

Client Alert

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Litigation Department

Senior SEC Enforcement Staff Describes Changes at the Division, Reflects on 2009 Performance, and Highlights Priorities for 2010

As they do every fall, senior members of the US Securities and Exchange Commission Division of Enforcement gathered in Washington, D.C. recently to discuss the Division's priorities and goals for the coming year during the annual "Dialogue with the SEC Enforcement Staff." The discussion, sponsored by the American Bar Association's Federal Regulation of Securities Committee, included the Division's Chief Counsel Joan McKown, Associate Directors Rick Firestone, Cheryl Scarborough, Antonia Chion, and Scott Friestad, and Deputy Chief Litigation Counsel Mark Adler.

Since the last Dialogue in November 2008, several key changes have taken place at the Commission, including the appointments of Commission Chairman Mary L. Schapiro, Commission General Counsel David M. Becker, and Enforcement Division Director Robert Khuzami. At this year's Dialogue, the Staff pointed to Enforcement Director Khuzami's August 2009 remarks before the New York City Bar as a road map for the Division in 2010.¹ In that speech, Khuzami explained that—in light of the revelations surrounding the Bernie Madoff debacle—the Division had engaged in a rigorous

self-assessment, and he announced a major reorganization of the Division's management structure, along with a number of new initiatives. Meanwhile, the Commission as a whole is in the process of reinventing itself, which was one of the themes in a luncheon speech that day by General Counsel Becker.² The Dialogue provided a useful opportunity for the senior staff to explain the significant changes taking place in the Division. The Enforcement panelists nonetheless emphasized that in many respects, the Division is focusing on its core mission and "business as usual," noting that several key areas of enforcement that the Division focused on in 2009 will continue to be priorities in fiscal 2010.

During the Dialogue, the Staff reported on the Division's performance in fiscal 2009 and provided practical insight into the Division's announced reorganization and new initiatives. The Staff also summarized key areas of enforcement, describing with respect to each area the Division's significant cases from fiscal 2009 and its enforcement goals for the coming year, and discussed developments relating to other enforcement issues.

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Fiscal 2009 Performance

Chief Counsel Joan McKown reported that the Division maintained a vigorous pace in fiscal 2009 (the year ended September 30, 2009), bringing 664 enforcement actions, the third-most ever instituted in a single year (the Division brought 671 enforcement actions in fiscal 2008, and 679 in fiscal 2003). According to the Commission's 2009 Annual Report, the actions spanned the usual enforcement areas:

- disclosure and reporting (22 percent of all actions initiated);
- broker/dealer actions (16 percent);
- investment advisors and investment companies (12 percent);
- securities offerings (21 percent);
- insider trading (6 percent);
- market manipulation (6 percent);
- late filings (14 percent); and
- other actions (3 percent).

The breakdown was in-line with historical trends, with the amount of broker/dealer actions increasing slightly and the percentage of insider trading actions decreasing slightly. McKown also described a "dramatic increase" in disgorgement recoveries, with more than \$2 billion in disgorgement distributed in fiscal 2009. The Commission administratively ordered, or obtained court orders for, a total of \$345 million in penalties, up almost \$100 million from 2008.

Deputy Chief Litigation Counsel Mark Adler reported that the Division's trial lawyers had another strong year in fiscal 2009. The Division had 13 trials in federal court (down from 17 in 2008), in which 16 of 21 defendants were found liable. The Division also succeeded in all administrative proceedings, in which 42 respondents in 31 administrative proceedings were found liable. The number of emergency actions more than doubled, increasing 82 percent from 39 filed in fiscal 2008 to 71 filed in fiscal 2009, in large part due to the increased number of actions involving Ponzi schemes. Adler noted that the

Division now had 300 cases in active litigation, and that as a consequence, the size of the Division's Trial Unit will be increasing

Reorganization and New Initiatives

Reorganization of the Division

Director Khuzami has planned a major reorganization of the Division's management structure in fiscal 2010. To streamline management, the Division will eliminate the branch chief position and redeploy many of its current branch chiefs to the "heart and soul function" of the SEC—conducting investigations. This will result in a flatter management structure, with only one level of supervision below the Associate Director level. As a result, Assistant Directors (who currently supervise, on average, three branch chiefs, each of whom supervises about four staff attorneys) will each have about six staff attorneys directly answering to them. The current branch chiefs will either be promoted to Assistant Director, in a limited number of cases, or be "redeployed" to be front-line investigating attorneys. According to Khuzami, "this flattening of our management structure will increase the resources dedicated to our investigative efforts, and will operate as a check on the extra process, duplication, unnecessary internal review and the inevitable drag on decision-making that happens in any overly-managed organization."³ During the Dialogue, the Staff reported that branch chiefs are currently being interviewed for possible promotion to Assistant Director, and the reorganization is proceeding as scheduled.

New Initiatives

Nationalized Special Unit Model

The Staff discussed the Division's introduction of a nationalized "special unit model," which will replace its current issue-based working groups model. Each special unit will be headed

by a Unit Chief, and will be staffed nationally by people with expertise in the respective enforcement areas or a desire to learn through specialized training. Initially, there will be five specialized units dedicated to complex area of securities laws:

1. **Asset Management:** This unit will focus on Investment Advisors, Investment Companies, Hedge Funds and Private Equity Funds, working closely with the Office of Inspections, Compliance and Examinations;
2. **Market Abuse:** This unit will build technological tools to focus on large-scale market abuses and complex manipulation schemes by institutional traders, market professionals and others;
3. **Structured and New Products:** This unit will focus on complex derivatives and financial products, including credit default swaps, collateralized debt obligations, and securitized products, for which the current markets lack transparency;
4. **Foreign Corrupt Practices Act:** This unit will work to develop new and proactive approaches to identifying possible FCPA violations; and
5. **Municipal Securities and Public Pensions:** This unit will scrutinize offering and disclosure issues, tax and arbitrage-driven activity, unfunded or underfunded liabilities, and "pay-to-play" schemes.

Office of Market Intelligence

The Office of Market Intelligence is a newly created office within the Division of Enforcement which is responsible for the collection, analysis and handling of the hundreds of thousands of tips, complaints and referrals the Commission receives each year. This office, which includes the Division's Market Surveillance Unit, will coordinate efforts with the Commission's other divisions and with the whistleblower office of the Financial Industry Regulatory Authority (FINRA). The Staff explained that the

centralization of this function should enhance the Division's ability to "remain current" on developments in the market.

Division of Risk, Strategy and Financial Innovation

The Staff also noted that in response to Chairman Schapiro's desire to have a stronger risk assessment process, the Commission created a new Division of Risk, Strategy and Financial Innovation (internally referred to as "RiskFin") in September 2009. RiskFin combines the former Offices of Economic Analysis and Risk Assessment, as well as other functions, and will assess new risk strategies being implemented across financial markets and recommend ways to adjust the Commission's own policies going forward.

Key Areas of Enforcement: Significant Cases from 2009, Priorities for 2010

When asked to reflect on the Division's most significant and high-profile cases from fiscal 2009, Associate Director Scott Friestad noted several cases involving alleged FCPA violations and Ponzi schemes. With respect to the Division's priorities for fiscal 2010, Associate Director Rick Firestone reported that Director Khuzami has pledged to make the Division "more agile" in the upcoming year, with a focus on utilizing its resources to bring cases "with the greatest deterrent impact." In addition to FCPA violations and Ponzi schemes, on which the Division will continue to focus, Firestone indicated that cases arising from the subprime mortgage and credit crisis area, along with cross-market misconduct and hedge fund-related activity, will be higher priorities going forward, though the Division will continue to focus on its traditional "bread-and-butter" cases, such as those involving insider trading and securities fraud. The Staff also indicated that there would be more "claw back" actions under Section 304 of the Sarbanes-Oxley Act of 2002.

Ponzi Schemes

Friestad declared 2009 the “Year of the Ponzi Scheme.” Indeed, since January 2009, the Commission has filed 55 cases involving Ponzi schemes or Ponzi-like payments. Friestad highlighted the SEC’s current litigation against Allen Stanford, three of his companies, and several officers for allegedly orchestrating a \$8.2 billion Ponzi scheme.⁴ According to the Commission’s complaint, which seeks permanent injunctions, disgorgement and civil penalties, the defendants misrepresented to purchasers of certificates of deposit that their deposits were safe. The complaint further alleges that Stanford paid thousands of dollars in bribes to the CEO of Antigua’s Financial Services Regulatory Commission to facilitate the Ponzi scheme.⁵ At the SEC’s request, the Northern District of Texas has entered a temporary restraining order and frozen the defendants’ assets, and appointed a receiver to marshal those assets. Friestad stressed that this area of enforcement will continue to be a priority for the Division in 2010.

Foreign Corrupt Practices Act Violations

With respect to FCPA actions, Friestad cited the Division’s action against German-based manufacturer Siemens AG as especially noteworthy, “if for nothing else the size and magnitude of the bribes in play.” In December 2008, Siemens agreed to pay \$1.6 billion to settle actions brought by the Department of Justice, the Office of the Prosecutor General in Munich and the Commission for allegedly bribing government officials around the world on an unprecedented scale and with widespread geographic reach, and for alleged violations of the internal controls and books and records provisions of the Securities Exchange Act of 1934.⁶ The \$1.6 billion settlement included \$350 million in disgorgement to the Commission, and stands as the largest

settlement in the 30-plus-year history of the FCPA. The Staff underscored the Siemens matter as an example of a particularly successful parallel proceeding with criminal authorities in both the US and Germany.

The Staff pledged that it would continue to cooperate with the Department of Justice and foreign regulators and prosecutors in conducting swift, efficient FCPA investigations. Friestad suggested that there will likely be “a lot of big cases in the FCPA area going forward.”

Subprime Mortgage and Credit Crisis Cases

A year ago, the Staff stated that 50 subprime market investigations were in progress. During this year’s Dialogue, Friestad pointed to two recently filed cases that resulted from those investigations, although he declined to discuss the details of the litigation. The first is the case against the former CFO and Controller of American Home Mortgage Investment Corp, the 10th largest mortgage lender in the US before it filed for bankruptcy protection in 2007.⁷ The Commission’s complaint alleges that the defendants understated first-quarter 2007 loan loss reserves, converted losses into fictional profit, and made misleading disclosures about the risk associated with American Home’s mortgages.⁸ American Home’s former CEO previously settled the Commission’s charges, agreeing to pay more than \$2.45 million and to be barred for five years from acting as a director or officer of a public company.

The second was the Countrywide case, in which the Commission charged three former executives of mortgage lender Countrywide Financial Corp. (which before 2007 was the largest US mortgage lender) with misleading investors about the quality of Countrywide’s loans, including risky subprime and adjustable-rate mortgages.⁹ In its complaint, the Commission also alleged that

Countrywide's former CEO Angelo Mozilo engaged in insider trading based on his exercise of stock options and sale of more than 5.1 million shares of Countrywide stock while allegedly in possession of material nonpublic information concerning Countrywide's loans, some of which Mozilo privately described as "toxic."¹⁰ Mozilo is viewed by some commentators as the most prominent executive charged by the Commission in connection with the housing market collapse. Just weeks before the Dialogue took place, the Central District of California rejected the defendants' motions to dismiss the lawsuit.

The Staff emphasized that cases arising from the credit crisis and subprime mortgages will remain a priority for the Division in the coming year. The Staff predicted that several complex subprime cases in the pipeline would be filed as enforcement actions during 2010.

Cross Market Misconduct and Hedge Funds Actions

The Staff indicated that another priority area for the Division in fiscal 2010 will be cross-market misconduct, which usually involves misusing the derivatives market—a newer market with less transparency than more established securities markets.

Friestad noted that hedge funds will remain a focus of the Division in 2010 and that hedge fund investigations often involve complex issues and intricate products. Some of these issues include valuation and conflicts of interest, including trade allocation (moving money from one fund to cover the losses in another). Friestad said the Division will look to bring actions involving these issues even when investors have not been harmed. Another area of concern is whether funds of funds—funds which invest in other hedge funds—are living up to their promises of vigorous due diligence.

Insider Trading Cases

Although the number of insider-trading cases was down in 2009, Friestad noted that "we brought a number of significant, high-profile cases." He cited the action against billionaire Mark Cuban, as well as the more recent action involving the Galleon hedge fund complex, as examples and noted that both have garnered significant press coverage.¹³ The Division's recent insider-trading actions, explained Friestad, are a result of efforts taken over the past few years to devote extra resources to combating insider trading by hedge funds and Wall Street professionals. "I think we're starting to see the payoff to that, [and] I expect more cases like that in the future," Friestad said.

With respect to the deterrent effect of insider trading actions, Firestone said that he would like to think the Division's enforcement actions and cases are having an impact on future actions by professionals. He noted that some of the investigative tactics used in the Galleon case, such as wiretaps that allowed the government to listen in on cell-phone conversations between traders and alleged informants, "would give me pause if I was on Wall Street." Firestone warned that "we will continue to focus on market professionals, on gatekeepers—on folks who should know better."

During the Dialogue, a number of issues regarding the Commission's action against Cuban were raised.¹⁴ According to the Commission's complaint, Cuban owned shares of a small public company, Mamma.com, Inc., which decided to conduct a PIPE financing¹⁵ transaction. Mamma.com officials called Cuban for his input as a significant shareholder of Mamma.com, and obtained an agreement from Cuban to keep the information confidential. Shortly thereafter, without disclosing the pending PIPE transaction to anyone, Cuban liquidated his position in Mamma.com, avoiding losses of more than \$750,000, the SEC alleged.

The Commission filed suit against Cuban based on the misappropriation theory of insider trading.¹⁶ The misappropriation theory imposes liability on persons who obtain material nonpublic information and trade on that information, in breach of a fiduciary duty or a duty arising out of a similar relationship of trust and confidence. Relying on Rule 10b5-2, which provides that such a duty exists “[w]hen a person agrees to maintain information in confidence,” the Commission alleged that because Cuban expressly agreed to keep nonpublic information confidential, he could not use the nonpublic information to trade in the company’s shares. In an *amici curiae* brief filed on Cuban’s behalf by five law professors, the professors argued that the SEC’s case rested on a regulation that is “an invalid exercise of the agency’s rule-making authority.”¹⁷ “In the context of a business relationship, a confidentiality agreement alone is insufficient to create a fiduciary or similar relationship of trust and confidence between the parties,” the professors wrote, echoing Cuban’s earlier filings.¹⁸

The court rejected this view, but also rejected the Commission’s view, reflected in its adoption of Regulation FD, that there is a necessary connection between the requirement for an insider to keep information confidential and the duty not to use such information in trading. The court held that Cuban’s contractual agreement to maintain confidentiality (*i.e.*, non-disclosure), was not enough to impose a legal duty to refrain from trading on or using the information for personal gain (*i.e.*, non-use).¹⁹ Rather, for a confidentiality agreement to create a fiduciary relationship for purposes of the misappropriation theory, a party must agree to *both* non-disclosure and non-use. Because the Commission’s complaint alleged facts sufficient only to establish non-disclosure, the complaint failed to state a claim.²⁰ The Division

has appealed this decision to the Fifth Circuit, setting the stage for another battle with Cuban, who has vigorously and publicly defended himself against the SEC in his personal blog and in court. The Commission is likely to argue it did not have an opportunity to prove that Cuban had a duty not to use the information, and that Cuban did in fact have such a duty. If the Fifth Circuit remands the case, it would return to the Texas district court for a full trial.

The Staff present at the Dialogue expressed their surprise at the decision issued by the lower court. One Staff member commented: “We didn’t feel like we were pushing the envelope [of Rule 10b5-2].” The Staff also believes that the district court’s ruling, if upheld, would create confusion regarding the requirements of Regulation FD, which prohibits selective disclosure. Many non-disclosure agreements currently designed to comply with Regulation FD specify only that a party agrees to keep information in confidence (non-disclosure), and do not address a duty not to trade or make use of that confidential information. In light of the court’s ruling, and the uncertainty surrounding the appeal, companies entering into non-disclosure agreements with potential investors or acquirers should be specific if they wish the recipient not to trade on the shared information. At minimum, non-disclosure agreements should contain a “sole use” provision, providing, for example, that “recipient agrees to use the information solely for the purpose of considering an investment/acquisition.” No such provision was present in *Cuban*.

Sarbanes-Oxley Section 304 “Claw back” Actions

The Staff also indicated that the Division will continue to use Section 304 of the Sarbanes-Oxley Act of 2002. Last July, the Commission filed the first action seeking to “claw back” compensation under Section 304 from someone

not alleged to have participated in misconduct, the unlucky someone being Maynard L. Jenkins, the former CEO of CSK Auto Corporation.²¹ Section 304, passed by Congress in the wake of the Enron and WorldCom scandals, provides that if an issuer is required to restate its financial statements due to material noncompliance, *as a result of misconduct*, with any financial reporting requirement under the securities laws, the SEC can claw back for the issuer's benefit from the CEO or CFO any incentive-based or equity-based compensation received by that person during the 12-month period following the first issuance or filing of the financial document embodying the financial reporting requirement; and also can claw back any profits realized from the sale of securities of the issuer during that 12-month period. In the Jenkins case, the Commission maintains that Jenkins is required to reimburse CSK for over \$4 million in bonuses and stock sale profits, even though Jenkins himself did not engage in any misconduct.²²

Clearly the Division is contemplating more cases following the Jenkins precedent. Just one week before the Dialogue took place, issuer Beazer Homes disclosed that the Commission had issued a Wells notice to Beazer CEO Ian McCarthy indicating that the Staff had tentatively decided to recommend to the Commission that it bring a civil action against McCarthy to collect certain incentive compensation and other amounts allegedly due under Section 304, even though the Staff has apparently not found any misconduct by McCarthy.²³ The McCarthy Wells notice arrived more than a year after Beazer settled the Commission's investigation into its financial statements.

Additional Enforcement Issues

The Staff also reported on developments relating to the following additional enforcement issues:

Enforcement Manual and Corporate Penalty Statement

The Staff noted the continuing vitality of the *Enforcement Manual*, published in October 2008, but stated that they anticipate updates to the *Manual* soon. The Staff also commented that the factors articulated in the Commission's Corporate Penalty Statement continue to be relevant to the Division's analyses of whether to seek corporate monetary penalties.

Incentives for Individual Cooperation

The Staff discussed Director Khuzami's stated mission to increase incentives to individuals who cooperate in SEC investigations, including drafting "Seaboard-type" standards to evaluate cooperation by individuals in enforcement actions and recommending to the Commission that the SEC enter into "Deferred Prosecution Agreements" to forego an enforcement action against an individual or entity subject to full cooperation and compliance with certain undertakings. The Staff reported that such standards are still a work in progress, and the Commission has yet to enter into a Deferred Prosecution Agreement. Firestone emphasized that the purpose of these tools will be "to reward extraordinary cooperation" and nothing less.

Financial Fraud Enforcement Task Force

During the Dialogue, the Staff emphasized the importance of parallel proceedings—attention to a matter by more than one enforcement agency—to investigate and prosecute financial fraud, and mentioned briefly the newly created interagency Financial Fraud Enforcement Task Force established earlier in the month by President Obama to strengthen efforts to combat financial crime.²⁴ The Department of Justice will lead the Task Force and the Department of Treasury, HUD and the SEC will serve

on the steering committee. The Task Force replaces the Corporate Fraud Task Force established in 2002, and will build upon the various agencies' current efforts to combat mortgage, securities, and corporate fraud. In the press release introducing the Task Force, Chairman Schapiro hailed the advantages the Task Force will bring to parallel proceedings: "Many financial frauds are complicated puzzles that require painstaking efforts to piece together. By formally coordinating our efforts, we will be better able to identify the pieces, assemble the puzzle and put an end to the fraud."²⁵

Formal Orders of Investigation

The Staff discussed the recent delegation of authority to the Division to issue formal orders of investigation, with their accompanying subpoena power. With respect to the recent increase in formal orders since this authority was delegated, the Staff explained that while it is certainly not "a norm" now to issue a formal order in every investigation, there is also no hesitation to issue such orders. In response to an audience question concerning the necessity for disclosing formal investigations as opposed to preliminary or informal investigations, Firestone remarked that from a disclosure standpoint, he had never understood the distinction as a basis for making a disclosure decision, saying "an investigation is an investigation—it's a way to gather evidence," and the underlying facts should determine disclosure.

Tolling Agreements

At the Dialogue, the Staff briefly touched upon the Division's new policy on tolling agreements, which states that all tolling agreements require prior approval from Director Khuzami or his designee. Though the Staff stated that statistics are not available to the public, the Division does track the number of tolling agreements to which it agrees. Since the new, stricter policy on tolling agreements has taken effect,

there have been only a handful of tolling agreements, the Staff reported. In addition, going forward, even when tolling agreements are granted, they will likely be for shorter periods of time, with the intent of moving investigations along faster than in recent years.

New Performance Metrics

Associate Director Cheryl Scarboro stated that the Division soon will be expanding the metrics it uses to measure its performance. The revised performance metrics are intended to account for more "qualitative factors" of enforcement success, such as the timeliness of cases, priorities of the Division as reflected in its caseload, the efficient use of its resources, the mix of case types, and the effective use of joint efforts with other agencies. Although these metrics will not easily translate into numerical data, Scarboro explained that they will be "reflected in the statistics that [the Division] present[s] to the outside world, [and] certainly something we are using internally as we decide which cases to bring and how to focus our resources going forward."

Endnotes

- ¹ Robert Khuzami, Speech by SEC Staff: Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (August 5, 2009)
- ² David Becker, Speech by SEC Staff: Remarks Before the Committee on Federal Regulation of Securities; Section of Business Law; American Bar Association (November 20, 2009)
- ³ See Khuzami, Speech by SEC Staff, *supra* note 1
- ⁴ Litigation Release No. 21092 (June 19, 2009)
- ⁵ Complaint, *SEC v. Stanford Financial Group Co.*, CV-09-0298 (filed N.D. Tex., June 19, 2009)
- ⁶ Litigation Release No. 20829 (December 15, 2008)
- ⁷ Litigation Release No. 21014 (Apr. 28, 2009)
- ⁸ Complaint, *SEC v. Strauss, et al.*, 09-CV-4150 (filed S.D.N.Y., Apr. 28, 2009)
- ⁹ Litigation Release No. 21068A (June 4, 2009)
- ¹⁰ Complaint, *SEC v. Mozilo*, 09-CV-03994 (filed C.D. Cal., June 4, 2009)
- ¹¹ See Khuzami, Speech by SEC Staff, *supra* note 1

¹² Litigation Release No. 21023 (May 5, 2009)

¹³ Litigation Release No. 20810 (Nov. 17, 2008);
Litigation Release No. 21284 (Nov. 5, 2009)

¹⁴ Complaint, *SEC v. Cuban*, 3-08-CV-2050-D (filed N.D. Tex., Nov. 17, 2008)

¹⁵ PIPE (Private Investment in Public Equity) financing is a form of equity financing in which a private investment company purchases a certain amount of stock in a publicly traded company at a discount from its current market value. Typically utilized by small-to medium-sized companies, PIPE financing is a less expensive and more efficient method to raise capital compared to traditional forms of financing such as secondary offerings. See "Private Investment in Public Equity," FINANCIAL DICTIONARY, available at <http://financial-dictionary.thefreedictionary.com/PIPE+Financing>.

¹⁶ *Id.*

¹⁷ See Exhibit A, Proposed Brief in Support of Defendant's Motion to Dismiss, Motion for Leave to File Amici Curiae Brief in Support of Defendant's Motion to Dismiss, at 3, *SEC v. Cuban*, 3-08-CV-2050-D (filed N.D. Tex., Feb. 2, 2009)

¹⁸ *Id.*

¹⁹ Memorandum Opinion and Order, *SEC v. Cuban*, 3-08-CV-2050-D (N.D. Texas, July 17, 2009)

²⁰ *Id.*

²¹ Litigation Release No. 21149A (July 23, 2009)

²² Litigation Release No. 21149A (July 23, 2009)

²³ Beazer Homes USA, Inc. Current Report (Form 8-K), at 1 (Nov. 16, 2009)

²⁴ Press Release No. 2009-249 (Nov. 17, 2009)

²⁵ *Id.*

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