

Client Alert

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Senior SEC Enforcement Staff Discusses Division Priorities and Challenges *Emphasis on Credit Crisis and FCPA*

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On November 21, 2008, senior members of the Division of Enforcement of the US Securities and Exchange Commission (SEC) summarized current developments at the Division during the annual "Dialogue with the SEC Enforcement Staff," sponsored by the American Bar Association's Sub-Committee on Civil Litigation. Participating Staff included Division Director Linda Thomsen, Deputy Director Scott Friestad, Chief Counsel Joan McKown, Associate Directors Rick Firestone, Antonia Chion, and Chris Conte, Chief Accountant Susan Markel, and Deputy Chief Litigation Counsel Mark Adler. The Dialogue provided useful insight into the current enforcement priorities of the Commission as well as recent developments in the investigative process.

Noting that the Dialogue took place during an extremely stressful time for the US financial markets (and indeed the global economy) due to the credit crisis, Ms. Thomsen stressed that the Division remains focused on "covering the waterfront," and it remains "business as usual" at the Commission. According to the Commission's Annual Report for fiscal 2008, there were more than 3,200 investigations pending at year end. At the Dialogue, Ms. McKown noted that SEC enforcement remains

robust, as the Commission brought 671 enforcement actions during fiscal year 2008—the second-most ever instituted in a single year. The cases filed covered all of the typical enforcement areas: disclosure and reporting (23 percent), broker/dealer actions (9 percent), investment advisers and companies (13 percent), securities offerings (18 percent), insider trading (9 percent), market manipulation (8 percent), late filings (16 percent), and other actions (4 percent).

Mr. Adler outlined the Division's strong trial record for fiscal year 2008. The Division had 17 trials in federal court (up from 10 in 2007), and 22 of 28 defendants (78 percent) were found liable. The Division also succeeded in the great majority of administrative proceedings, as 28 of 32 defendants (88 percent) were found liable. The Division's trial unit remained very busy, with approximately 100 cases pending this year—33 handled by the home office in Washington, D.C. and between four and eight cases at each of the regional offices. Mr. Adler noted that the Division's cases, especially accounting cases and subprime cases involving valuation, have become increasingly complex. While not discussed at the Dialogue, the recent trial in *SEC v. Alan C. Goldsworthy and Walter T.*

Hilger illustrates the difficulties that the Commission faces in litigating a complex accounting case. There, following trial, the court rejected most of the Commission's claims (including fraud charges) against former Applix, Inc. CEO Alan Goldsworthy and former CFO Walter Higler, and found only negligent conduct by Higler.¹

Although the Division may be covering the waterfront, in describing specific recent cases brought by the Commission and upcoming priorities and challenges for the Division, the Staff focused on two principal areas: the credit crisis and enforcement of the Foreign Corrupt Practices Act (FCPA).

Credit Crisis

Ms. Thomsen identified three specific vehicles through which the Division is addressing the current credit crisis:

- 1) the Division's Subprime Working Group, created in early 2007 (now coordinating with the Commission-wide Subprime Task Force created in January of this year), which is aggressively investigating possible fraud (including market manipulation) and breaches of fiduciary duty that may have contributed to the recent turmoil in the credit markets;
- 2) the Division's nationwide Auction Rate Securities Working Group, which is focused on fraud in the sale of auction rate securities; and
- 3) the Division's wide-ranging investigation into market manipulation and false rumors, which was announced on September 19, 2008, and has included obtaining statements under oath from market participants under Section 21(a)(1) of the Securities Exchange Act of 1934 (Exchange Act).²

Subprime

The Staff noted two cases as demonstrative of the Commission's response in the subprime area. The first was the case against former hedge fund managers Ralph Cioffi and Matthew Tannin, which the Staff identified as a pioneering credit-crisis enforcement action brought through the work of the Division's Subprime Working Group, along with the FBI and federal prosecutors.³ Cioffi and Tannin allegedly fraudulently misled investors about the poor financial condition of the firm's two largest hedge funds caused by their exposure to subprime mortgage-backed securities before the funds collapsed in June 2007. The second was the *World Group* case, in which the Commission charged five Los Angeles-area mortgage brokers/registered representatives with putting their unsophisticated customers at risk by refinancing their homes with subprime mortgages that they could not afford so that the brokers could fraudulently sell them unsuitable securities.⁴

The stark difference between these two matters—one involving highly sophisticated investors and fund managers working in Wall Street, and the other involving extremely unsophisticated investors and brokers on Main Street—illustrates the Staff's conclusion that the scope and nature of enforcement actions that will be brought in the subprime area remain difficult to forecast. At present, the Division has more than 50 ongoing investigations relating to the subprime market. How many of these investigations will result in enforcement actions is difficult to project, according to the Staff, in part because the asset valuation issues that many of these investigations involve are complex, and the Division wants to distinguish between improper practices that warrant enforcement action and business judgments that do not.

Auction Rate Securities

The Staff touted the Division's recent settlements in principle with six major Wall Street firms involving alleged misrepresentations in the sale of auction rate securities. These firms sold auction rate securities to institutional and retail customers after allegedly representing that the securities were liquid investments akin to money market accounts. The Staff focused on obtaining swift relief for the retail customers, small businesses and charities, and obtained agreements from the firms to buy back more than \$50 billion in auction rate securities. Ms. Thomsen recognized that requiring buybacks was extraordinary and that these cases involved liquidity, not credit, issues, so that similar relief might not be warranted in other matters arising out of the credit crisis.

Rumors and Market Manipulation

The Staff highlighted the fraudulent rumor case brought by the Commission against Wall Street trader Paul Berliner, who allegedly wrote and disseminated a false rumor regarding The Blackstone Group's proposed acquisition of Alliance Data Systems Corp. (ADS) while he sold ADS short.⁵ The Staff noted that it is too early to tell whether this is an isolated case or the first of many, acknowledging that it can be difficult for the government to demonstrate that a rumor is an actionable misrepresentation rather than a legal expression of opinion. Though the *Berliner* case was brought against the originator of a false rumor, Ms. Thomsen noted that the Division will not always limit enforcement to the source of the rumor, as passing along rumors one hears can, under certain circumstances, provide a basis for liability.

The Staff also discussed its wide-ranging investigation into false rumors and the Commission's issuance of Section 21(a) demands to require investment firms to make statements under oath regarding their use of credit default swaps, short sales and rumors to manipulate

securities related to certain financial institutions. The Staff recognized that Section 21(a) demands should be used selectively and only when a broad swath of information is needed quickly. The deadline for response to the Commission's demands has passed, and there has been a high compliance rate. The Staff is presently evaluating and acting upon the information obtained.

Early Publicity by the SEC in Credit Crisis Cases

The Staff also discussed the fact that the Commission has publicized certain of its investigations and enforcement actions in this area at earlier stages than is customary. Normally, SEC investigations are entirely nonpublic and remain so unless and until the Commission files an enforcement action. This rule has been broken a number of times in credit crisis cases. In the auction rate securities cases, the Division has announced a series of settlements in principle with major Wall Street firms even though the Commission had not approved any of the settlements. We infer from what the Staff said at the Dialogue that the timing of these announcements was influenced by the SEC's desire to alert investors to the progress it was making in solving the liquidity problem, and also by pressure from cooperating regulators whose settlement approval processes are swifter than the SEC's. The Staff noted that the Commission may revise these settlements in principle as needed.

Similarly, in the fraudulent rumor investigation, the Commission publicly announced the existence of the investigation at an early stage.⁶ According to the Staff, the Commission made the announcement to assure investors and possibly-affected securities issuers that it was addressing the issue and also to assure the recipients of the demands that they were not alone in receiving a demand. The Commission has been careful not to identify any individuals or companies from whom information was sought.

Future Areas of Credit Crisis Focus—Accounting Fraud, Outside Counsel

The Staff noted that although accounting cases have decreased over the past few years, possibly as a result of the Sarbanes-Oxley Act and improved corporate practices, they anticipate an increase in the exposure of accounting fraud due to the credit crisis. They expect an increase in whistleblowing in the coming months as more people lose their jobs at public companies and decide to expose wrongdoing they witnessed on the job. In addition, the tightening of credit has increased the importance of hitting covenant targets and thereby given corporate executives additional incentive to massage their companies' financial results. The Staff also noted that the Division will not ignore the role of outside counsel in its credit crisis investigations, citing as a warning case a pre-credit-crisis action the Commission brought in December 2007 charging lawyer Joseph Collins with aiding and abetting violations by his client, commodity broker Refco Inc.⁷

Foreign Corrupt Practices Act

The Staff noted that despite the national focus on the credit crisis, the Division would continue to pursue investigations unrelated to the present crisis. Ms. Thomsen specifically stated that the Division continues to focus on FCPA violations, and that observers will "see more, not less" FCPA activity in the coming years. (At a subsequent event, Deputy Director Friestad reportedly said that he expects that disgorgement and penalty amounts obtained in FCPA enforcement actions over the next two to six months will "dwarf" the amounts obtained in the past.)⁸ The Staff noted that cooperation and self-reporting are particularly important in the FCPA arena, and that companies that self-report can sometimes avoid bribery charges under Section 30A of the Exchange Act and instead settle to lesser books-and-records charges. Self-

reporting can also substantially affect whether and to what extent monetary penalties will be assessed.

The Staff noted that the Commission brought more FCPA matters in 2007 and 2008 than in the previous 30 years combined. The Division has cooperated closely with the Department of Justice on these matters, and the Staff noted that it believes that the Department of Justice may devote additional resources to FCPA enforcement in the coming year.

Additional Enforcement Issues

Among the other subjects discussed during the Dialogue were the Staff's policy regarding access of those who receive a Wells call to relevant information in the Staff's investigative files, the Division's cooperation with other law enforcement agencies, and the Division's recently published Enforcement Manual.

Investigative Files

Recipients of Wells notices often request to review portions of the Staff's investigative file. The Staff noted that it retains full discretion to provide or not provide access to such information until compelled by civil or administrative discovery rules. But it noted that it has favored making facts available when disclosure will benefit the Staff and the Wells-notice recipient in gauging the strength of the evidence that forms the basis for the Division's recommendation.

Cooperation with Other Regulators

The Staff stated that the Division is cooperating closely with banking and other regulatory agencies to address issues arising out of the credit crisis. The Division keeps in mind the agencies' differing missions and standards; for example, the banking regulatory agencies typically stress the safety and soundness of the banking

institution's practices, whereas the Commission stresses investor protection. The Staff indicated that the Division will be mindful of the other agencies' objectives but will principally serve the Commission's interest in investor protection. A very recent case of multi-agency cooperation is *SEC v. Lee*.⁹ In *Lee*, the Commission filed a civil complaint charging four individuals with engaging in a fraudulent scheme to overvalue the commodity derivatives trading portfolio at Bank of Montreal (BMO) and inflate BMO's financials. Parallel criminal and regulatory charges were filed simultaneously by the US Attorney's Office for the Southern District of New York, the New York County District Attorney's Office, and the Commodity Futures Trading Commission.

The Staff noted that the Division and the Department of Justice continue to cooperate on matters over which both have jurisdiction to conduct efficient and thorough investigations. The agencies' close cooperation is buttressed by the Ninth Circuit's recent decision in *United States v. Stringer*,¹⁰ which confirmed that the agencies may share information in bona fide parallel investigations. The Staff noted that the Stringer panel held that the SEC's Form 1662, which the Division routinely provides to investigative witnesses from whom it seeks information, makes clear that information they provide may be shared by the SEC with criminal authorities. The Staff also noted that the Division routinely notices testimony in the jurisdiction in which a parallel criminal investigation is pending to make it easier for prosecutors to pursue charges if the SEC's witness commits perjury.

The Staff also noted that the Commission continues to cooperate with the PCAOB, and that the two agencies seek to avoid duplication of efforts. Which agency handles a matter may depend, in part, on which agency's available remedies are more appropriate.

Enforcement Manual

The Staff discussed this October's publication of the Division's Enforcement Manual, which is a reference for Division staff conducting investigations.¹¹ Chief Counsel Joan McKown noted that the Manual establishes no new policies, but is a codification of existing Division practice. During the Dialogue, the Staff also emphasized that the Manual contains discretionary guidelines rather than rules and that the Division remains limited only by applicable law. Nonetheless, the Staff anticipates that the Manual will assist the public and practitioners in responding to Commission investigations. In our view, the Manual could be useful to any individual subject to SEC investigation and potentially to enforcement action, and is an important tool for any lawyer practicing in the area of SEC enforcement who does not have recent experience serving in the Division of Enforcement.

Endnotes

- ¹ Litigation Release No. 20808 (Nov. 14, 2008).
- ² SEC Press Release 2008-214 (Sept. 19, 2008).
- ³ Litigation Release No. 20625 (June 19, 2008).
- ⁴ Litigation Release No. 20768 (Oct. 3, 2008).
- ⁵ Litigation Release No. 20537 (Apr. 24, 2008).
- ⁶ SEC Press Release 2008-140 (July 13, 2008).
- ⁷ Litigation Release No. 20402 (Dec. 18, 2007).
- ⁸ Lynne Marek, Larger Foreign Corrupt Practices Fines Ahead, *The National Law Journal* (Nov. 25, 2008), at <http://www.law.com/jsp/law/international/LawArticleIntl.jsp?id=1202426258993>.
- ⁹ Litigation Release No. 20811, Civil Action No. 08-CIV-9961 (S.D.N.Y.) (Nov. 18, 2008).
- ¹⁰ 535 F.3d 929 (9th Cir. 2008).
- ¹¹ The Manual is available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

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