



PROGRAM MATERIALS

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SEC Enforcement Trends and Priorities 2008: Key Considerations for Issuers and their Employees and Counsel

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SEC ENFORCEMENT TRENDS AND PRIORITIES 2008

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INTRODUCTION

- Last year, the SEC brought a record number of cases
- Many had parallel DOJ actions
- To examine trends in SEC enforcement:
 - Consider key policy changes, cases and related matters from 2007; and
 - Project important emerging issues for 2008 and beyond.

INTRODUCTION

Primary points to consider

- Statistics – record number of cases
- Wins & losses
- Principal enforcement policy issues
(including calls for reform)
- Key cases
- Analysis & Conclusions

STATISTICS

Record number of cases

- 2007 – for the first time in years, the number of cases increased
- Enforcement cases were up by about 10%
- In prior years, cases had been decreasing by about 5% annually

STATISTICS

Record number of cases (cont)

- In 2007, the SEC brought
 - 1776 investigations
 - 262 civil actions
 - 394 administrative proceedings

STATISTICS

Record number of cases (cont)

- The SEC brought cases in the following areas:

- Financial Fraud
- Issuer disclosure
- Backdating of options
- The Foreign Corrupt Practices Act
- Self-Regulatory organizations
- Broker-Dealers
- Mutual Funds and Investment Advisers
- Investment fraud
- Insider trading

U.S. S.E.C. 2007 Performance and Accountability Report (Nov. 15, 2007)
www.sec.gov/about/secpar/secpar2007.pdf

WINS & LOSSES

The SEC claims it prevailed in the great majority of its enforcement cases

- 92% settled or ended in default
- \$520,000,000 in disgorgement and penalties obtained – down 50% from 2006
- SEC claims success in virtually every case category – financial fraud, self-regulatory, broker dealer, mutual funds and others

WINS & LOSSES

Some significant losses

- All litigated PIPE/hedge fund cases involving Section 5 claims, discussed *infra*
- *SEC v. PacketPort.com, Inc.*
 - Case dismissed for want of prosecution. *SEC v. PacketPort.com, Inc.*, Civil Action No. 3:05 cv 1747 slip op. (D. Conn. Mar. 21, 2007)
 - Case settled in October 2007 on terms favorable to defendants

WINS & LOSSES

Some significant losses (cont)

- *SEC v. Jones*, No. 07 Civ 7044 (S.D.N.Y Feb. 26, 2007):
 - The Court refused to award a penalty because the 5 year statute of limitations had passed; and
 - The Court refused to enter an injunction, finding it was punitive and thus also barred by statute.
- *SEC v. Todd*, Civil Action 03 CV 2230 (S.D. Cal. May 30, 2007)
 - Post trial defense motions largely granted where court concluded SEC misrepresented key evidence regarding whether defendant signed a claimed false filing

ENFORCEMENT POLICIES

Overview

- There has been considerable debate regarding certain policy issues, including:
 - Cooperation with other regulators
 - Parallel proceedings
 - Cooperation credit
 - Corporate penalties
 - Private litigation
 - Increased use of monitors
- There has been discussion of reform in certain policy areas, including:
 - Standardized enforcement procedures
 - Efficiency
 - Cooperation

ENFORCEMENT POLICIES

Cooperation with other regulators

- Coordination with, and the cooperation of, other regulators is often key
- In some instances, this results in referrals to other enforcers, such as DOJ

ENFORCEMENT POLICIES

Cooperation with other regulators (cont)

- In other instances, it stems from international arrangements the SEC has entered into over the years
 - On January 8, 2008, an agreement was entered into to increase cooperation and collaboration with the Securities and Exchange Board of India
 - Many of SEC's high profile cases were based on coordinated action with other regulators
 - TXU Options Case (*SEC v. One or More Unknown Purchasers of Call Options for the Common Stock of TXU Corp.*, Civil Action No. 1:07-cv-01208 (N.D. Ill. March 2, 2007)), insider trading case brought with assistance of U.K. Financial Services Authority and Swiss Federal Banking Commission

ENFORCEMENT POLICIES

Cooperation with other regulators (cont)

- Giant Foods case – SEC filed ten enforcement actions on January 18, 2007 against thirteen individuals alleging they aided and abetted a massive financial fraud. (*See SEC v. Bell*, Civil Action No. 07-120 (D.D.C.) (January 18, 2007) (and related cases). Action was coordinated with:
 - U.S. Attorney
 - New York Office of the Federal Bureau of Investigation
- Chevron FCPA Case (*SEC v. Chevron Corp.*, Civ. Action No. 07-10299 (S.D.N.Y. filed Nov. 14, 2007)), brought in conjunction with
 - U.S. Attorney
 - Manhattan District Attorney and
 - Office of Foreign Asset Control

ENFORCEMENT POLICIES

Cooperation with other regulators (cont)

- Trend will continue – Chairman Cox:

“Enforcement will, of course, remain the bread and butter of international securities regulatory cooperation.... Increasingly, not just two or three but a half dozen or more countries can be involved in a securities fraud.”

www.sec.gov/news/speech/2007/spch121907cc.htm

ENFORCEMENT POLICIES

Parallel proceedings

- Increasingly, there are parallel inquiries with DOJ
- Parallel proceedings offer efficiencies for government and defendants
- Also present significant pitfalls

ENFORCEMENT POLICIES

Parallel proceedings (cont) – Key cases

- The pending appeal in *U.S. v. Stringer*, No. 06-30100 (9th Cir.)
 - Lower Court: Case was dismissed where USAO hid behind SEC investigators during inquiry and government failed to tell witnesses or advise of conflict. *U.S. v. Stringer*, 408 F. Supp. 2d 1093 (D. Ore 2006).
 - On appeal, SEC argues it had no obligation to inform of parallel inquiry because its standard Form 1662 is sufficient notice of any possible criminal inquiry
 - Case has been briefed and argued

ENFORCEMENT POLICIES

Parallel proceedings (cont) – Key Cases

- *SEC v. Reyes*, No. C 06-04435 CRB, Minute Order (N.D. Cal. Oct. 4, 2006): In an option backdating case, court refused stay of SEC case pending resolution of criminal case as unfair where SEC & DOJ filed simultaneous cases following joint press conference
- *In the Matter of Turk*, Admin. Proc. File No. 301244 (June 25, 2007): SEC reversed censure and permanent bar entered by NYSE against specialist who declined to testify based on Fifth Amendment, noting that if respondent established SRO, had become intertwined with government or state action, specialist could invoke constitutional rights

ENFORCEMENT POLICIES

Cooperation credit

- Key issue for many issuers is cooperation credit
- Prospect of no charges or reduced charges in exchange for cooperating with government
- SEC policies contained in Seaboard Release of 2001
 - Sets forth a series of factors for staff to consider in evaluating cooperation and making charging decision
 - Specifies that waiver of privilege may be necessary, but does not say it is required
 - Example of cooperation in release is of company not being charged that waived privilege

ENFORCEMENT POLICIES

Cooperation credit (cont)

- DOJ has similar policies contained in a series of memos by Deputy AGs
 - The Thompson Memorandum has provisions which are similar to those in the Seaboard Release
 - The Thompson Memorandum, however, directed prosecutors to view offers of cooperation with skepticism

ENFORCEMENT POLICIES

Cooperation credit (cont)

- Critics of these policies claim they have created a “culture of waiver” which effectively strips organizations and individuals of their rights
 - Letter from Karen J. Mathis, President, American Bar Association to The Honorable Christopher Cox, Chairman, SEC (Feb. 5, 2007) (available at http://www.abanet.org/poladv/letters/attyclient/2007feb05_privwaivsec_l.pdf)
 - The Coalition to Preserve the Attorney-Client Privilege has been formed which includes
 - The Association of Corporate Counsel
 - The Business Roundtable
 - The Financial Services Roundtable
 - The National Association of Criminal Defense Lawyers
 - The National Association of Manufacturers
 - The U.S. Chamber of Commerce
- Portions of the Thompson Memo were held unconstitutional in *U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006)

ENFORCEMENT POLICIES

Cooperation credit (cont)

- DOJ revised its policies with the McNulty Memorandum in November 2006
 - Directs prosecutors to respect privilege
 - Limits the circumstances under which a waiver can be sought

Memorandum from Paul J. McNulty, Deputy Attorney General to Head of Department Components and United States Attorneys, available at http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf

ENFORCEMENT POLICIES

Cooperation credit (cont)

- SEC has not altered its policies
- April 2007 speech by Enforcement Chief Linda Thomson cited two examples of cooperation
 - In one, the company waived privilege and was not charged
 - In the second example, the company did not waive privilege and was charged

www.sec.gov/news/speech/2007/spch0412071ct.htm

ENFORCEMENT POLICIES

Cooperation credit (cont)

- Cooperation with SEC and even waiver leads to unpredictable and inconsistent results:
 - *SEC v. Wagner*, Civil Action No 07-22123 (D.D.C. Filed Dec. 7, 2007): former msystems, Ltd. Director traded in advance of a merger, but then self reported. He settled for:
 - A permanent fraud injunction, disgorgement of trading profits and prejudgment interest
 - But NO penalty
 - *SEC v. The BISYS Group, Inc.*, 07-Civ-4010 (KMK) (S.D.N.Y. Filed May 23, 2007): In a Press release, the SEC acknowledged “extensive cooperation” in a pervasive corporate accounting fraud case involving senior management, but settlement required consent to statutory injunction prohibiting future violations of the relevant reporting, books-and-records, and internal controls provisions
 - *In the Matter of de Leon-Meredith*, Exchange Act Release No. 44970 (October 23, 2001): In this case which is cited in Seaboard, the SEC declined to prosecute the corporation in a financial fraud case based on its cooperation
 - Report of Investigation Pursuant to Section 2(a) of the Securities Exchange Act of 1934: *The Retirement System of Alabama*, Release No. 574461 (March 6, 2008): concluding that system engaged in insider trading which could have been prevented if the system had adequate policies but considering acknowledgement of error, cooperation and fact that no individual profited.

ENFORCEMENT POLICIES

Corporate penalties

- There have been repeated reports of a split among SEC Commissioners over corporate penalties when all five were present
 - One argument is that penalties are a deterrent
 - Another is that penalties ultimately hurt shareholders:
 - “Where there has been disagreement among us is on the appropriateness of imposing corporate penalties, which, at the end of the day, are paid by the shareholders.”

Commissioner Cynthia Glassman, SEC, “SEC in Transition: What We've Done and What's Ahead” (June 15, 2005)

<http://www.sec.gov/news/speech/spch061505cag.htm>

ENFORCEMENT POLICIES

Corporate penalties (cont)

- In 2006, SEC announced a policy on penalties which sets forth a number of factors
- Two key factors are
 - The presence or absence of a benefit to the corporation, and
 - The degree to which it will recompense/harm shareholders

www.sec.gov/news/press/2006-4.htm

ENFORCEMENT POLICIES

Corporate penalties (cont)

- 2007: New corporate penalty settlement procedure announced by Chairman Cox in an April 13, 2007 speech:
 - Traditionally staff negotiated tentative settlement, including penalty, for Commission consideration
 - Now Commission will direct staff prior to negotiations on penalty; then staff can negotiate settlement

www.sec.gov/news/speech/2007/spch041207cc.htm

ENFORCEMENT POLICIES

Corporate penalties (cont)

- Chairman Cox says the policy will empower the staff and ensure uniformity
- Critics claim the policy undercuts the staff, will further slow the process and impede meaningful discussions with defense counsel

ENFORCEMENT POLICIES

Private litigation

- Traditionally, the SEC has stated that private damage actions are a necessary supplement to its enforcement program
- Is the policy changing? Consider —
 - *In Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499 (2007), concerning the key issue of what constitutes a “strong inference” of scienter, the SEC argued in an amicus brief for a standard which favored business and which is, in fact, was more stringent than that adopted by the Court

ENFORCEMENT POLICIES

Private litigation

- *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761 (Jan. 15, 2008)
 - While this case, concerning whether “scheme liability” is within the scope of Section 10(b), was pending certiorari, the SEC voted 3-2 to file an amicus brief in favor of plaintiffs, who were arguing traditional SEC position
 - The Solicitor General refused permission and filed a brief which ultimately argued pro-business position adopted by the Court
 - In a footnote, the Solicitor General argued that the traditional SEC “scheme liability” theory is wrong
 - Ultimately, court adopted position of Solicitor General

ENFORCEMENT POLICIES

Increased use of monitors

- Frequently used in certain types of settlements by SEC and DOJ such as FCPA cases:
 - *SEC v. York International Corp.*, Civil Action No. 7-01750 (D.D.C. Filed Oct. 1, 2007): the settlement called for an independent compliance officer
 - *U.S. v. York International Corp.*, No. 07-01750 (D.D.C. Filed Oct. 1, 2007): deferred prosecution agreement required the company to implement a compliance program and procedures reviewed by an independent monitor
- DOJ had detailed its position on the selection and use of monitors in a memo
 - Contains standards for selection and key points on duties
 - The monitor is there to ensure compliance
 - Monitor is not a corporate employee – therefore, there is no privilege
- DOJ policies can influence SEC settlements

REFORM OF ENFORCEMENT POLICIES

Standardized enforcement procedures

- A U.S. Senate Committee which held hearings on the botched Pequot hedge fund investigation made three key recommendations:
 - Standardized, comprehensive investigative procedures should be prepared similar to the U.S. Attorney's Manual
 - Procedures for assessing the complexity and needs of a case in terms of staff and resources should be developed
 - Steps should be taken to prevent improper influences

Minority Staff of S. Comm. On Finance, 110th Cong. 1st Sess., “The Firing of an SEC Attorney and the Investigation of Pequot Capital Management” at 46 (S. Prt. 110-28 Aug. 2007)

REFORM OF ENFORCEMENT POLICIES

Standardized enforcement procedures (cont)

- SEC Commissioner Atkins also called for the creation of uniform enforcement standards, including an Enforcement Manual

Commissioner Paul S. Atkins, SEC, “Remarks to the 'SEC Speaks in 2008' Program of the Practising Law Institute”

(Feb. 8. 2008) (available at

<http://www.sec.gov/news/speech/2008/spch020808psa.htm>)

- These suggestions have not been adopted

REFORM OF ENFORCEMENT POLICIES

Efficiency

- A November 2007 GAO study called for the Enforcement Division to revise certain procedures to promote efficiency
 - Report focused on SEC-SRO relationship
 - Notes that SRO reports need to be utilized to increase efficiency of investigations
- Chairman Cox announced this is being implemented

REFORM OF ENFORCEMENT POLICIES

Cooperation

- SEC Commissioner Atkins has called for an end to cooperation credit. Paul S. Atkins, Speech by SEC Commissioner: Remarks at the Federalist Society Lawyers' Chapter of Dallas, Texas (Jan. 18, 2008) (<http://www.sec.gov/news/speech/2008/spch011808psa.htm>)
- As noted above, the ABA has requested that the SEC reform its cooperation policies

REFORM OF ENFORCEMENT POLICIES

Cooperation (cont)

- Congress: Attorney Client Protection Act of 2007
 - Passed in the House
 - Pending in the Senate
 - Prohibits any government attorney from requesting a waiver
- Despite pending legislation and McNulty Memorandum, there is still pressure to waive
 - Survey by former Delaware Supreme Court Justice Norman Veasey at the request of Senator Spector confirms this.
www.acc.com/public/veasey.pdf
- SEC has not altered its policies

REFORM OF ENFORCEMENT POLICIES

Other issues

- New Wells Commission
 - To review and reform settlement procedures
 - Proposed by SEC Commissioner Atkins

Commissioner Paul S. Atkins, SEC, Remarks at the Eighth Annual A.A. Sommer, Jr. Corporate, Securities and Financial Law Lecture, October 9, 2007 (available at <http://www.sec.gov/news/speech/2007/spch100907psa.htm>)

- Open file settlements
 - Procedure used by many criminal prosecutors
 - Previously tried in some SEC offices
 - Proposed by SEC Commissioner Atkins

Commissioner Paul S. Atkins, SEC, “Remarks to the 'SEC Speaks in 2008' Program of the Practising Law Institute” (Feb. 8, 2008) (available at <http://www.sec.gov/news/speech/2008/spch020808psa.htm>)

- Neither suggestion has been adopted

REFORM OF ENFORCEMENT POLICIES

Other Issues

- Decisions in *SEC v. Jones* and *SEC v. PacketPort.com, Inc.* (both discussed *supra*) suggest there should be time limits on bringing enforcement actions
 - Traditionally, statute of limitations does not apply except to penalties
 - Laches does not apply
- No procedures adopted

SIGNIFICANT CASES

In 2007, areas in which SEC brought cases include:

- Insider trading
- Foreign Corrupt Practices Act
- Financial fraud
- Hedge funds
- Option backdating
- Attorneys

In addition, the Enforcement Division formed a subprime task force

INSIDER TRADING

Renewed enforcement emphasis

- Insider trading has long been a staple of the enforcement program
- Recently it has received renewed emphasis
 - Linda Thomsen, head of the Enforcement Division said insider trading appears to be “rampant” in the markets. Rachelle Younglai, “SEC Sees Rampant Insider Trading on Wall Street, Reuters (Oct. 25, 2007)
<http://www.reuters.com/article/newsOne/idUKN2558382320071025>
 - Markets and regulators around the globe report increased insider trading

INSIDER TRADING

Renewed enforcement emphasis (cont)

- In the fall of 2006, Congress held hearings on insider trading during which SEC officials chronicled the difficulties of proving such cases. Linda Thomsen, Testimony Concerning Insider Trading before the U.S. Senate Committee on the Judiciary (Sept. 26, 2006)
<http://www.sec.gov/news/testimony/2006/ts092606lct.htm>
- The U.S. Senate, in the report on the Pequot Capital investigation, directed the SEC to focus more resources on insider trading See Minority Staff of S. Comm. On Finance, 110th Cong. 1st Sess., “The Firing of an SEC Attorney and the Investigation of Pequot Capital Management”

INSIDER TRADING

Renewed enforcement emphasis (cont)

- A new elite “watch dog” has been created
 - Composed of investigators from FINRA, ORSA, NYSE Regulation, and SEC
 - Focus is serial insider trading rings
 - Group shares information
 - Developed new computer models to monitor the markets
 - Carefully reviews suspicious trading

INSIDER TRADING

Renew enforcement emphasis (cont)

- SEC is looking at new approaches
 - Office of Compliance and Examinations is testing a new template for its inspections which has an insider trading component
 - Profiling – the SEC began circulating an information request to hedge funds and others to try and create a profile of potential insider traders. The program was so controversial it was dropped. Jesse Westbrook, “SEC Abandons Hedge Fund Probe Tactic After Complaints” Bloomberg.com, (Mar. 13, 2008)
<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aSWH042Y1GUu>

INSIDER TRADING

Renewed enforcement emphasis (cont)

- Enforcement has explored new areas such as Rule 10b5-1 plans
 - The plans were created as a “safe harbor” for executives to sell company shares
 - A business school study reported that trades by executives under the plans out performed others by almost 6%, raising insider trading concerns

INSIDER TRADING

Renewed enforcement emphasis (cont)

■ Rule 10b5-1 plans (cont)

- Enforcement Director Linda Thomsen has stated that they are scrutinizing trading under these plans

Linda Chatman Thomsen, Director, Division of Enforcement, SEC, Remarks at the 2007 Corporate Counsel Institute (Mar. 8, 2007) (transcript available at <http://www.sec.gov/news/speech/2007/spch030807lct2.htm>)

- No cases have been brought in this area to date
 - New Century Financial Corp. has disclosed that it is under investigation by the SEC, DOJ and others in part in connection with executive trading under Rule 10b5-1 plans Vikas Bajaj & Julie Creswell, Authorities Investigate Big Lender, N.Y. Times, March 3, 2007 at C 1.

INSIDER TRADING

Renewed enforcement emphasis (cont)

- Many of the cases involved trading in advance of a merger announcement, while others concerned trading on corporate information such as prior to earnings announcements or similar events
- Enforcement cases can be grouped into seven overlapping categories

INSIDER TRADING

Renewed enforcement emphasis (cont)

- The Cases Categories:
 1. Defining insider trading
 2. International cases
 3. Wall Street Professionals
 4. Corporate executives
 5. Pillow talk
 6. Family members
 7. Attorneys

INSIDER TRADING

The Cases: Defining insider trading

- What is insider trading – “Big Boy” Letters
 - In the classic insider trading case, the insider uses corporate material non-public information in breach of a fiduciary duty to gain an informational advantage which is unknown to the other traders
 - A big boy letter tells the other party the letter writer may have undisclosed material information about the deal
 - The SEC believes this is insider trading

INSIDER TRADING

The Cases: Defining insider trading (cont)

- *SEC v. Barclays Bank*, Civil Action No. 07-CV-04427 (S.D.N.Y. Filed May 30, 2007) involved Big Boy letters
 - The SEC's complaint alleged that Defendant Steven Landzberg obtained and traded bonds on inside information in six different bankruptcy cases
 - Mr. Landzberg typically obtained the information as a creditor representing the bank in a bankruptcy
 - In some of the trades, the bank issued Big Boy letters

INSIDER TRADING

The Cases: Defining insider trading (cont)

- Some of the agreements under which the bank obtained the information did not expressly prohibit trading
- The bank and Mr. Landzberg settled the case by consenting to statutory injunctions:
 - The bank agreed to an order requiring the payment of disgorgement, prejudgment interest and a penalty equal to twice the disgorgement
 - Mr. Landzberg agreed to pay a penalty

INSIDER TRADING

The Cases: Defining insider trading (cont)

- “Spring loaded” options also raise a question as to what constitutes insider trading
 - “Spring loaded” means the grant date was set so that an insider can take advantage of an undisclosed corporate event when exercising the options
 - As with classic insider trading, the insider uses corporate information that is undisclosed for personal gain
 - Academics have debated if this is insider trading
 - The SEC Chief Accountant has taken the position that while companies that backdated their options may have to restate their profits, those that practiced spring-loading will not have to do so
 - The SEC has not brought a “spring loaded” case during the recent scandal

INSIDER TRADING

Defining insider trading (cont)

- To prove insider trading, the SEC must establish that there is a breach of duty under either the classic theory or the misappropriation doctrine
- In *SEC v. Dorozhko*, Civil Action 07-cv-9606 (S.D.N.Y. Oct. 29, 2007), the court dismissed an insider trading claim, concluding that the Commission had failed to establish any breach of duty
 - The complaint alleged the defendant misappropriated inside information by hacking into Thomson's computer system to obtain the information regarding IMS Health Inc.
 - The Court held that while this may violate some laws, it is not insider trading
 - The case is on appeal and before the Second Circuit

INSIDER TRADING

International cases

- Insider trading is an international problem, rising in U.S. and markets around the world
- Cases on U.S. markets frequently have international implications requiring the SEC and DOJ to coordinate with foreign regulators to collect evidence
- SEC reportedly is considering opening a European office

INSIDER TRADING

International cases (cont)

- The News Corp./Dow Jones Case is emblematic of these cases. *SEC v. Wong*, Civil Action No. 07 Civ. 3628 (SAS) (S.D.N.Y. Filed May 8, 2007)
 - The initial defendants, in a complaint filed shortly after the merger announcement, were Kan King Won and Charlotte Ka On Wong Leung, a married couple living in Hong Kong.

INSIDER TRADING

International cases (cont)

- The News Corp./Dow Jones Case -- *SEC v. Wong* (cont)
 - The amended complaint names as Defendants News Corp Board member David Li, a respected Hong Kong businessman, and his close friend and business associate Michael Leung
 - It alleges Mr. Li tipped Mr. Leung, who in turn told his daughter and son-in-law, the initial defendants
 - Trading took place through the account of the daughter and son-in-law in Hong Kong and funds for part of the trading were wired to the account from Mr. Leung's account at JP Morgan International Bank, Brussels

INSIDER TRADING

International cases (cont)

- The News Corp./Dow Jones Cases - Settlement
 - Each defendant consented to the entry of a statutory injunction prohibiting future violations of the Section 10(b) and Rule 10b-5;
 - Mr. Li was ordered to pay an \$8.1 million civil penalty;
 - Mr. Leung was ordered to pay \$8.1 million in disgorgement plus prejudgment interest and a civil penalty in the same amount; and
 - K. K. Wong was ordered to pay \$40,000 in disgorgement plus prejudgment interest and a \$40,000 civil penalty.
- The SEC thanked Hong Kong Securities and Futures Commission

INSIDER TRADING

International cases (cont)

- Petco Options case: *SEC v. One or More Unknown Purchasers of Call Options for the Common Stock of Petco Animal Supplies, Inc.*, Case No. 06CV1446 DMS (S.D. Cal. Filed July 18, 2007)
 - Complaint alleged that over 1,400 call options were purchased prior to the announcement by Petco that it would be acquired
 - The complaint was amended to name Taher Suterwalla who purchased options through a Swiss broker and derivatives through U.K. brokerages
 - The case is pending
 - SEC coordinated with the Chicago Board of Options Exchange, the U.K. Financial Services Authority, the Swiss Federal Banking Commission and the Ontario Securities Commission
- Other international cases are discussed in the following sections

INSIDER TRADING

Wall Street professionals

- Last year, the SEC brought a number of insider trading cases against Wall Street professionals.
- The *Guttenberg* litigation. This case has been called the most significant since the late 1980's
 - Both the SEC and DOJ filed cases; *SEC v. Guttenberg*, Case No. 1:07-cv-01774-PKC (S.D.N.Y. 2007); *U.S. v. Jurman*, Case No. 1:07-cr-00140-TPG (S.D.N.Y. Filed Feb. 26, 2007) (and related cases)
 - The SEC named fourteen defendants while DOJ filed ten separate cases against thirteen defendants.
 - Many of the defendants were Wall Street professionals, including professionals from UBS and Morgan Stanley

INSIDER TRADING

Wall Street professionals (cont)

- The *Guttenberg* litigation (cont)
 - The SEC complaint alleged two key insider trading schemes
 - The UBS scheme claimed that from 2001 to 2006 UBS executive director Mitchel Guttenberg provided inside information about upcoming UBS analyst recommendations to other Wall Street traders who traded and tipped others
 - The Morgan Stanley scheme claimed that an attorney in the global compliance department misappropriated information and tipped her husband and a broker.
 - Eleven defendants have pled guilty
 - The SEC case is pending

INSIDER TRADING

Wall Street professionals (cont)

■ The TXU option cases

- The case centers on the take over of TXU by a KKR lead group
- Within days of the announcement, the SEC filed suit claiming unknown purchases acquired 8,020 TXU call options for an unrealized profit of \$5.4 million and obtained a freeze order over the proceeds. *SEC v. One or More Unknown Purchasers of Call Options For the Common Stock of TXU Corp.*, Civil Action No. 1:07-cv-01208 (N.D. Ill. March 2, 2007)
 - An amended complaint named Mr. & Mrs. Sehgal, claiming they purchased 700 call options for a profit of \$270,000
 - A second amended complaint named a Credit Suisse investment banker, Hafiz Naseem, and claimed he tipped an investment banker at AmX in Pakistan
 - DOJ indicted Mr. Naseem, who was convicted of securities fraud and awaits sentencing. *U.S. v. Naseem*, Case No. 1:07-mj-00706-UA-1 (S.D.N.Y. Filed May 3, 2007)

INSIDER TRADING

Corporate executives

- Other cases were brought against corporate executives
- NSD Bancorp director: *SEC v. Lenzner*, Civil Action No. 07-cv-01404 (W.D. P.A. Filed October 17, 2007)
 - Settled insider trading action which alleged bank director Charles Lenzner tipped Michael Pitterich about a merger
 - Both defendants consented to statutory injunctions
 - Mr. Lenzner agreed to disgorgement, prejudgment interest and a civil penalty
 - Mr. Lenzner agreed to a civil penalty

INSIDER TRADING

Corporate executives (cont)

- Corporate director: *SEC v. Keeney*, Case No. 1:07CV0103 (D.D.C. Filed Sept. 25, 2007): a settled case against director of Frederick's of Hollywood for tipping
- Bank VP: *SEC v. Glamb*, Civil Action No. 07-CV-2743 (D.N.J. Filed June 13, 2007): a settled insider trading case against former Hudson United Bankcorp Asst. VP who traded on information obtained from a co-worker

INSIDER TRADING

Pillow talk cases

- An increasing number of cases have been brought which involve either spouses trading together or one spouse trading on information obtained from another.
- Spouses trading together: *SEC v. Wang*, Civil Action No. 07-3715 (S.D.N.Y. Filed May 10, 2007); *U.S. v. Wang*, Case No. 1:07-cr-00730-CM (S.D.N.Y. May 9, 2007)
 - Jennifer Xujia Wang, employee of Morgan Stanley, and her husband, Ruben Chen, a former ING Investment Management Services employee, named as defendants
 - Trades based on tips from the wife's employment through her mother's account in Beijing, China yielded \$600,000 in profits
 - The couple has pled guilty and been sentenced to 18 months
 - The SEC's case is still pending

INSIDER TRADING

Pillow talk cases (cont)

- Husband & wife: *SEC v. Chiang*, Civil Action No. 1:07CV00285 (D.D.C. Filed Feb. 8, 2007): a settled insider trading case where couple traded on information from husband's employment
- Husband & wife: *SEC v. Suman*, No. 07-C-6625 (S.D.N.Y. Filed July 24, 2007): an insider trading case alleging that husband misappropriated inside information that he and his wife used to trade. The case is in litigation.

INSIDER TRADING

Pillow talk cases (cont)

- Husband: *SEC v. Melton*, Civil Action No. cv 07-2655 GHK (C.D. Cal. Filed April 23, 2007): a settled insider trading case where husband traded on information obtained from wife and she instructed him not to trade
- Husband: *SEC v. Balkenhol*, Civil Action C-07-2537 (N.D. Cal. Filed May 14, 2007): a settled civil action where husband traded on information obtained from wife, but he alone is alleged to have been involved in the trading

INSIDER TRADING

Pillow talk cases (cont)

- Husband: *SEC v. McKay*, Civil Action No. 5:07-CV-00378-H (E.D.N.C. Filed Sept. 28, 2007): a settled insider trading case where husband misappropriated inside information from wife
- Wife & brother: *SEC v. Rockledge*, Civil Action No. 05-10074 (D. Mass. Filed Jan 12, 2005): a settled insider trading case where wife learned information from husband and had secret deal to tip her brother who traded

INSIDER TRADING

Family members

- A number of cases involve family members trading together.
- *SEC v. Aragon Capital Management, LLC*, Case No. 1:07-cv-00919 (S.D.N.Y. Feb. 2, 2007) – father and sons
- *SEC v. Dearmin*, Civil Action No. 1:07-CV-01089 (D.D.C. Filed June 18, 2007) – father and daughter

INSIDER TRADING

Family members (cont)

- *SEC v. Drucker*, Civil Action No. 06 Civ. 1644 (S.D.N.Y. Filed Mar. 2, 2006) – Dec. 2007 jury verdict against father and son
- *SEC v. Smith*, Civil Action No. 07-CV-8394 (S.D.N.Y. Filed Sept. 27, 2007) – settled insider trading case against son, former employee of BAC Securities, and father, former employee of Broadband Capital

INSIDER TRADING

Family members (cont)

- *SEC v. Frohna*, Civil Action No. 07-C-0702 (E.D. Wis. Filed Aug. 1, 2007) – settled insider trading case involving two brothers
- *SEC v Calder*, Civil Action No. 07-01786 (D.D.C. Filed Oct. 4, 2007) – settled insider trading case where one brother misappropriated inside information from another who had obtained it from his wife

INSIDER TRADING

Attorneys

- Three cases were brought against attorneys last year:
 - *SEC v. Belcher*, Case No. 07-CV-02507 (D. Col. Filed Dec. 3, 2007) – settled case against attorney in private practice who obtained the information from a client
 - *SEC v. Heron*, Civil Action No. 07-CV-01542 (E.D. Pa. Filed April 3, 2006) – insider trading case in litigation against former general counsel of company
 - *SEC v. Schwinger*, Civil Action No. 1:07-CV-01047 (D.D.C. Filed June 13, 2007) – a settled civil action against managing partner of law firm who learned information from lateral partner candidate

FCPA

Background

- The Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd-1 et seq., is rooted in the Watergate scandal and the SEC's "volunteer program" of the 1970s
- Since its passage in 1978, it has been a traditional SEC enforcement area

FCPA

Background (cont)

- There are two key sections of the statute
 - The anti-bribery provisions, which generally prohibit payments to foreign officials to obtain or retain business
 - The books, records and internal control provisions
- While the bribery provisions may be better known, the books, records and internal control sections have a much broader impact because they apply to all 34 Act registrants and are not limited to foreign transactions
- Enforcement is shared between DOJ and SEC
 - DOJ has authority to bring criminal cases and limited civil enforcement authority
 - SEC has civil enforcement authority
- Recently, there is renewed enforcement emphasis
 - Last year, there were 38 FCPA cases compared to 15 the prior year
 - At year end 2007, there were more than 100 open FCPA investigations
 - There is a docket of significant pending FCPA cases heading for trial

FCPA

Expansive interpretation

- Enforcers have been aggressive and expansive
- A key limitation on the antibribery provisions is “obtain/retain” business, but this has been broadly interpreted
 - *U.S. v. Kay*, 359 F.3d 738 (5th Cir. 2004); *U.S. v. Kay*, 2007 WL 3088140 (5th Cir. Oct. 24, 2007) (reading phrase very broadly based on facts and circumstances to include bribes to reduce taxes)
 - *In the Matter of Bristow Group, Inc.*, Admin. Proc. File No. 3-12833, SEC Release 5633 (Sept. 26, 2007)

www.sec.gov/litigation/admin/2007/34-56533.pdf

FCPA

Expansive interpretation (cont)

- Promotional expenses – 15 U.S.C. § 78dd-2(c)(2) permits the payment of a “reasonable and bona fide expenditure, such as travel and lodging expenses ...” and the payment of expenses for “the promotion, demonstration, or explanation of products or services”

FCPA

Expansive interpretation – expenses (cont)

- Last year, SEC brought two cases on this issue and DOJ issued two rulings
- *SEC v. Lucent Technologies, Inc.*, Civil Action No. 07-092301 (D.D.C. Filed Dec. 21, 2007)
 - Complaint alleged that over three years, the company paid over \$10 million for about 1,000 Chinese foreign officials to travel to the U.S.
 - 315 trips had disproportionate amounts of sightseeing, entertainment and leisure
 - Trips were booked to a “factory inspection account”
 - Lucent, according to the complaint, had inadequate FCPA training

FCPA

Expansive interpretation – expenses (cont)

- *SEC v. Lucent Technologies, Inc.*, (cont)
 - Settlement
 - Consent to an FCPA books and records injunction
 - Order requiring payment of \$1.5 million civil penalty
 - DOJ: non-prosecution agreement which required payment of \$1million fine
- *See also SEC v. The Dow Chemical Company*, Civil Action No. 07-00336 (D.D.C. Filed Feb. 13, 2007) (settled action based on payment of \$37,000 in gifts, travel, entertainment and other items)
- DOJ rulings:
 - FCPA Op. Proc. Rel 2007-01
 - FCPA Op. Proc. Rel 2007-02

FCPA

Record penalties

- Last year both DOJ and SEC obtained record penalties in FCPA cases
- *Baker Hughes* Litigation set two records for penalties
 - one for the largest settlement payment in combined DOJ/SEC settlement: \$44 million
 - one for largest civil penalty for violating a prior Cease & Desist order: \$10 million

FCPA

Record penalties (cont)

■ *Baker Hughes* Litigation (cont)

- SEC complaint alleged that the company paid \$5.2 million to two agents knowing that some or all of the money was intended to bribe officials of state-owned companies in Kazakhstan
- The company was awarded a contract in two oil fields and had over \$219 million in gross revenue. The company also obtained a second contract.
- *Baker Hughes* also made payments to officials in Nigeria, Angola, Indonesia, Russia, Uzbekistan and Kazakhstan

FCPA

Record penalties (cont)

■ *Baker Hughes* Litigation (cont)

○ Settlement – SEC

- Consent to an injunction based on the anti-bribery, books and records and internal control provisions
- Disgorgement of \$19,944,778
- Prejudgment interest of over \$3 million
- \$10 million civil penalty for violating a prior C&D FCPA order
- Retain an independent consultant to review FCPA compliance

SEC v. Baker Hughes, Inc. Civil Action No. 07-01408 (S.D. Tex. Filed April 26, 2007)

FCPA

Record penalties (cont)

■ *Baker Hughes* Litigation (cont)

- Settlement – DOJ

- Baker Hughes sub BHS pled guilty to FCPA violations

- The company entered into a deferred prosecution agreement
- Under the agreement the company must hire an independent monitor for 3 years to oversee the creation of a robust compliance program and to make a series of reports to DOJ

U.S. v. Baker Hughes, Inc., No. 07-130 (S.D. Tex. Filed April 11, 2007)

FCPA

Record penalties (cont)

- *U.S. v. Vetco Gray Controls, Inc.*, 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)
 - According to the indictments, the Vetco companies had authorized a freight forwarding agent to make at least 378 corrupt payments totaling \$2.1 million to Nigerian Customs officials to obtain preferential treatment relating to the provision of services and construction equipment to Nigeria's first deep water oil drilling project.
 - Three subsidiaries of Vetco International pled guilty to FCPA bribery violations, while a fourth entered into a non-prosecution agreement. The plea agreements required:
 - The payment of \$26 million;
 - An undertaking to conduct a complete investigation of the conduct in various countries; and
 - An undertaking that if any of the companies were sold, the acquirer would be obligated to honor the terms of the plea agreement.
 - The fine was the largest imposed by DOJ in an FCPA case

FCPA

Industry wide investigations

- Another key trend is industry wide investigations
- Most significant matters are based on the U.N. Oil For Food Program (“OFFP”) report which concluded:
 - Iraq manipulated the program to dispense contracts based on political preferences and to obtain illicit payments
 - 2,253 companies paid over \$1.8 billion in illicit income to the Iraqi government
 - About two dozen companies have disclosed inquiries
 - SEC and DOJ have a number of open investigations
- Typically, the cases focus on payments made on either the oil side or the humanitarian side of the program and frequently there are joint settlements of SEC and DOJ investigations

FCPA

Industry wide investigations – OFFP (cont)

■ Oil side – El Paso Corp.

- SEC claimed that beginning in 2001 the company paid about \$2.1 million in surcharges to Iraq's State Oil Marketing Organization on 15 contracts
- Surcharges recorded as “cost of goods sold”
- Settlement
 - SEC: injunction prohibiting future violations of the books and records provisions, disgorgement of profit (satisfied by paying fine to U.S. Attorney) and fine of \$2.2 million
SEC v. El Paso Corp., Civil Action No. 07-00899 (S.D.N.Y. Filed Feb 7, 2007)
 - DOJ: Non-prosecution agreement requiring forfeiture of about \$5.8 million transferred to Development Fund of Iraq sanctioned under a U.N. resolution (Office of Foreign Asset Control also participated in settlement)

FCPA

Industry wide investigations – OFFP (cont)

■ Humanitarian side: Textron, Inc.

- SEC alleged books, records and internal control violations
- Two French subs paid over \$650,000 in “kickbacks” as “after sales service fees” by inflating the value of the contract and increasing the agents’ commission
- Booked as “commissions” and “consulting fees”
- Company made about \$1.9 million in profits on the deals
- Settlement
- SEC: consent to a permanent injunction based on the books and records provisions, disgorgement of \$2.2 million plus prejudgment interest, a fine of \$800,000 and compliance with undertakings re FCPA compliance program
 - *SEC v. Textron, Inc.*, Civil Action No. 07-01505 (D.D.C. Filed Aug. 23, 2007)
 - DOJ: non-prosecution agreement with payment of a \$1.5 million fine.
www.usdoj.gov/opa/pr/2007/August/07_crm_646.html

FCPA

Industry wide investigations – OFFP (cont)

- The SEC and DOJ have brought a number of other similar cases
- *SEC v. York International Corp.*, Civil Action No. 7-01750 (D.D.C. Filed Oct. 1, 2007) (\$647,000 in kickbacks on humanitarian goods and \$522,500 in bribes to UAE officials); *U.S. v. York International Corp.*, No. 07-01750 (D.D.C. Filed Oct. 1 2007)

FCPA

Industry wide investigations – OFFP (cont)

- *SEC v. Ingersoll-Rand Co. Ltd.*, Civil Action No. 07-01955 (D.D.C. Filed Oct. 31, 2007) (\$718,000 in kickback payments on six oil side contracts through German subs, \$474,000 in side payments on four contracts through Italian sub and other service fees paid on equipment sales); *U.S. v. Thermo King Ireland Ltd.*, No. 07-296 (D.D.C. Filed Oct. 31, 2007); *U.S. v. Ingersoll-Rand Italiana S.P.A.*, No. 0700294 (D.D.C. Filed Oct. 31, 2007)

FCPA

Industry wide investigations – OFFP (cont)

- *SEC v. Chevron Corp.* Civil Action No. 07-10299 (S.D.N.Y. Filed Nov. 14, 2007)
 - Chevron Corp. paid \$20 million in surcharges on 78 million barrels of crude oil under 36 contracts
 - Settled with
 - SEC
 - DOJ
 - New York County District Attorney's Office
 - OFAC

FCPA

Industry wide investigations – OFFP (cont)

- Akzo Nobel, N.V., paid kickbacks of \$38,741 for one contact and \$240,750 in service fees on other contracts
 - Settled with
 - The SEC (*SEC v. Akzo Nobel, N.V.*, Civil Action No. 07-02293 (D.D.C. Filed Dec. 20, 2007))
 - DOJ for a non-prosecution agreement and, in a first, DOJ deferred penalties to Dutch authorities conditioned on penalties being imposed in that action

FCPA

Focus on individuals

- In 2007 DOJ brought ten cases against individuals compared to ten in the prior three years
- Former executive of Schnitzer Steel alleged to have paid \$200,000 in bribes and gifts to managers of government owned steel mills. *SEC v. Wob*, No. 07-957 (D. Or. Filed June 29, 2007); *U.S. v. Wob*, No. 07-244 (D. Or. Filed June 26, 2007)

FCPA

Focus on individuals (cont)

- Three executives of ITXC Corp, alleged to have paid \$266,000 in bribes to foreign officials of state and foreign owned telecommunications carrier Nigeria, Rwanda and Senegal. *SEC v. Ott*, Civil Action No. 06-4195 (D.N.J. Filed Sept. 6, 2006); *SEC v. Amoako*, Civil Action No. 05-4284 (D.N.Y. Filed Sept. 1, 2005); *U.S. v. Young*, No. 07-609 (D.N.J. Filed Sept. 25, 2007); *U.S. v. Ott*, No. 07-608 (D.N.J. Filed July 25, 2007); *U.S. v. Amoako*, No. 05-1122 (D.N.J. Filed June 28, 2006)

FCPA

Focus on individuals (cont)

- Former government affairs director of Asia for Monsanto alleged to have paid a \$50,000 bribe to senior Indonesian Ministry of Environment to try and repeal consent decree. *SEC v. Martin*, No. 07-0434 (D.D.C. Filed March 6, 2007)
- Former president of A.T. Kearney India, sub of EDS, alleged to have paid \$720,000 in illicit payments to senior Indian company officials to avoid having contracts canceled. *SEC v. Srinivasan*, Civil Action No. 07-01699 (D.D.C. Filed Sept. 25, 2007)
- Founder and former chairman of Syncor Int. alleged to have made payments over 17 years to doctors and hospitals in Taiwan as commissions/referral fees. *SEC v. Monty Fu*, Civil Action No. 07-01735 (D.D.C. Filed Sept. 28, 2007)

FCPA

Merger due diligence

- Many cases arise of mergers during pre-deal due diligence
- *SEC v. Delta & Pine Land Co.*, No. 07-01352 (D.D.C. Filed July 25, 2007) is a settled action which arose from self-reporting by Monsanto following pre-merger due diligence that involved a parent and sub alleged to have made about \$43,000 in payments to Turkish officials to obtain reports and certifications

FINANCIAL FRAUD

Overview

- Traditional enforcement area
- Cases brought last year continue to focus on traditional areas such as managing earnings, revenue recognition and the misuse of reserves
- One study which came out last year suggests that post-SOX, the SEC has focused on larger companies

FINANCIAL FRAUD

Overview (cont)

- Other issues concern:
 - The impact of cooperation under the Seaboard Release
 - The application of the statement on corporate penalties
 - The new settlement procedure for settling cases which potentially involve a corporate penalty
- Overall, it is difficult to assess the precise impact of cooperation standards or the policy on penalties, but there is some suggestion in the settled cases, examples of which are listed below

FINANCIAL FRAUD

Cooperation/penalties

- *SEC v. The BISYS Group, Inc.*, 07-Civ-4010 (KMK) (S.D.N.Y. Filed May 23, 2007): a settled civil injunctive action against leading provider of products and support services to financial institutions
 - A variety of improper accounting techniques were used over a period of years to meet Wall Street expectations
 - For fiscal years of 2001–2003, results overstated by about \$180 million
 - Based on two restatements, pretax income was overstated 69%, 58%, and 43% for fiscal years 2001-2003

FINANCIAL FRAUD

Cooperation/penalties (cont)

■ *SEC v. The BISYS Group, Inc.*, (cont)

○ Settlement

- Statutory injunction prohibiting future violations of the books and records provisions
- Payment of disgorgement and prejudgment interest of \$25 million

○ Note: The settlement does not contain an antifraud injunction or a penalty. In view of the pervasive fraud alleged and the fact that the company profited, both could have been sought. These omissions appear to be the result of cooperation, which the SEC acknowledged in its press release.

FINANCIAL FRAUD

Cooperation/penalties (cont)

- *SEC v. Nortel Networks Corp.*, Civil Action No. 07-CV-8851 (S.D.N.Y. Oct. 15, 2007)
 - In 2000–2001, the company improperly accelerated recognition of revenue to meet targets
 - In 2002, the company improperly established and maintained reserves
 - Settlement: Consent to statutory injunction and agreed to pay a civil penalty of \$35 million
 - The SEC said the settlement reflected significant cooperation

FINANCIAL FRAUD

Managing earnings

- *SEC v. Federal Home Loan Mortgage Corp.*, Case No. 07-CV-1728 (D.D.C. Filed Sept. 27 2007)
 - The settled action alleged that from 2000-2002 the company improperly smoothed earnings trends by misreporting income
 - This resulted from a culture which emphasized steady earning, not compliance
 - Settlement: Statutory injunction and the payment of a \$50 million civil penalty. Each officer involved settled on similar terms

FINANCIAL FRAUD

Managing earnings (cont)

- *SEC v. Cardinal Health, Inc.*, Case No. 07CV6709 (S.D.N.Y. Filed July 26, 2007)
 - Company allegedly used a variety of practices to manage reported earnings
 - Improper practices include misclassifying revenue, selectively accelerating payment of vendor invoices, improperly adjusting reserve accounts and improperly classifying expected litigation settlement proceeds to increase operating earnings
 - Settlement: consent to a statutory injunction prohibiting future violations of the antifraud and reporting provisions and to pay a \$35 million civil penalty

FINANCIAL FRAUD

Reserves

- *SEC v. ConAgra Foods, Inc.*, Civil Action No. 07-cv-01557 (D. Col. Filed July 25, 2007)
 - Complaint alleged misuse of reserves which in some instances was fraudulent to manipulate reported earnings
 - Settlement: Consent to a statutory injunction and agreement to pay \$45 million civil penalty

FINANCIAL FRAUD

Round tripping

- *SEC v. Collins & Aikman Corp.*, Civil Action No. 1:07-CV-2419 (S.D.N.Y. March 26, 2007)
 - In addition to the company, the complaint named David Stockman, former Director of OMB, as a defendant
 - The Complaint alleged the use of round trip transactions, wash sales and other improper revenue recognition techniques to conceal the financial condition of the company
 - Also alleged disinformation campaign to deceive investors
 - Company settled by consenting to a statutory injunction
 - Mr. Stockman and the other individual defendants are litigating the case
 - DOJ has filed parallel criminal charges

FINANCIAL FRAUD

Aiding and abetting

- *In the Matter of Motorola, Inc.*, Admin. Proc. File No. 3-12630
 - This action stems from conduct similar to that in the Supreme Court's Stoneridge decision, which the court held it could not be reached in a private action
 - The Order for Proceedings alleged the company engaged in round trip transactions to help Adelphia artificially inflate its earnings
 - SEC alleged Motorola should have realized from red flags that the agreements lacked economic substance
 - Motorola settled for:
 - The entry of a C&D
 - The payment of \$25 million in disgorgement and prejudgment interest
- *See also SEC v. Adelphia Communications Corp.* 02 Civ. 5776 (PKC) (S.D.N.Y).

HEDGE FUNDS

Background

- In July 2006 the DC Circuit vacated the SEC's rule requiring hedge fund advisors to register. The SEC did not appeal. *Goldsein v. SEC*, 451 F.3d 871 (D.C. Cir. 2006).
- SEC Chairman Cox told Congress that “[h]edge funds are not, should not be, and will not be unregulated.” Testimony Concerning the Regulation of Hedge Funds (July 25, 2006), www.sec.gov/news/testimony/2006/ts072506cc.htm
- Subsequently, the SEC passed Rule 206(4)-8, an antifraud rule focused on hedge funds
- The agency has brought a series of cases against the funds involving private investment in public equity (“PIPE”) offerings

HEDGE FUNDS

Settled cases

- The complaints in these cases typically allege insider trading and the sale of unregistered securities
 - The hedge fund participated in one or more PIPE offerings and traded in the shares of the issuer prior to the announcement in violation of Section 10(b)
 - The hedge fund sold the shares of the issuer short with the intent to cover with the shares from the resale registration statement from the PIPE in violation of Section 5 because those shares were not registered at the time of the short sale
- The SEC has lost each litigated Section 5 claim, but the insider trading claims in these cases are pending
- Examples of cases which have settled are
 - *SEC v. Spiegel*, Civil Action No. 1:07CV00008 (RCL) (D.D.C.) (Filed January 4, 2007): settled civil injunctive action involving short selling in connection with a PIPE.
 - *SEC v. Friedman, Billings, Ramsey & Co., Inc.*, Civil Action No. 06-cv-02160 (D.D.C. Filed December 20, 2006): a settled civil injunctive action alleging insider trading, selling of unregistered securities, and failure to supervise in connection with CompuDyne Corporation's sale of a PIPE against investment banker Friedman, Billings, as well as its founder and Co-Chairman and its Director of Compliance.

HEDGE FUNDS

Litigated cases

- *SEC v. Lyon*, Civil Action No. 06-CV 14338 (S.D.N.Y. Filed Dec. 12, 2006)
 - The SEC alleged managing partner and chief investment officer of group of funds engaged in an unlawful trading scheme with respect to 36 PIPE offerings by engaging in insider trading and the sale of unregistered securities
 - The court dismissed the Section 5 and related fraud claims in an opinion which was sharply critical of the SEC
 - “The Court finds this characterization of a short sale [by SEC] inaccurate and not reflective of what occurs in the market.”
 - The court later noted that the SEC’s position was based on an “inherent logical implausibility.”
 - The insider trading claims are in litigation

HEDGE FUNDS

Litigated cases (cont)

- *SEC v. Mangan*, Civil Action No. 3:06-CV-531
(W.D.N.C. Filed Dec. 28, 2006)
 - The complaint contains similar allegations to *Lyon* and others, insider trading and Section 5 claims related to a PIPE
 - The court dismissed the Section 5 claims in an opinion which criticized the SEC
 - The court characterized the Section 5 claim as nothing more than hindsight

HEDGE FUNDS

Litigated cases (cont)

- *SEC v. Berlacher*, Civil Action No. 07-cv-3800 (E.D. Pa. Filed Sept. 13, 2007)
 - The complaint here is similar to *Lyon* and *Mangan*, alleging insider trading and Section 5 violations related to a PIPE
 - Again, the court dismissed the Section 5 claim
 - The insider trading claim is pending
- *See also SEC v. Colonial Investment Management LLC*, Civil Action No. 07-Civ-8849 (S.D.N.Y. Filed Oct. 15, 2007) (similar allegations to other cases except the short sale violations are based on Rule 105 which prohibits such sales within 5 days of an offering; the case is pending)

BACKDATED OPTIONS

Background

- The option backdating scandal began in the fall of 2005 when academic studies were published which suggested executives were obtaining abnormal returns on options, there was media coverage of the issue from the *New York Times* and *Wall Street Journal*
- The SEC, DOJ and others began investigating
 - By the first quarter of 2007, there were reportedly:
 - 140 companies under inquiry
 - Over 200 other companies that have voluntarily disclosed internal investigations related to options

BACKDATED OPTIONS

Prosecution standards – initial cases

- A key question as the investigations continued focused on the standards which would be used to assess liability for individuals and the corporations
- The initial cases were brought against executives at Brocade Communications and were announced at a joint press conference held by the SEC and DOJ in San Francisco
 - *SEC v. Reyes*, Civil Action No. C-06-4435 (N.D. Cal. Filed July 20, 2006); *U.S. v. Reyes*, Case No. CR06-556CRB (N.D. Cal).
 - The complaint alleged that defendants Reyes and Jensen repeatedly backdated stock options of Brocade Communications so that they were in the money
 - The conduct detailed in the complaint and the indictment was fraudulent
 - Subsequently, both Mr. Reyes and Ms. Jensen were convicted
 - The civil cases are pending

BACKDATED OPTIONS

Prosecution standards – initial cases (cont)

- The next set of cases brought about one month later involved Comverse Technologies and alleged fraudulent conduct:
 - *SEC v. Alexander*, Case No. 1:06-cv-03844 (E.D.N.Y. Filed August 9, 2006); *U.S. v. Alexander*, Case No. 1:06-cr-00628 (E.D.N.Y. Filed Sept. 20, 2006)
- Mr. Alexander is currently a fugitive in Namibia and is fighting extradition

BACKDATED OPTIONS

First cases against company

- In 2007, the SEC brought its first cases against a company
 - *SEC v. Mercury Interactive, LLC*, Case No. 07-2822 (N.D. Cal Filed May 31, 2007)
 - The complaint named the company, its chairman and CEO, former CEO and former General Counsel as defendants
 - It alleged a fraudulent scheme in which options were repeatedly backdated
 - The company, which had merged, settled by consenting to a statutory injunction and paying a \$28 million civil penalty

BACKDATED OPTIONS

First cases against company (cont)

- Also on May 31, 2007, the SEC filed an action against a company, *SEC v. Brocade Communications System, Inc.*, Case No. 07028-21 (N.D. Cal. May 31, 2007)
 - The complaint alleged that the company falsified its reported income from 1999 to 2004 as a result of the backdated options
 - The company settled by consenting to a statutory injunction and agreeing to pay a civil penalty of \$7 million
 - Previously, the SEC and DOJ had brought actions against Brocade CEO Gregory Reyes and the director of human resources, Stephanie Jensen

BACKDATED OPTIONS

Other cases

- *SEC v. Heinen*, Case No. 07-2214 (N.D. Cal. Filed April 24, 2007)
 - Complaint against former General Counsel Nancy Heinen and CFO Fred Anderson of Apple
 - Alleged backdated options and the preparation of false documents
 - Ms. Heinen is litigating
 - Mr. Anderson settled by consenting to a statutory injunction and agreeing to pay \$3 million in disgorgement, prejudgment interest and fines.
 - Mr. Anderson did not consent to an officer director bar, which has become a standard remedy in SEC settlements although he is retired
 - Steve Jobs, Apple CEO, who reportedly knew of the grants but stated he did not understand the accounting implications, has not been named

BACKDATED OPTIONS

Other cases (cont)

- *SEC v. McGuire*, Civil Action No. 07-CV-4779 (D. Min. Filed Dec. 6, 2007)
 - Action against William W. McGuire, M.D., Chairman and CEO of United Healthcare Group
 - This is the first settlement with an individual involving a SOX “clawback” under Section 304
 - The complaint alleged that between 1994 and 2005, Dr. McGuire received more than 44 million split-adjusted options, most of which were backdated
 - 11 million of the backdated options were exercised for an in-the-money gain of over \$6 million
 - Dr. McGuire also was paid about \$5 million in incentive-based cash compensation in 2005 and 2006 based on hitting earnings targets that would not have been met if the options were properly accounted for

BACKDATED OPTIONS

Other cases (cont.)

- *SEC v. McGuire*, Civil Action No. 07-CV-4779 (D. Min. Filed Dec. 6, 2007) (cont)
 - To settle the action, Dr. McGuire consented to a statutory injunction, a 10-year officer/director bar, and to disgorge over \$10 million and pay prejudgment interest and a civil penalty of \$7 million.
 - In addition, under the clawback provisions, Dr. McGuire agreed to return \$448 million in incentive-based compensation. His obligations can be satisfied by returning \$600 million in cash and options.
 - This agreement also settled shareholder and derivative suits
- From 2006 to date, the SEC has brought 24 cases against 36 individuals and entities based on backdated options
- A number of companies have also been given closing letters
- As of September 2007, the SEC reportedly has approximately 89 companies under investigation

BACKDATED OPTIONS

Changing standards

- A case filed at the end of last year suggests that prosecution standards may be shifting
 - *SEC v. Maxim Integrated Products, Inc.*, Civil Action No. C-07-65121 (N.D. Cal. Filed Dec. 4, 2007)
 - SEC alleged that Maxim routinely granted in-the-money options to its employees
 - The grants were backdated
 - CEO Gifford directed CFO Jasper to properly account for the options but Jasper failed to do so
 - Mr. Gifford settled by consenting to a statutory injunction prohibiting future violations of Section 17(a)(3) – a negligence standard – and agreeing to disgorge \$652,000 which represented his portion of his bonuses and a civil penalty of \$150,000
 - This is the first option backdating case based on negligence
 - A fraud action against Mr. Jasper is in litigation. *SEC v. Jasper*, Case No. C-07-6122 (N.D. Cal. Filed Dec. 4, 2007)

ATTORNEYS

Counsel as a defendant

- Last year, the SEC brought ten cases which named lawyers as a defendant, a record number. Frank C. Razzano, *Is the SEC Targeting Lawyers?* 36 Sec. Reg. L. J. 4 (Spring 2008)
- These cases involved allegations of insider trading, option backdating and fraud
- Two key examples are the cases against former Mayer Brown partner Collins and the former general counsel of Tenet Healthcare

ATTORNEYS

Counsel as defendant (cont)

- *SEC v. Collins*, Case No. 07 CV 111343 (S.D.N.Y. Filed Dec. 18, 2007)
 - The complaint is based on the collapse of Refco
 - The complaint alleges that Mr. Collins, as the long time outside counsel to the firm, participated in fraudulent transactions involving the former Chairman of Refco in which they concealed millions of dollars in debt through round trip lending transactions.
 - Mr. Collins was also indicted. *U.S. v. Collins*, Case No. 1:0-cr-01170 (S.D.N.Y. Filed Dec. 18, 2007).
 - Both case are pending

ATTORNEYS

Counsel as defendant (cont)

- *SEC v. Tenet Healthcare Corp.*, No. CV-07-2144 (C.D. Cal. Filed Apr. 2, 2007)
 - Christi R. Sulzbach, former general counsel and chief compliance officer named as defendant along with the company and several other senior officers
 - Complaint alleges defendants misled investing public by failing to disclose company strategy, its impact on revenues and earnings and its unsustainability in MD&A section of filings
 - The company and several officers settled
 - Ms. Sulzbach's case is in litigation

SUBPRIME CRISIS

- Spring 2007 – Enforcement Division formed a subprime task force
- Initially, Chairman Cox told Congress that the SEC is investigating whether sellers of portfolios of subprime mortgages packaged into securities provided proper disclosure to buyers
- In February 2008, Chairman Cox told Congress the task force was investigating several issues, including questions relating to securitization, as well as disclosure and valuation issues and sales to investors

SUBPRIME CRISIS

- The SEC is coordinating with banking regulators as well as the International Organization of Securities Commissioners (“IOSCO”) Subprime Task Force
- IOSCO has also formed a Credit Rating Agencies Task Force that the SEC chairs
- Perhaps the most detailed description of subprime lending practices is contained in the 581-page report prepared by investigators working for the Trustee of New Century, *In re New Century TRS Holdings, Inc.*, Case No. 07-10416 (U.S. Bank. D. Del.)
 - The report details how the lender engaged in increasingly risky practices
 - It also details seven improper accounting practices

SUBPRIME CRISIS

- The SEC reportedly has approximately 36 open investigations in this area. “SEC juggling three dozen subprime probes,” *Financial Week* (Mar. 27, 2008)
- The investigations have resulted in one filed case to date
 - *SEC v. Cao*, Civil Action No. CV 06-1269 (C.D. Cal. Filed Oct. 29, 2007)
 - Settled insider trading case against former vice president of Countrywide Financial Corp.

ANALYSIS AND CONCLUSIONS

Statistics

- The increased number of cases suggest a more robust enforcement program
- At the same time, other statistics such as the significant drop in the amount of disgorgement and penalties seem to contradict this point
- Partial explanations for the reduced payments may be the legitimate debate regarding penalties and the fact that last year the SEC did not have a blockbuster Worldcom or Enron type case
- Thus, the statistics seem to raise more questions than they answer

ANALYSIS AND CONCLUSIONS

Policies and procedures

- A review of policy and procedure issues raises similar questions.
- The new procedure regarding corporate penalties was introduced with claims by Chairman Cox that it would aid efficiency; its impact is debatable
- The SEC's willingness to revisit its controversial "profiling" efforts in the insider trading area and then drop it, demonstrates a willingness to listen to constructive criticism

ANALYSIS AND CONCLUSIONS

Policies and procedures (cont)

- Other procedural and policy issues raise difficult questions
 - Calls from Congress and others for the creation of an enforcement policy and procedure manual similar to the one used by DOJ seem to have gone unheeded
 - Suggestions for an improved settlement process by convening a Wells-type committee and using an open file process appear to have been ignored
 - Likewise, calls for the SEC to revisit its cooperation standards also have been ignored
 - Benefits of cooperation are at best difficult to assess
 - Despite the increase in parallel proceedings and clear potential difficulties, the SEC has adhered to its usual policy of relying on its standard form warnings
- These trends suggest that issuers and their employees should carefully consider how they approach an investigation in terms of whether there are other parallel inquiries and what might be the pros and cons of cooperation

ANALYSIS AND CONCLUSIONS

The cases

- Analysis of the cases brought last year suggests that the SEC is focusing its efforts on insider trading, FCPA cases, hedge funds, financial fraud and perhaps attorneys
- At the same time the option backdating scandal seems to be coming to a slow close – with a caveat
- Subprime is just beginning

ANALYSIS AND CONCLUSIONS

Insider trading

- There should be little doubt that there is a renewed emphasis on insider trading cases
- This focus is consistent with that of other regulators around the globe
- The SEC has had some of its best success in this area
- The SEC has made it clear that it will take an expansive view of what constitutes insider trading
- The aggressive posture of the SEC may suggest that any informational advantage in trading will be carefully scrutinized
- This trend suggests that issuers and their executives should carefully review all compliance procedures

ANALYSIS AND CONCLUSIONS

FCPA

- Equally clear is the renewed emphasis on FCPA enforcement
- Both the SEC and DOJ are bringing record numbers of cases and have a record number of open investigations
- The SEC and DOJ are obtaining record-setting penalties in these cases

ANALYSIS AND CONCLUSIONS

- These cases also suggest a very aggressive posture
- This trend suggests that any company doing business abroad and all issuers carefully
 - Review their FCPA compliance program
 - Take steps to make sure that employees receive periodic education
 - Review any prior settlement
 - In pre-merger situations, conduct careful due diligence and obtain appropriate representations in the merger agreement
 - Carefully assess “country risk” when doing business abroad
 - Scrutinize arrangements with agents abroad
 - Limit “travel and entertainment” for foreign agents

ANALYSIS AND CONCLUSIONS

Hedge funds

- The SEC is continuing to pursue hedge funds as the Chairman promised after the *Goldstein* case
- Despite litigation losses in its hedge fund/PIPE cases and negative comments by the courts, the SEC seems undeterred
- This suggests that the SEC will continue to pursue these cases despite the results

ANALYSIS AND CONCLUSIONS

Financial fraud

- No doubt this traditional area continues to be a focus of the Enforcement Division
- This suggests that issuers carefully review internal procedures
- Likewise, in view of the SOX certification requirements, it is clear that the CEO and CFO should carefully review the internal certification procedures used

ANALYSIS AND CONCLUSIONS

Attorneys

- There is no doubt that the number of cases involving attorneys has increased
- While this may in part be the result of the option backdating scandal, at the same time it may be part of a focus on those perceived to be gatekeepers
- This suggests that both in-house and outside counsel need to take care that they do not become the target of an investigation

ANALYSIS AND CONCLUSIONS

Options backdating

- The SEC is clearly working its way through its inventory of options backdating cases
- To date the cases brought suggest a consistent theme of fraudulent conduct
- *SEC v. Maxim Integrated Products, Inc.*, brought against Maxim International and John Gifford, its Chairman, however is disturbing
- The case raises disturbing issues for every executive who must rely on others

Subprim

- The investigations here are just beginning
- Look for continuing investigations, calls for regulatory and new cases and investigations

ANALYSIS AND CONCLUSIONS

Conclusions

- SEC enforcement procedures raise significant questions
- These questions raise difficult issues for any company or individual facing an inquiry
- The trend of enforcement cases suggests that in the future the SEC will continue to focus on
 - Insider trading
 - FCPA
 - Hedge funds
 - Financial fraud
 - Gatekeepers, such as attorneys
- Subprim has the potential to rewrite the regulatory landscape