges a scheme to falsify revenue. According to the SEC, a subsidiary of Prudential entered into round-trip transactions with reinsurance giant General Re. The transactions had no substance or purpose other than to build up and then draw down off-balance sheet sums. The complaint does not allege a material impact in the period from 1997 to 2002 when the scheme took place. The company did not restate its financial statements. And, there is little likelihood of a reoccurrence since the subsidiary involved was sold five years ago. Nevertheless, the SEC filed this action and settled it with a consent injunction prohibiting future violations of the books and records provisions.

Finally, the current market crisis will clearly serve to reemphasize this traditional enforcement area. The subprime and large financial institutions working groups, two of the key enforcement groups focused on market crisis events, are both conducting investigations which are keyed to financial fraud issues. Those issues include questions regarding the use of reserves, valuation of assets, loan quality, credit risk and related disclosure and internal control issues. In view of the large number of investigations being conducted and the significant amount of resources being devoted to these inquiries there should be little doubt that financial fraud will be a high priority in coming months.

E. Option Backdating Option backdating cases have been a focus of enforcement in recent years. Essentially, these cases involve fraudulently backdating stock option grants so that they are in the money and then not properly recording the related compensation expenses in the financial statements.

The SEC is reportedly working its way through what was once a large inventory of option backdating cases. Most of these cases have been based on allegations of scienter based fraud, frequently coupled with intentional acts such as cover-ups. In some instances criminal charges have been brought.[100] A few cases have been based on negligence, using Securities Act Section 17(a)(3). This year, these trends have continued.

SEC v. Sycamore Networks, Inc., No. 08-11166 (D. Mass. July 9, 2008) typifies many of these cases in this area. Here, an action was brought against Sycamore Networks, an optical networking company, its former CFO Frances M. Jewels, former Director of Financial Operations Cheryl E. Kalinen and former Director of H.R., Robin A. Friedman. The complaint alleged that between 2000 and 2005 Sycamore used backdated options to compensate employees without properly accounting for about $250 million in related expenses. Between October 1999 and July 2002, defendants repeatedly backdated option grants, providing themselves and employees with options. The prices at which they could purchase shares were lower than the market price at the time the options actually were granted. To conceal these practices, grant documents were falsified.

To settle the case, the company consented to the entry of a permanent injunction prohibiting future violations of the antifraud, reporting and proxy provisions of the federal securities laws. Similarly, Defendants Jewels, Kaline and Friedman also consented to the entry of permanent injunctions. In addition, Ms. Jewels agreed to pay disgorgement of $30,000 plus prejudgment interest and to a directive that the company be reimbursed under Section 304 of the Sarbanes-Oxley Act (''SOX'') for the $190,000 in cash bonuses she received. She also agreed to pay a penalty of $230,000 and to the entry of an order barring her from serving as an officer or director of a public company for five years. In a related administrative proceeding, Ms. Jewels agreed to be barred from appearing or practicing before the SEC as an attorney or accountant for five years. Ms. Kalinen consented to an order requiring her to pay $28,000 in disgorgement plus prejudgment interest and to the payment of a civil penalty of $150,000. Ms. Friedman agreed to pay a civil penalty of $150,000.

SEC v. Karatz, No. 08-06012 (C.D. Cal. filed Sep. 15, 2008) is another example of a settled options backdating case. This action was brought against the former chairman and CEO of KB Home, Inc.

The complaint alleged that Mr. Karatz engaged in a multi-year scheme to backdate stock options for himself and others at the company. From 1999 through 2005, Mr. Karatz used hindsight to pick advantageous grant dates according to the complaint. This resulted in Mr. Karatz receiving a total of 2,860,000 shares of KB Home stock which yielded $6 million when exercised.

[98] *SEC Charges Banker And Brokerage Executives With Multimillion Dollar Financial Fraud*, Lit. Release No. 20811, *SEC v. David Lee, et al.*, No. 08-9961 (S.D.N.Y. 2008)

[99] *See also SEC v. Hozhabri*, No. 08-1359 (D.D.C. filed Aug. 6, 2008). Defendant Ali Hozhabri, a former project manager for ABB Network Management, fraudulently submitted $468,714 in cash and check disbursement requests to his employer between 2002 and 2004. There is no allegation that the conduct had any impact on the financial statements of the company. The SEC settled for a consent decree containing an injunction which prohibits future violations of the books and records provisions after Mr. Hozhabri pled guilty to criminal charges.

[100] *See, e.g., U.S. v. Reyes*, No. 06-cr-0556 (N.D. Cal. Aug. 27, 2007) (former CEO of Brocade Communications convicted on criminal backdating charges); *but see U.S. v. Roberts*, Case No. 07-00100 (N.D. Cal. filed Feb. 27, 2007) (former general counsel of MacAfee acquitted of fraud charges based on option backdating but jury hung on charges regarding falsification of books and records which the Judge recommended government drop; the charges were later dismissed).

To resolve the case, Mr. Karatz consented to the entry of a permanent injunction prohibiting future violations of the antifraud, reporting and proxy provisions of the federal securities laws. In addition, he agreed to the entry of an order requiring him to pay approximately $6.7 million in disgorgement and interest and a civil penalty of $480,000. He also consented to the entry of an order barring him from service as an officer or director of a public company for five years.

SEC v. Kohavi, No. 08-4348 (N.D. Cal. Sep. 17, 2008) should serve as a warning to all officers and directors of the Commission's views regarding the performance of their obligations. *Kohavi* is an option backdating case brought against three outside directors. The complaint claims that from 1997 through 2002, the directors approved 21 separate backdated option grants. A series of ''red flags'' that were ignored by the directors when they approved these grants are detailed in the complaint. Those red flags, which are the predicate for the directors' liability, include approving grants which were ''as of'' a date which preceded the time the three directors executed the approval papers. In two instances the three directors executed approvals that were backdated for employees and, a short time later, again executed a consent for backdated options for the same employees, but with different ''as of'' dates to take advantage of a share price drop. In essence, the complaint alleges that the directors simply went along with management.

To settle the action, each defendant consented to the entry of a permanent injunction prohibiting future violations of the antifraud, proxy and reporting provisions of the federal securities laws. In addition, each defendant consented to the entry of an order requiring that they pay a civil penalty of $100,000. The action against the company had previously settled. *SEC v. Mercury Interactive, LLC*, No. 07-2822 (N.D. Cal. May 31, 2007).

In some instances, the Commission has encountered difficulties because many of these cases are based on years-old conduct. For example, in *SEC v. Berry*, No. 07-04431, slip op. (N.D. Cal. May 7, 2008), part of the case was dismissed on statute of limitations grounds.

Berry is an option backdating case brought against Lisa Berry, former General Counsel of Juniper Networks, Inc. and KLA-Tencor. The SEC's complaint claimed that from 1997 to 2002, Ms. Berry routinely used hindsight to identify dates with historically low stock prices, facilitating the backdating of option grants by KLA's stock option committee. After moving to Juniper, Ms. Berry established a similar backdating process at that company, creating minutes of fictitious stock option committee meetings to document false grant dates. This resulted in materially false disclosure and overstated net income at KLA and Juniper. Violations of the antifraud, proxy and books and records provisions were alleged.

Ms. Berry moved to dismiss based on the statute of limitations and a failure to plead fraud with particularity. The motion was granted in part. A five-year statute of limitations applies to any relief that is a penalty but not to the equitable relief. The court held that the request by the SEC for a penalty is time barred, but permitted repleading to demonstrate equitable tolling.

The court also held that Federal Civil Rule 9(b), requiring that fraud be pled with particularity, applies. Here, the SEC's complaint against Ms. Berry failed to detail her role in the backdating scheme and thus failed to meet this standard. In this regard the court held ''Ms. Berry has carried her burden of demonstrating the SEC has failed to allege with particularity any securities fraud based on misstatements, other than the SEC's allegations arising from Ms. Berry signing KLA's two Form S-8.''

In many of the option backdating cases, the issuer cooperates with the SEC in an effort to earn ''cooperation credit'' in the charging decision. Two examples from the inventory of option backdating cases brought last year illustrate the approach of the Commission in such instances.

SEC v. Brooks Automation, Inc., No. 08-10834 (D. Mass. May 19, 2008) is a settled option backdating case in which the SEC termed the cooperation of the company ''swift, extensive and extraordinary.'' The company was able to settle the action by consenting to the entry of a permanent injunction prohibiting future violations of the reporting provisions but without a fraud charge or a penalty.

A second example is *SEC v. UnitedHealth Group, Inc.*, No. 08-6455 (D. Minn. filed Dec. 22, 2008). In this settled option backdating case, the SEC also gave the company credit for cooperation. In an unusual statement, the SEC outlined the cooperation of the company. According to the Commission, that cooperation consisted of: 1) conducting an internal investigation; 2) disclosing the findings and conclusions of that inquiry in a Form 8-K; 3) sharing the facts uncovered with the government; and 4) adopting extensive remedial actions.

The company settled the case by consenting to the entry of a permanent injunction based on the books and records provisions. The company was not charged with fraud and a penalty was not imposed.

Finally, while most option backdating cases are based on conduct involving scienter, in some instances the Commission has based its claims on negligence as in *SEC v. Tullos*, No. 08-242 (C.D Cal. filed March 4, 2008). This option backdating case was brought against Nancy M. Tullos, the former vice president of human resources of Broadcom Corporation.

According to the complaint, Ms. Tullos participated in a scheme from 1998 to 2003 to backdate options at Broadcom. As part of the scheme, grants were backdated to the low closing price for the company's stock. Ms. Tullos communicated the grant dates within the company, provided spreadsheets of stock option allocations for the backdated grants to the finance and shareholder services departments, knowing that they would use the information to prepare Broadcom's books and records and periodic SEC filings. She also personally profited.

To resolve the case, Ms. Tullos consented to the entry of a permanent injunction prohibiting future violations of Securities Act Section 17(a)(3) and Exchange Act Section 13(b)(5). She also agreed to the entry of an order requiring her to pay over $1.3 million in disgorgement and prejudgment interest to be offset by the value of her exercisable stock options which were cancelled and to pay a civil penalty of $100,000.

IV. SIGNIFICANT LEGAL RULINGS

A. Primary Liability And Aiding And Abetting The distinction between primary and secondary liability in SEC enforcement actions can be significant. Four recent decisions illustrate the debate on this point. In *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008), the court considered the question of primary liability in the context of a

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market timing case. Here the SEC claimed two senior executives of a broker dealer, which served as the primary underwriter for a group of mutual funds, were responsible for misstatements regarding the market timing policies of the funds.

The case was brought against James Tambone and Robert Hussey, executives of Columbia Funds Distributor, Inc., a registered broker dealer. The company was the principal underwriter and distributor for a group of approximately 140 mutual funds. In that capacity the broker dealer was primarily responsible for selling the shares of the funds and distributing information about them. Columbia Advisors, a registered investment advisor, was primarily responsible for creating the content of the prospectuses for the funds. According to the complaint, the funds' prospectuses included a strict prohibition on market timing. Although the defendants knew about this provision they permitted certain clients to repeatedly trade in and out. The SEC claimed fraud based on the policy statement in the prospectuses. The district court dismissed the complaint for, among other things, failing to properly plead primary liability because neither defendant made a material misstatement.

The First Circuit reversed. The circuit court held that Securities Act Section 17(a)(2) covers conduct that may not be prohibited by Section 10(b). Specifically, the court concluded that the language in the section, which provides that ''in the offer or sale of any securities . . . obtain money . . . by means of any untrue statement of a material fact,'' does not require that the defendant actually make the statement claimed to be false. Nevertheless, defendants Tambone and Hussey, as executives of a mutual fund's primary underwriter, were responsible for the content of the prospectuses. This conclusion was more than sufficient under the court's construction of Section 17(a)(2) for primary liability. It was also sufficient to satisfy the ''bright line'' test used by some courts to distinguish primary from secondary liability. Under that test the primary violator must actually make the false statements communicated to investors. Here since defendants were, as underwriters, responsible for the content of the offering documents they can be found to be primary violators the court concluded.

The defendants in *Tambone* have requested rehearing *en banc*. That request is pending before the Court. The position adopted by the court reflects the arguments of the Commission in its brief on the question of rehearing.[101]

The Tenth Circuit in *SEC v. Wolfson,* 539 F.3d 1249 (10th Cir. 2008) also considered the question of primary liability in the context of a Commission enforcement action. There the court analyzed the issue on summary judgment where the defendant was alleged to have written false disclosure documents for the issuer. Following its earlier holding in *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996), the court applied the bright line test. Under that test as articulated in *Anixter,* if the defendant made the statement directly to investors, or made it knowing it would be communicated to the public, that person can be held to be primarily liable. Here, since the defendant was responsible for the false statements in the filings, there is primary liability.

The court declined to impose the public attribution prong of the bright line test followed by some courts in private damage actions. Under that part of the test the statement must be attributed to the defendant in public. The court concluded that this portion of the bright line test is grounded in the reliance element of a Section 10(b) claim. Accordingly, it is inapplicable to a Commission enforcement action where there is no requirement to link the claimed fraud to damages or injury through reliance.

In *SEC v. Lucent Technologies, Inc.,* No. 04-2315, 2009 U.S. Dist. LEXIS 35593 (D.N.J. Apr. 27, 2009), the court also considered the question of primary liability. The complaint alleged financial fraud and named the company and several employees. Four defendants were claimed to have participated in sales which were improperly booked because there were oral side agreements giving vendors, among other things, a right to return.

In assessing whether the four defendants were primarily liable under Section 10(b), the court also applied the ''bright line'' discussed in *Anixter* and followed by the Second Circuit.[102] While this test evolved prior to the Supreme Court's decision in *Stoneridge Investment Partners, LLC. v. Scientific-Atlanta, Inc.,* 128 S.Ct. 761 (2008), that decision did not alter or even discuss the bright line test. Indeed, from *Central Bank* to *Stoneridge*, ''the Supreme Court has consistently narrowed the class of defendants reachable by the implied cause of action under Section 10(b).''[103] The court thus found it appropriate to follow the bright line test.

Applying that test, the court concluded that the conduct of the four individuals constituted little more than part of the mix that ultimately resulted in the financial statements being false. Being in the chain of events, however, is not sufficient to establish primary liability.

Finally, in *SEC v. Papa,* 555 F.3d 31 (1st Cir. 2009) the court focused on the question of liability for aiding and abetting in an SEC enforcement action. The complaint named six former employees of Putnam Fiduciary Trust Company. According to the SEC, the six executives engaged in a scheme to defraud Putnam client Cardinal Health, Inc. The misconduct centered on the cover-up of a one-day delay in investing certain assets of Cardinal in a defined benefit plan in 2001. The delay caused Cardinal to miss out on about $4 million of market gains. Following the error, the defendants chose not to inform Cardinal. Rather, they took steps to conceal the error by improperly shifting about $3 million of the costs to the shareholders of other Putnam mutual funds through backdated accounting entries and various accounting mechanisms. Cardinal bore about $1 million in losses.

The district court, on a motion to dismiss, concluded that three of the defendants were primarily violators having directly participated in the scheme. Three others, however, only attended meetings about the cover-up and one year later executed what are effectively internal audit confirmations stating that all accounts were accurately stated. The district court con-

[101] Brief of Securities and Exchange Commission Regarding Rehearing *en banc,* filed in *SEC v. Tamborne,* Case No. 07-1384 (1st Cir.).

[102] *See also* the court's earlier opinion. *SEC v. Lucent Technologies, Inc.,* 363 F. Supp. 2d 708, 719 (D. N.J. 2005).

[103] *SEC v. Lucent Technologies, Inc.,* No. 04-2315, 2009 U.S. Dist. LEXIS 35593 at *19 (D.N.J. Apr. 27, 2009). Legislation may be proposed to harmonize primary liability standards. *See* Section I at n. 32.

cluded that this conduct was not sufficient to constitute aiding and abetting liability. Accordingly, the case was dismissed as to these three defendants.

On the SEC's appeal, the court affirmed. The test of aiding and abetting liability is whether each defendant rendered substantial assistance to the wrong committed. The execution of the audit letters did not render substantial assistance because the fraudulent scheme was already complete. Likewise, the SEC's claim that the three defendants breached their fiduciary duty in executing the confirmations because if they had been answered truthfully the fraud would have been revealed would turn the scheme into a continuing and never ending one. The court rejected this notion of aiding and abetting.

B. Parallel Proceedings Frequently, SEC investigations are conducted at the same time as those by the Department of Justice and other regulators and self-regulatory organizations. Parallel proceedings offer certain efficiencies for both the government and a potential defendant. Their use has repeatedly been upheld by the courts. They do, however, present certain pitfalls.[104]

U.S. v. Stringer is a key decision involving parallel SEC and DOJ investigations. The district court dismissed a criminal indictment based on misconduct by the U.S. Attorney's Office and the SEC. The court concluded that the U.S. Attorney's Office (''USAO'') and the SEC violated the constitutional rights of defendants by merging their investigation and concealing the criminal inquiry behind the SEC civil investigation which was used to collect evidence for the USAO. *U.S. v. Stringer*, 408 F. Supp. 2d. 1083 (D. Or. 2006).

The Ninth Circuit reversed. *U.S. v. Stringer*, 521 F.3d 499 (9th Cir. 2008). The court held that the government fully disclosed the possibility that information received in the course of the civil investigation could be used for criminal proceedings by furnishing witnesses SEC standard Form 1662, which lists a set of routine uses made of the information obtained in investigations noting that it may be furnished to other agencies. The decision is predicated on the court's determination that the SEC did not make any affirmative misrepresentations. Reliance on Form 1662 was argued by the SEC in an amicus brief.[105]

V. ANALYSIS AND CONCLUSIONS The SEC was once considered an effective and efficient regulator, Wall Street's top cop who protected investors and maintained the integrity of world class capital markets. The market crisis, budget cuts, deregulatory trends and a lack of leadership have all taken a significant toll on the agency. Now, its new Chairman is struggling to quickly rejuvenate the SEC and reclaim its place as a premier regulator.

As the market crisis evolves, it is safe to project that new legislation giving regulators increased authority will be passed. Whether that legislation is based on the Treasury White Paper, a variation of that proposal or other concepts remains to be seen. Key areas that will be considered, however, include derivatives, mortgage backed securities and hedge funds. While there will undoubtedly be much lobbying on these issues and substantial debate, it seems likely that the SEC, the CFTC and the Federal Reserve will obtain enhanced regulatory authority.

Regardless of how much, if any, increased authority the SEC is given, it is likely that the agency will receive more funding and a directive from Congress to carry out the promise of its new Chairman to rejuvenate enforcement. Chastised by its critics and scandal and fueled with a zeal to restore its reputation, SEC enforcement is likely to be renewed with a vigor that could become overzealous or even turn punitive.

Reform has already started. A new enforcement director has been appointed, the process for obtaining a formal order has been streamlined and the cumbersome procedures for the staff to obtain authority to negotiate a settlement which includes a corporate penalty dropped. At a minimum, a new enforcement-minded tone at the top with streamlined procedures should begin to move the division forward in a positive manner. At the same time, facilitating the process for corporate penalties could accelerate what some see as a trend of ever increasing civil penalties which, at some point, can become counter productive.

While Congress debates the proposals in the Treasury White Paper and others, SEC enforcement can be expected to move forward with its market crisis investigations with increasing speed. Those inquiries undoubtedly will result in actions against lenders, financial institutions, hedge funds, investment advisers, market professionals and traders — at least initially. The early cases are likely to focus on financial fraud and disclosure issues such as the improper use of loan loss reserves, improper evaluation of assets, mispricing securities, the use of improper underwriting standards, market manipulation and improper disclosure regarding risk. The actions involving the former Countrywide executives and those at Reserve Management Company may represent the initial blue print for a number of these cases. The investigations may well expand to other areas and focus on additional persons as they continue beyond their initial market crisis focus.

SEC enforcement can also be expected to continue and expand its emphasis in key traditional areas. These will include, the FCPA, insider trading and financial fraud. Renewed zeal can also be expected to propel the current trend toward the criminalization of securities enforcement if for no other reason than it is easier to write an indictment than to plead a civil enforcement complaint.

The key to avoiding liability, or at least mitigating it, is suggested in cases such as the *Retirement Systems of Alabama* Section 21(a) report, the *Merrill Lynch* squawk box case and a number of the FCPA cases — strong internal compliance procedures and employee education programs. Good internal accounting and disclosure controls, insider trading prohibitions and mechanisms to contain material non-public information can help create a defense to enforcement investigations and actions. Strong procedures and employee educational policies are essential, particularly in the FCPA area, to avoid or mitigate liability. Likewise, active and attentive independent directors, as suggested by the *Kohavi* backdating case, are critical. In the end, vigilance by issuers and their directors and officers along with effectively monitoring and properly crafted procedures,

[104] *See, e.g., Kastigar v. United States*, 406 U.S. 441 (1972).

[105] Brief of the Securities and Exchange Commission as Amicus Curiae Supporting Appellants, *United States v. Stringer*, No. 06-301 (9th Cir. 2006).

compliance and education programs which are periodically updated are the keys to avoiding liability in the post market crisis era.