

July 9, 2009

THE SEC IN TRANSITION: A MID-YEAR REVIEW OF SEC ENFORCEMENT IN 2009

To Our Clients and Friends:

Without question, the first six months of 2009 have been a period of sharply increased enforcement activity at the Securities and Exchange Commission. The financial crisis, the new administration, new SEC leadership, increased funding and the focus of Congress and the media have all combined to encourage heightened government scrutiny. And even though it has only been a few months since a new Chairman took office, already there are tangible signs that the SEC has taken a more aggressive enforcement posture. In this alert, we review the changes the new SEC leadership has instituted and is considering, the observable impact of the new administration on enforcement activity and significant cases in key areas that reflect the agency's evolving enforcement program.

I. Overview of Changes

A. The Backdrop

The events of 2008 led directly to the current enforcement agenda. The collapse of the subprime mortgage market, the ensuing credit crisis, the demise of several major investment banks and, perhaps most of all, the Madoff case led to a loss of confidence in the agency's ability to protect investors. This loss of confidence was manifested in Congressional hearings and an intensified media spotlight. At the same time, the SEC's Inspector General has issued a number of reports critical of the agency, and Congress intensified pressure on the SEC and Department of Justice to bring cases in the wake of the financial crisis. At a March hearing of the Senate Judiciary Committee on the law enforcement response to the financial crisis, Senator Patrick J. Leahy declared, "I want to see prosecutions.... I want to see people go to jail."

B. The New SEC

Against this backdrop, the Obama Administration took office with a new regulatory and enforcement agenda. Mary Schapiro was sworn in on January 27, 2009 as the twenty-ninth Chairman of the SEC. She wasted no time in implementing changes to "reinvigorate" enforcement. In February, in her first speech as Chairman, Ms. Schapiro announced two changes to the enforcement process at the SEC intended to "empower" the staff of the Enforcement Division.[\[1\]](#)

First, Chairman Schapiro ended a two-year "pilot" program, implemented by the prior Chairman, which required the Enforcement staff to seek prior approval of the Commission before negotiating a civil money penalty against a public company for alleged securities fraud. Chairman Schapiro stated that the pilot program had introduced significant delays into the process of bringing a corporate penalty case, discouraged staff from arguing for a penalty and sometimes resulted in reductions in the size of penalties imposed. Chairman Schapiro further stated that the end of the program was designed "to expedite the Commission's enforcement efforts and ensure that justice is swiftly served."

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Second, Chairman Schapiro provided for more rapid approval of formal orders of investigation authorizing the staff to issue subpoenas by permitting approval within a couple of days pursuant to the SEC's "seriatim" or "duty officer" procedures. As Chairman Schapiro explained the change, "in investigations that require subpoena power, time is always of the essence."

In March, Chairman Schapiro announced an initiative to revamp the SEC's process for reviewing complaints and tips. The SEC retained the Center for Enterprise Modernization, operated by the MITRE Corporation, to assist with the creation of a more centralized process to identify leads for potential investigations and inspections.

Chairman Schapiro has also initiated efforts to bring greater industry expertise to the staff. In April, Chairman Schapiro announced a new Industry and Markets Fellows Program to give industry professionals an opportunity to work for two years in the Office of Risk Assessment and help identify and assess risks in the financial markets. In addition, Chairman Schapiro created new senior level positions within the examination program for individuals with expertise in areas such as derivatives, valuation, securities trading, risk management and forensic accounting.

C. New Director of Enforcement Division and More Changes

In February, Chairman Schapiro announced the appointment of Robert Khuzami, a former federal prosecutor and investment bank general counsel, as the new Director of the Division of Enforcement. In his May testimony to the Senate Banking Committee,[\[2\]](#) Mr. Khuzami discussed proposals to reallocate resources within the Enforcement Division to improve efficiency, including:

- increasing the number of trial unit attorneys to present a "credible threat" to defendants, improve the ability to win at trial and increase settlement outcomes;
- increasing administrative, paralegal, and para-professional support, to free up enforcement lawyers and accountants to focus on high-value investigative tasks; and
- increasing information technology support for screening tips, improving case and document management, analyzing market data and assessing risks to investors.

Mr. Khuzami also outlined organizational changes under consideration with a focus on making the Enforcement Division more "strategic, swift, smart and successful," including:

- creating specialized groups of attorneys along product, market or transactional lines and increasing collaboration among staff across regions;
- flattening the management structure of the Division and reducing the levels of review and approvals required for investigative steps to be taken;
- revising performance metrics to deemphasize quantitative factors, such as the number of cases filed, and instead focus on qualitative factors, such as timeliness, programmatic significance and deterrent effect; and
- increasing the rewards to individuals for cooperating in investigations, including a potential request to Congress for an expanded whistleblower program (beyond the existing statutory authorization for insider trading cases) and greater use of agreements similar to deferred prosecution agreements.

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The appointment of Mr. Khuzami was followed by appointments of two other former federal prosecutors to senior positions: George Canellos, as Director of the New York Regional Office, and Lorin Reisner, as Deputy Director of the Enforcement Division. Both Messrs. Canellos and Reisner served in the U.S. Attorney's Office for the Southern District of New York earlier in their careers. Most recently, news reports indicate that Mr. Khuzami has also taken steps toward eliminating one entire tier of supervisors within the Enforcement Division in an effort to reduce the levels of review.

D. Increased Enforcement Activity

Both Chairman Schapiro and Mr. Khuzami have cited a number of statistics to demonstrate a significant up-tick in enforcement activity.^[3] According to these statistics, between February and May of this year, the number of emergency cases seeking temporary restraining orders has nearly tripled (most likely due to the wave of Ponzi scheme cases filed this year in the wake of the Madoff case) and the number of formal orders of investigation issued has more than doubled from the same period last year.

	<u>Feb.-May 2008</u>	<u>Feb.-May 2009</u>
TRO Cases	12	34
Investigations Opened	292	358
Formal Orders	74	188

Aside from the increase in TRO cases, the increase in the number of new investigations opened and formal orders issued indicates a greater level of *investigative* activity. But has there been an increase in the number of enforcement *cases* being filed? The answer is a clear yes. We compared injunctive actions filed in the first six months of 2009 and 2008. We found that the number of injunctive actions filed and number of defendants charged is up significantly year over year.

	<u>Jan.-June 2008</u>	<u>Jan.-June 2009</u>
Injunctive Actions Filed	114	167
Number of defendants	317	527

Our analysis also reflected a noteworthy trend in the cases being filed. While the number of cases filed and defendants charged is up, the percentage of defendants whose charges were settled at the time of filing is down significantly year over year.

	<u>Jan.-June 2008</u>	<u>Jan.-June 2009</u>
Percentage of defendants settled at time of filing	32%	20%

This reflects not only increased enforcement activity, but particularly a willingness by the SEC to file cases against defendants in the absence of settlements. This may again be partly a result of the recent number of Ponzi scheme cases that are typically filed on an emergency basis. But, as discussed in more detail in the next section, it also likely reflects a priority on bringing cases against individuals more quickly, without settlements and without awaiting the result of possible parallel criminal investigations.

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E. Significant Cases and Trends

More telling than the statistics, in the last few months, the SEC has filed a number of high profile cases that demonstrate a more aggressive enforcement approach and that are consistent with the themes that Mr. Khuzami has articulated. Not surprisingly, the SEC has focused its attention on cases related to the financial crisis. In addition, in an effort to bring cases more quickly, the SEC has also more frequently filed these cases in the absence of settlements and in the absence of parallel criminal cases. Moreover, presumably towards its goal of sending an "outsized message of deterrence," the SEC has charged senior level individual executives. As a consequence, the SEC likely will face vigorous defenses and full litigation. The following cases illustrate these points:[\[4\]](#)

- *SEC v. Mozilo*, the SEC alleges that former executives of Countrywide Financial misrepresented credit risks the company was undertaking to maintain its market share; the SEC also alleges the former chief executive officer engaged in insider trading despite having followed a 10b5-1 plan in selling company stock.
- *SEC v. Reserve Mgmt. Co.*, the SEC alleges that managers of the Reserve Primary Fund money market fund failed to disclose material facts about the fund's vulnerability as Lehman Brothers sought bankruptcy protection.
- *SEC v. Strauss*, the SEC alleges that former officers of American Home Mortgage failed to disclose the company's deteriorating financial condition in 2007.
- *SEC v. Rand*, the SEC alleges that the former chief accounting officer of Beazer Homes artificially reduced the company's income during the housing boom by improperly increasing reserves and liabilities and then reversed those entries when the housing market declined to continue meeting analysts' expectations.
- *SEC v. Rorech*, the first case to allege insider trading in credit default swaps, the SEC alleges that a hedge fund manager traded in credit default swaps on bonds based on nonpublic information from a bond salesman at an investment bank that an upcoming restructuring of a bond offering would impact the price of the swaps.

Note the following similarities in these cases:

- The cases touch on aspects of the financial crisis, demonstrating the SEC's emphasis on making this area a priority.
- With the exception of one defendant, the cases were filed without settlements. This indicates an emphasis on bringing cases against individuals, on bringing cases more quickly, and a greater willingness to litigate cases. Going forward, it will be interesting to observe whether the SEC has sufficient resources to sustain the continued filing of cases that are likely to be litigated to final judgment.
- The cases were also filed without any parallel criminal actions against the individual defendants. This indicates a trend away from holding off on filing civil cases while waiting for criminal prosecutors to determine whether to pursue criminal charges.

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F. Increased Funding

Congress and the Administration have also provided additional money for securities enforcement. In May, the President signed the Fraud Enforcement and Recovery Act of 2009, which adds \$265 million per year to the 2010 and 2011 budgets of the SEC, DOJ and other law enforcement agencies for the investigation and prosecution of fraud involving financial institutions. In addition, the Omnibus Appropriations Act of 2009 added \$37 million to the SEC's 2009 budget which the agency is using to enhance enforcement. The President's 2010 budget proposal would increase the SEC's budget by 13%, with the additional resources to be used to "increase staff and use new technology to pursue risk-based approaches" to better detect fraud.[\[5\]](#)

G. The Future of SEC Enforcement

This era of heightened enforcement will continue for the foreseeable future. In this environment, it is more important than ever that financial services firms and public companies reinforce efforts to assure that their legal and compliance infrastructure is identifying and resolving potential issues of concern to regulators and positioning the company to respond effectively to possible future regulatory inquiries.

II. Financial Reporting Cases

In the first half of 2009, the SEC has emphasized financial reporting cases related to the collapsed subprime mortgage market. Other cases reflect the SEC's continuing prosecution of allegedly manipulative accounting entries. The SEC also resolved outstanding stock option backdating claims that arose beginning in the spring 2005.

A. Subprime and Financial Crisis Related Cases

In April, in *SEC v. Strauss*, the SEC charged three former executives of American Home Mortgage Corporation, including the CEO, CFO and controller.[\[6\]](#) The SEC alleges the defendants failed to disclose the extent to which the company issued loans without income verification and the impact that accelerating defaults were having on the company's liquidity in 2007. Pursuant to a settlement, the company's former CEO consented to \$2.2 million in disgorgement, a \$250,000 penalty and a five year officer and director bar. Litigation continues against the other defendants.

In June, in *SEC v. Mozilo*, the SEC charged three former executives of Countrywide Financial Corporation, including the CEO, the COO and the CFO.[\[7\]](#) The SEC alleges that the defendants presented the company as a lender of prime quality mortgage loans, different from competitors who engaged primarily in riskier subprime lending, and did not disclose that the company had actually developed a "supermarket" strategy that widened underwriting guidelines to match products offered by its competitors. The complaint cites to internal email messages that allegedly reflect knowledge of the increasing risks the company was undertaking. The CEO, Mozilo, was also charged with insider trading.

On July 1, in *SEC v. Rand*, the SEC charged the former chief accounting officer of Beazer Homes USA, Inc.[\[8\]](#) The SEC alleges that the defendant artificially decreased the company's income during the housing boom by improperly increasing reserves and recording additional liabilities and then reversed those entries when the housing market declined in 2006 and 2007 in order to continue meeting analysts' expectations. On the same day, Beazer reached agreements to resolve criminal and

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civil charges with the Department of Justice and the Department of Housing and Urban Development alleging false mortgage originations and accounting practices. Pursuant to a deferred prosecution agreement, Beazer will pay up to \$50 million in fines and restitution to home buyers.[\[9\]](#)

B. Vendor Payment and Inventory Management Claims

The SEC also resolved a number of financial reporting cases outside the realm of the subprime mortgage market. The SEC announced a settlement with CSK Auto Corporation alleging that the company overstated operating income from 2002 to 2004 by failing to write off uncollectible vendor allowances receivables and recognizing vendor allowance receivables in the wrong time period.[\[10\]](#) The settlement with CSK followed similar charges in March against several former CSK employees. The litigation against the individuals is continuing.[\[11\]](#)

The SEC also settled claims against several former employees of Cardinal Health, Inc., alleging that they inflated the company's earnings by misclassifying bulk sales as operating revenue, selectively accelerating recognition of cash discount income, and improperly adjusting reserves. Pursuant to settlements, the defendants paid civil penalties ranging from \$50,000 to \$100,000, and consented to officer and director bars and suspensions from appearing or practicing before the SEC as an accountant for three to five years.[\[12\]](#)

C. Backdating Cases

The SEC continued to settle several outstanding stock option backdating investigations that began in 2005. The SEC reached a settlement with Monster Worldwide, Inc., with a \$2.5 million penalty,[\[13\]](#) Take-Two Interactive Software, Inc., with a \$3 million penalty,[\[14\]](#) and Quest Software, Inc., with no penalty.[\[15\]](#) Former executives of Take-Two and Quest also reached settlements. In addition, in May 2009, following a trial, Monster's former chief operating officer, James Treacy, was found guilty of criminal charges for his role in options backdating at Monster.

III. Cases Against Broker-Dealers

The SEC's enforcement actions against broker-dealers have addressed the financial crisis, but have also encompassed sales practices, information barriers, international business and market operations.

A. Financial Crisis

In May, the SEC charged ten brokers in Florida in connection with the sale of collateralized mortgage obligations (CMOs) to retirees and other conservative investors.[\[16\]](#) The SEC alleged that the brokers misrepresented the CMOs as guaranteed by the U.S. government and suitable for investors with conservative objectives. The SEC also alleged that the defendants misrepresented the extent to which margin would be used and the risks it would create.

B. Cross-Border Business

This year the SEC played a role in challenging a foreign financial institution allegedly used by U.S. citizens to avoid taxes. The defendant was a Swiss financial institution that was not registered as either a broker-dealer or investment adviser in the U.S. In a settled enforcement action, the SEC alleged that the defendant opened accounts in Switzerland for U.S. citizens, but used U.S. jurisdictional means to provide brokerage and advisory services to those customers in the U.S.[\[17\]](#) Thus, the SEC alleged that the defendant acted as a broker-dealer and investment adviser without registering as such. Pursuant to

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the settlement, the defendant agreed to pay \$200 million in disgorgement. The defendant also entered into a deferred prosecution agreement with the Department of Justice pursuant to which it will pay an additional \$180 million, as well as \$400 million in tax-related payments.

C. Information Barriers

In 2005 and 2006, the SEC filed enforcement actions against brokers at several firms and day traders outside those firms, alleging that the brokers permitted the day traders to hear confidential information regarding the firms' institutional customers' unexecuted orders as they were transmitted over the firms' squawk box. The day traders allegedly traded ahead of the institutional customer orders and profited from price movements caused by execution of the institutional customer orders. The brokers allegedly received kickbacks from the day traders in exchange for providing access to the information.

This year, the SEC instituted a settled action against one of the broker-dealer firms alleging that the firm had not established, maintained and enforced written policies and procedures reasonably designed to prevent the misuse of material, non-public information relating to customer orders.^[18] According to the SEC's administrative order, the firm lacked policies and procedures to limit and track employee access to the squawk box and to supervise its use. Pursuant to the settlement, the firm agreed to pay a \$7 million penalty and to implement certain policies and procedures to prevent misuse of the squawk boxes.

D. Markets

In 2004, the SEC brought settled administrative proceedings against the seven specialist firms on the New York Stock Exchange alleging trading ahead and inter-positioning. In March of this year, the SEC brought similar enforcement actions against fourteen specialist firms that operated on several regional and options exchanges.^[19] As in the earlier actions, the SEC alleged that the specialist firms did not fulfill their obligation to match executable public customer orders and instead traded ahead of such orders or inter-positioned proprietary trades between them. Pursuant to the settlement, the fourteen firms agreed to pay collectively nearly \$70 million in disgorgement and penalties.

IV. Cases Against Investment Advisers

Cases against investment advisers also focused on the financial crisis. In general, the cases involving advisers reflect a continued emphasis on fulfilling fiduciary duties of accurate and timely disclosure to clients of material information and potential conflicts of interest.

A. Cases Related to the Financial Crisis

The SEC filed an action against managers of the Reserve Primary Fund money market fund, which "broke the buck" when its net asset value fell below \$1.00 per share the day after Lehman's bankruptcy filing.^[20] The SEC alleges that, following the bankruptcy filing, the defendants made inaccurate disclosures concerning the fund's exposure to Lehman and the management company's willingness and ability to provide capital support.

In another enforcement action, the SEC challenged an investment adviser's valuations of a mutual fund's holdings of mortgage-backed securities.^[21] In this settled action, the SEC's administrative order alleged that the respondents overstated the value of mortgage-backed securities in the fund's portfolio in 2007 and 2008 by failing to take into account certain adverse information, such as the

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decline in a benchmark asset-backed derivative index and the cessation of payments on a CDO tranche held by the fund, and recommended overriding the declining valuations provided by third-party pricing vendors. In June 2008, the fund's valuation committee re-priced several of the securities in the fund, which caused a decline in its NAV. According to the SEC's order, the respondents prepared talking points for wholesalers to provide to certain sales channels and to respond to investor inquiries. The SEC's order alleged that the respondents' selective disclosure of information about the repricing to certain fund shareholders, and failure to disclose such information more broadly, constituted a separate violation of the Advisers Act, which allowed certain investors to redeem their shares ahead of others at a higher net asset value. Shortly after the re-pricing, investor redemptions led the fund to close and go into liquidation. Pursuant to the settlement, the respondents agreed to pay a total of \$40 million in compensation to fund shareholders, disgorgement and penalties, and to retain an independent compliance consultant to review certain policies and procedures.

B. Due Diligence of Other Advisers

In a settled enforcement action, the SEC challenged the sufficiency of due diligence performed by an investment adviser before placing client funds with another adviser.^[22] The SEC alleged that the respondents, a hedge fund consultant and its principal, breached fiduciary duties owed to clients by not performing the due diligence evaluation it represented it would do before and after recommending investment in the Bayou Fund. The SEC's administrative order alleged that the respondents failed to conduct a portfolio trading analysis and failed to verify Bayou's relationship with its outside auditor. In settling the matter, the respondents agreed to pay approximately \$800,000 in disgorgement and penalties.

C. Public Pension Fund Asset Management

In the last six months, the SEC, in conjunction with the New York State Attorney General, has taken action against individuals who have allegedly participated in arrangements to require investment advisers to pay consideration in return for the opportunity to manage money from a New York State pension fund.^[23] In its original complaint, filed in March 2009, the SEC alleged that David Loglisci, former Deputy Comptroller and Chief Investment Officer of the New York State Common Retirement Fund, working with Hank Morris, a political adviser to the former New York State Comptroller, required investment managers seeking to manage Common Fund money, to pay a "finder's fee" to Morris and others. The complaint alleges that those who received the payments did not perform legitimate services for the fees and that the fees were merely kickbacks of a portion of the investment advisory fees received by the advisers. Since filing the original complaint, the SEC has added several other individual defendants who also received payments, as well as one investment adviser who made such payments.^[24] The SEC's release announcing charges against the investment adviser noted that, at the time of making the suspect payments, the adviser was serving as an outside consultant to the Common Fund, thus making the adviser a fiduciary of the Common Fund.^[25] The New York State Attorney General has pursued parallel criminal charges against some of the same defendants.

E. Ponzi Schemes

In a typical year, we would not discuss Ponzi schemes. However, this has not been a typical year thus far. In the wake of the Madoff case, the SEC has filed a series of Ponzi scheme cases. This is probably due to both increased investor redemption demand exposing more schemes and the SEC's heightened focus on these cases. Many of these cases have been against individuals and firms that were, or purported to be, investment advisers.

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One particularly noteworthy development came in the Stanford case. For the first time, to our knowledge, the SEC has charged a foreign regulator with violation of the U.S. securities laws. In June, the SEC amended its complaint in the Stanford case to add as a defendant the administrator and chief executive officer of Antigua's Financial Services Regulatory Commission for allegedly accepting bribes to ignore the Ponzi scheme, supplying Stanford with confidential information about the SEC's investigation and collaborating with Stanford to withhold information requested by the SEC.[\[26\]](#)

V. Insider Trading

This year the SEC for the first time alleged insider trading in credit default swaps. In another case the SEC charged insider trading despite the defendant's use of a 10b5-1 plan.

A. Insider Trading in Credit Default Swaps

In May 2009, the SEC filed the first case alleging insider trading in credit default swaps, in this case swaps on the bonds of Dutch company, VNU N.V.[\[27\]](#) The defendants are a bond salesman at an investment bank and a portfolio manager at a hedge fund. The SEC alleges that the bond salesman learned from fellow employees confidential information concerning changes in a proposed VNU bond offering that the investment bank was underwriting, changes that would increase the price of credit default swaps on VNU bonds. The SEC alleges that the bond salesman tipped the hedge fund manager about the confidential information and that the hedge fund manager purchased credit default swaps on VNU bonds for his hedge fund and later covered the position for a profit when news of the bond restructuring became public. As for the SEC's jurisdiction over trading in the credit default swaps, the complaint alleges, "The CDSs at issue in this matter qualify as security-based swap agreements under the Gramm-Leach-Bliley Act of 2002 and are therefore subject to the antifraud provisions set forth in Section 10(b) of the Exchange Act and the rules promulgated thereunder." This case will likely test the SEC's assertion of jurisdiction over trading in credit default swaps in general and in the circumstances of this case in particular.

Of more immediate concern, however, are the implications of this case for ongoing compliance at broker-dealers and investment advisers who trade in credit default swaps. Whether or not the SEC prevails in this case, the filing of the case means that broker-dealers and investment advisers need to make sure their information barriers designed to prevent the misuse of material nonpublic information encompass potential trading in credit default swaps. Depending on the nature of the organization, this may mean the implementation of additional surveillance systems or physical separation of personnel not previously considered to be at risk for insider trading.

B. Insider Trading and 10b5-1 Plans

In *SEC v. Mozilo*, in addition to the disclosure allegations discussed above, the SEC also alleged insider trading.[\[28\]](#) The complaint alleges that, at the time Mozilo established four Rule 10b5-1 plans to sell Countrywide stock, he was aware of nonpublic information concerning Countrywide's increasing credit risk and the risk that the poor expected performance of its loans would prevent the company from continuing its business model of selling its loans into the secondary market. This case emphasizes the care that must be taken when establishing a 10b5-1 plan to ensure that it will provide an effective defense to potential allegations of insider trading.

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VI. The SEC In The Courts -- Litigation Developments

As one would expect, in the first half of 2009, the SEC met with some successes and some setbacks in the courts. We focus here on court decisions that have implications for future litigation against the SEC.

A. Statute of Limitations

For years, the SEC has struggled with litigating old conduct and, consequently, often has to surmount a defense based on the statute of limitations, typically relying on arguments that the statute should be tolled due to the defendant's concealment of the fraud. These arguments have met with varied success in the courts. This year, the SEC prevailed in a case in the Seventh Circuit.^[29] In *SEC v. Koenig*, the SEC filed its complaint more than five years after the alleged accounting fraud had ended, but less than five years after the company issued a press release announcing that its prior financial statements were unreliable. The court held that in applying the statute of limitations in 18 U.S.C. §2462 to an SEC fraud claim, the statute does not begin to run until the SEC discovers, or reasonably could have discovered, the fraud. The court determined that the company's press release was the earliest event that put the SEC on notice of the need for inquiry, and thus, the SEC's complaint was timely. The *Koenig* decision sets a lower threshold for the SEC to establish tolling than the standard previously articulated by a district court in the Southern District of New York.^[30] Thus, while the *Koenig* decision is helpful to the SEC, the divergence in these cases means that the SEC will continue to face uncertainty over the viability of claims in future litigation involving old conduct.

B. The Scope of Secondary Liability

The SEC received a setback from the First Circuit on the scope of aiding and abetting liability.^[31] In *SEC v. Papa*, the First Circuit affirmed the dismissal of aiding and abetting claims against three defendants who signed audit confirmations that failed to disclose a prior fraud allegedly committed by three other co-defendants.

The SEC complaint named six former executives of a trust company that provided administration services to pension funds and mutual funds. According to the allegations of the complaint, the trust company inadvertently delayed investing a pension fund's assets, which caused losses to the fund. The defendants then tried to remedy the loss by executing certain back-dated cross-trades between the pension fund client and mutual fund clients that partially shifted the losses from the pension fund to the mutual funds, without disclosure to the affected clients. The complaint alleged that all six defendants participated in meetings in which the plan was discussed and agreed to; three of the defendants effected the trades and associated accounting entries; and three signed audit confirmations one and two years later that did not disclose these events.

The district court dismissed all claims against the three defendants who had signed the audit confirmations, holding that the SEC had not stated a claim of either primary or secondary liability. On appeal the SEC pressed only the theory of secondary liability, that the false audit confirmations substantially assisted the fraud by continuing the trust company's breach of fiduciary duty of disclosure to the clients. The First Circuit affirmed the dismissal, holding that the execution of audit confirmations did not render substantial assistance to the fraud because the fraud had ended long before the letters were signed. In the words of the court, "one cannot aid and abet a fraudulent scheme that is already complete." As the court explained, to hold otherwise "would extend the supposed

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wrong indefinitely and until its disclosure," and "would *create* new liability under section 10(b), long after the original transactions" had occurred.[\[32\]](#)

The *Papa* decision puts into question the viability of aiding and abetting fraud claims against a defendant whose only misconduct consists of signing an inaccurate audit confirmation. On the other hand, in *dicta*, the court noted the possibility that the SEC might have sustained an aiding and abetting claim against the same three defendants based solely on their alleged acquiescence to the original plan, a theory the SEC had not pursued on appeal. Thus, the SEC may take from this decision encouragement toward asserting such claims in the future.

C. The Scope of Primary Liability

In December 2008, a divided panel of the First Circuit held that the SEC had adequately alleged a primary violation of Section 10(b) and Rule 10b-5(b) for misstatements concerning market timing "impliedly" made in mutual fund prospectuses by defendants, employees of the underwriter and distributor of mutual fund shares.[\[33\]](#) In *SEC v. Tambone*, the First Circuit reasoned that underwriters hold a "unique position" that carries with it a "duty to review and confirm the accuracy of the material in the documentation" an underwriter distributes. Thus, even though the defendants did not author the statements at issue, the court held that defendants' "use" of the prospectuses to sell securities amounted to "implied statements of their own regarding the accuracy and completeness of those prospectuses." A sharply-worded dissent criticized the court's holding for enlarging the scope of primary liability and blurring the line between primary and secondary liability that the Supreme Court recently drew in *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*[\[34\]](#) Subsequently, the court solicited briefs from the parties and *amici* in connection with the defendants' motion for a rehearing *en banc*, but then denied the defendants' motion for rehearing. The defendants' petition for certiorari is pending in the Supreme Court.

D. Transnational Enforcement Actions

In emergency actions, the SEC frequently obtains preliminary asset freeze orders, but such orders may not have extraterritorial effect. Recently, the SEC received affirmation of its ability to freeze assets abroad through a foreign court.[\[35\]](#) At the outset of *SEC v. Lydia Capital LLC*, in 2007, the SEC obtained from a U.S. district court an asset freeze order against a defendant who was a citizen of the U.K. In 2008, with the assistance of the U.K. FSA, the SEC retained U.K. counsel and filed a limited notice application with the High Court of Justice, Queen's Bench Division, seeking an order freezing the defendants assets in the U.K.[\[36\]](#) The High Court granted the SEC's emergency request the same day, and then, following an evidentiary hearing, extended the freeze order pending adjudication of the SEC's enforcement action in the U.S. The defendant appealed the High Court's order, and, in January 2009, a three-judge panel of the Supreme Court of Judicature Court of Appeal dismissed the defendant's appeal, upholding the asset freeze order in the U.K.

E. Discovery in Enforcement Litigation Against the SEC

The SEC drew a sharp rebuke from Judge Shira Scheindlin in the Southern District of New York, for its posture in responding to discovery requests in *SEC v. Collins & Aikman Corp.*[\[37\]](#) The court ruled that the SEC's production of a 10.6 million page, unorganized database of documents produced in its investigation was improper because it was not maintained that way "in the usual course of business." Instead, the court required the SEC to identify and produce particular documents responsive to the defendant's specific document demands or produce the documents in the manner in which the SEC

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staff had organized them, rejecting the SEC's assertion of work product protection as to the staff's organization.

The defendant also requested discovery on the SEC's consideration in other contexts of accounting pronouncements at issue in the litigation. The SEC asserted the "deliberative process" privilege. The court declined to accept at face value the SEC's broad claim of the privilege. The court held that the deliberative process privilege must be construed narrowly, that the SEC's privilege log was conclusory, and that its search for documents was inadequate. Accordingly, the court ordered that the SEC produce the withheld documents for *in camera* review and negotiate in good faith regarding a search protocol for internal SEC emails that had not yet been searched.

This decision may reduce the cost of litigating against the SEC and permit access to information which could support a defense that good faith regulatory and accounting judgments were made in an uncertain environment.

[1] Mary L. Schapiro, Chairman, SEC, Address to Practising Law Institute's "SEC Speaks in 2009" Program (Feb. 6, 2009), <http://sec.gov/news/speech/2009/spch020609mls.htm>.

[2] Robert Khuzami, Director, Div. of Enforcement, SEC, Testimony Concerning Strengthening the SEC's Vital Enforcement Responsibilities (May 7, 2009), <http://sec.gov/news/testimony/2009/ts050709rsk.htm>.

[3] Mary L. Schapiro, Chairman, SEC, Testimony Before the Subcommittee on Financial Services and General Government (June 2, 2009), <http://sec.gov/news/testimony/2009/ts060209mls.htm>.

[4] The descriptions of SEC actions in this article are based on allegations made by the SEC in its charging documents and do not assume the truth of the facts alleged in them. Gibson, Dunn & Crutcher LLP represents various parties in related matters. Thus, these descriptions do not reflect the positions of the firm, its lawyers or its clients.

[5] Press Release No. 2009-37, SEC, Statement from Chairman Schapiro on Proposed Budget for SEC (Feb. 26, 2009), <http://www.sec.gov/news/press/2009/2009-37.htm>.

[6] *SEC v. Strauss, et al.*, No. 09-CV-4150 (RB) (S.D.N.Y. filed April 28, 2009); *see also* SEC Litig. Release No. 21014 (April 28, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr21014.htm>.

[7] *SEC v. Mozilo, et al.*, No. CV 09-03994 (VBF) (C.D. Cal. filed June 4, 2009); *see also* SEC Litig. Release No. 21068 (June 4, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr21068.htm>.

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- [12] *SEC v. Miller, et al.*, No. 09-CV-4945 (S.D.N.Y. filed May 27, 2009); *see also* SEC Litig. Release No. 21058 (May 27, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr21058.htm>.
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- [15] SEC Release No. 2009-57, SEC Charges Quest Software and Three Executives for Stock Option Backdating (Mar. 12, 2009), <http://www.sec.gov/news/press/2009/2009-57.htm>.
- [16] *SEC v. Betta, et al.*, No. 09-80803 (S.D. Fla. filed May 28, 2009); *see also* SEC Litig. Release No. 21061 (May 28, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr21061.htm>.
- [17] *SEC v. UBS AG*, No. 1:09-cv-00316 (D.D.C. filed Feb. 18, 2009); *see also* SEC Litig. Release No. 20905 (Feb. 18, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr20905.htm>.
- [18] *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Inc.*, File No. 3-13407 (SEC Mar. 11, 2009), <http://www.sec.gov/litigation/admin/2009/34-59555.pdf>.
- [19] *See* SEC Release No. 2009-42, with links to five complaints and seven administrative orders, <http://www.sec.gov/news/press/2009/2009-42.htm>.
- [20] *SEC v. Reserve Mgmt. Co., Inc. et al.*, No. 09-CV-4346 (S.D.N.Y. filed May 5, 2009); *see also* SEC Litig. Release No. 21025 (May 5, 2009), <http://sec.gov/litigation/litreleases/2009/lr21025.htm>.
- [21] *In the Matter of Evergreen Inv. Mgmt. Co., LLC*, File No. 3-13507 (SEC June 8, 2009), <http://www.sec.gov/litigation/admin/2009/34-60059.pdf>.
- [22] *In the Matter of Hennessee Group LLC*, File No. 3-13454 (SEC Apr. 22, 2009), <http://www.sec.gov/litigation/admin/2009/ia-2871.pdf>.
- [23] *SEC v. Morris, et al.*, No. 09-CV-2518 (S.D.N.Y. filed Mar. 19, 2009); *see also* SEC Litig. Release No. 20963 (Mar. 19, 2009), <http://www.sec.gov/news/press/2009/2009-62.htm>.
- [24] *SEC v. Morris*, No. 09-CV-2518 (S.D.N.Y. amended complt. filed May 12, 2009); *see also* SEC Litig. Release No. 21036 (May 12, 2009), <http://sec.gov/litigation/litreleases/2009/lr21036.htm>.
- [25] *SEC v. Morris*, No. 09-CV-2518 (S.D.N.Y. amended complt. filed Apr. 30, 2009); *see also* SEC Litig. Release No. 21018 (Apr. 30, 2009), <http://sec.gov/litigation/litreleases/2009/lr21018.htm>.

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- [27] *SEC v. Rorech, et al.*, No. 09-CV-4329 (JGK) (S.D.N.Y. May 5, 2009); *see also* SEC Litig. Release No. 21023 (May 5, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr21023.htm>.
- [28] *SEC v. Mozilo*, No. CV 09-03994 (VBF) (C.D. Cal. filed June 4, 2009); *see also* SEC Litig. Rel. No. 21068 (June 4, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr21068.htm>.
- [29] *SEC v. Koenig*, 557 F.3d 736 (7th Cir. 2009).
- [30] *SEC v. Jones*, 476 F. Supp. 2d 374 (S.D.N.Y. 2007).
- [31] *SEC v. Papa*, 555 F.3d 31 (1st Cir. 2009).
- [32] *Id.* at 37 (emphasis in original).
- [33] *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008), *reh'g. denied* (1st Cir. 2009).
- [34] *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).
- [35] *SEC v. Lydia Capital, LLC*, No. 07-10712-RGS, 2008 WL 5273313 (D. Mass. Dec. 19, 2008).
- [36] *SEC v. Manterfield*, Claim No. HQ08X00798 (High Court of Justice, Queen's Bench Division, Royal Courts of Justice).
- [37] *SEC v. Collins & Aikman Corp.*, 256 F.R.D. 403, 2009 WL 94311 (S.D.N.Y. Jan. 13, 2009).



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Palo Alto

[Timothy Roake](mailto:troake@gibsondunn.com) - Palo Alto (650-849-5382, troake@gibsondunn.com)

New York

[Mark K. Schonfeld](mailto:mschonfeld@gibsondunn.com) (212-351-2433, mschonfeld@gibsondunn.com)

[Lee G. Dunst](mailto:ldunst@gibsondunn.com) (212-351-3824, ldunst@gibsondunn.com)

[Jim Walden](mailto:jwalden@gibsondunn.com) (212-351-2300, jwalden@gibsondunn.com)

[Lawrence J. Zweifach](mailto:lzweifach@gibsondunn.com) (212-351-2625, lzweifach@gibsondunn.com)

[Alexander H. Southwell](mailto:asouthwell@gibsondunn.com) (212-351-3981, asouthwell@gibsondunn.com)

Washington, D.C.

[Barry R. Goldsmith](mailto:bgoldsmith@gibsondunn.com) (202-955-8580, bgoldsmith@gibsondunn.com)

[John H. Sturc](mailto:jsturc@gibsondunn.com) (202-955-8243, jsturc@gibsondunn.com)

[K. Susan Grafton](mailto:sgrafton@gibsondunn.com) (202-887-3554, sgrafton@gibsondunn.com)

Los Angeles

[Michael M. Farhang](mailto:mfarhang@gibsondunn.com) (213-229-7005, mfarhang@gibsondunn.com)

[Douglas M. Fuchs](mailto:dfuchs@gibsondunn.com) (213-229-7605, dfuchs@gibsondunn.com)

Dallas

[M. Byron Wilder](mailto:bwilder@gibsondunn.com) (214-698-3231, bwilder@gibsondunn.com)

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July 27, 2009

SEC ENFORCEMENT ACTION ON SECTION 13(D) DISCLOSURE REQUIREMENTS FOR INSTITUTIONAL INVESTORS CLARIFIES THE EXCEPTION FOR "ORDINARY COURSE OF BUSINESS"

To Our Clients and Friends:

In a settled enforcement action instituted July 21, 2009, the SEC provided significant guidance on the filing obligations of institutional investors under Section 13(d) of the Securities Exchange Act of 1934. Specifically, the guidance addresses the meaning of the "ordinary course of business" prong of Rule 13d-1(b)(1)(i) and reflects an expansive interpretation of Section 13(d). The SEC's administrative order found that the respondent, a registered hedge fund adviser, Perry Corp., should have filed a Schedule 13D within 10 days of acquiring beneficial ownership of more than five percent of the shares of Mylan Inc. and was not entitled to rely on the deferred filing option for institutional passive investors under Rule 13d-1(b). Consequently, institutional investors will need to assess carefully their filing obligations when acquiring substantial positions in companies for other than purely passive or ordinary market making activities. The case is *In the Matter of Perry Corp.*, File No. 3-13561 (SEC July 21, 2009), <http://sec.gov/litigation/admin/2009/34-60351.pdf>.

Section 13(d) of the Exchange Act

Under Section 13(d), generally, any person who acquires beneficial ownership of more than five percent of a registered class of shares must disclose the acquisition and information required by Schedule 13D within ten calendar days. Schedule 13D's reporting requirements are fairly detailed: among other things, Schedule 13D filers are required to disclose the purpose of the transaction, including any plans or proposals relating to a proposed merger involving the issuer, and to provide prompt updates for certain events.

Under limited circumstances, detailed in Rule 13d-1(b), qualified institutional investors that exceed the five-percent threshold may disclose their acquisitions on a short-form Schedule 13G within 45 days of the end of the calendar year in which the five-percent threshold was reached. This exception is only available if the institutional investor acquired the securities "in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer."^[1]

The Facts as Set Forth in the SEC's Order

According to the SEC's order, on July 26, 2004, Mylan announced an agreement to acquire King Pharmaceuticals Inc. in a stock-for-stock merger, subject to shareholder approval. According to the order, Perry engaged in a merger arbitrage strategy, shorting Mylan stock and buying King stock, which would yield a profit on the spread between the price of King's shares and the merger price, if the merger was consummated. According to the order, a "prominent activist investor" (Carl Icahn) then acquired a large block of Mylan shares and announced his opposition to the merger. In an effort to counteract the opposition, Perry began acquiring more Mylan stock primarily from two banks in conjunction with "swap" transactions, the net effect of which was to provide Perry with the ability to

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vote Mylan shares but without any economic risk of share ownership. Perry crossed the five-percent threshold on September 24, 2004.

According to the order, Perry consulted with counsel regarding its filing obligations under Section 13(d) and ultimately received advice that it need not file a Schedule 13D and instead could report on the deferred short-form Schedule 13G. The advice concluded that Perry's ownership in an acquiring company to vote in favor of a merger would not amount to "influencing control" of the issuer and appears to have assumed, without specific analysis, that the circumstances of the investment were "in the ordinary course" of Perry's business.

According to the order, in November 2004, the activist investor announced an intent to make a tender offer for Mylan. Perry then received legal advice that, in view of the tender offer, Perry could be said to hold Mylan shares with the purpose or effect of influencing control of Mylan and, accordingly, Perry filed a Schedule 13D to report its ownership in Mylan shares.

The SEC's Analysis of "Ordinary Course"

The SEC's order finds that Perry should have filed a Schedule 13D within ten days of crossing the five-percent threshold as it did not qualify for the deferred short-form Schedule 13G. The order does not challenge Perry's qualification under the first prong of Rule 13d-1(b) (*i.e.*, that Perry's ownership of shares in an *acquiring* company (Mylan) to vote in favor of a merger, as opposed to the target company (King)), did not amount to "influencing control" of the issuer. Rather, the order finds that the circumstances of Perry's investments were not "in the ordinary course" of Perry's business.

The SEC's order emphasizes the "pivotal" importance of Section 13(d), stating that it is "not a mere 'technical' reporting provision," but rather "a regulatory scheme that may represent the only way that corporations, their shareholders and others can adequately evaluate ... the possible effects of a change in substantial shareholdings." Order ¶ 30 (citing *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587, 607 (S.D.N.Y. 1993)). Since the order then provides the SEC's first significant guidance on the meaning of "ordinary course" of business, we set forth the relevant language from the order below:

Irrespective of whether transactions of this type are routine for an institutional investor, reliance on Rule 13d1-1(b)(1)(i) based on the "ordinary course of business" provision is inappropriate when transactions of the type executed by Perry are undertaken. The exception ... is available only where such investors are acquiring securities for passive investment or ordinary market making purposes as part of their routine business operations.

When institutional investors acquire . . . the beneficial ownership of securities with the purpose of influencing the management or direction of the issuer or affecting or influencing the outcome of a transaction – such as acquiring securities or an interest in securities, for the purpose of voting those securities in favor of a merger – the acquisition of those securities cannot be said to be in the "ordinary course of [the institutional investor's] business.... [W]hen institutional investors rapidly accumulate securities of an acquirer after the announcement of a business combination transaction with the intent to ensure completion of a merger by the acquirer, the legislative purpose of Section 13(d) is defeated in the absence of full disclosure. When such acquisitions are made, or when such institutional investors act in concert with the management or advisors of one of the parties to the transaction to ensure

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completion of the merger, those institutions are ineligible to certify that the securities were acquired and are held in the "ordinary course of [the institutional investor's] business"....

Order ¶¶ 33-34.

The order imposes a cease and desist order, a censure and a \$150,000 penalty.

Implications of the Order

This case is significant in several respects. First, it demonstrates that this Commission is taking a broad approach to interpretation of its disclosure requirements generally and those under Section 13(d) in particular. Accordingly, after acquiring more than five percent of a public company's shares, it is critical for investors to determine their Schedule 13D/13G eligibility and to report ownership on the correct form. Even if an investor is not seeking to influence "control" of the issuer, if an investor is seeking to influence the management or direction of the issuer or affect the outcome of a shareholder vote or transaction, ownership should be reported on Schedule 13D within the ten-calendar day filing deadline. It should be noted that the SEC recently communicated to Congress a request that the deadline for Schedule 13D filings be shortened, likely to five calendar days.[2]

Second, the SEC's order raises some questions. The order purports to turn solely on the "ordinary course" of business prong and does not find that ownership in an acquiring company amounts to "influencing control" of the issuer. However, the order's analysis of "ordinary course" specifically rejects any reference to the institutional investor's business ("[i]rrespective of whether transactions of this type are routine for an institutional investor..."). Rather, the order conflates the two prongs of the test -- the fact that negates the "ordinary course" prong is the acquisition of shares "with the purpose of influencing the management or direction of the issuer or affecting or influencing the outcome of a transaction...." In other words, by acquiring more than five percent of any company to influence management or the outcome of a shareholder vote, you may not be seeking to "influence control," but you are not acting in the "ordinary course" of your business. This raises the question of whether there really remain two separate prongs to the test.

Third, it is noteworthy that the SEC pursued this matter as an enforcement case. According to the order, Perry relied on legal advice in an area lacking significant precedent or guidance. The SEC's determination to pursue an enforcement case under these circumstances is yet further evidence of the heightened level of regulatory scrutiny under this Commission.

Finally, the SEC did not address the ultimate issue of the propriety of so-called "vote-buying" (*i.e.*, the acquiring of voting power without attendant investment risk) the issue that was initially raised in all the publicity surrounding the merger dispute in 2004.

[1] See Rule 13d-1(b)(1)(i).

[2] See Rich Edson, *SEC Gives 'Wish List' of 42 Changes It Wants In Securities Law*, Fox Business, July 16, 2009, (last visited July 27, 2009).

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New York

*Mark K. Schonfeld (212-351-2433, mschonfeld@gibsondunn.com)
Lee G. Dunst (212-351-3824, ldunst@gibsondunn.com)
George A. Schieren (212-351-4050, gschieren@gibsondunn.com)
Jim Walden (212-351-2300, jwalden@gibsondunn.com)
Lawrence J. Zweifach (212-351-2625, lzweifach@gibsondunn.com)
Alexander H. Southwell (212-351-3981, asouthwell@gibsondunn.com)*

Washington, D.C.

*Barry R. Goldsmith (202-955-8580, bgoldsmith@gibsondunn.com)
John H. Sturc (202-955-8243, jsturc@gibsondunn.com)
F. Joseph Warin (202-887-3609, fwarin@gibsondunn.com)
K. Susan Grafton (202-887-3554, sgrafton@gibsondunn.com)*

Los Angeles

*Debra Wong Yang (213-229-7472, dwongyang@gibsondunn.com)
Michael M. Farhang (213-229-7005, mfarhang@gibsondunn.com)
Douglas M. Fuchs (213-229-7605, dfuchs@gibsondunn.com)*

GIBSON, DUNN & CRUTCHER LLP

Palo Alto

Timothy Roake (650-849-5382, troake@gibsondunn.com)

San Francisco

Charles R. Jaeger (415-393-8331, cjaeger@gibsondunn.com)

Denver

Robert C. Blume (303-298-5758, rblume@gibsondunn.com)

Dallas

M. Byron Wilder (214-698-3231, bwilder@gibsondunn.com)

Securities Regulation and Corporate Governance Group:

John F. Olson - Washington, D.C. (202-955-8522, jolson@gibsondunn.com)

Brian J. Lane - Washington, D.C. (202-887-3646, blane@gibsondunn.com)

Ronald O. Mueller - Washington, D.C. (202-955-8671, rmueller@gibsondunn.com)

Amy L. Goodman - Washington, D.C. (202-955-8653, agoodman@gibsondunn.com)

James J. Moloney - Orange County (949-451-4343, jmoloney@gibsondunn.com)

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July 27, 2009

SEC'S FIRST USE OF SOX "CLAWBACK" AGAINST UNCHARGED EXECUTIVE

To Our Clients and Friends:

In a case that raises important questions about the nature and scope of the remedy provided in Section 304 of Sarbanes-Oxley Act of 2002, the SEC on July 22, 2009, filed a civil suit seeking to "claw back" compensation from a former chief executive officer who has not been accused of any securities law violation. The case is *SEC v. Jenkins*, Case 2:09-cv-01510-JWS (D. Ariz. July 23, 2009) (available at <http://sec.gov/litigation/complaints/2009/comp21149.pdf>).

Background

Maynard Jenkins was formerly the chief executive officer of CSK Auto Corp., an automotive parts retailer. Earlier this year, the SEC instituted a settled enforcement action against the company which alleged that CSK improperly accounted for vendor allowances and consequently overstated income in 2002, 2003, and 2004.[1] The SEC also filed civil charges against several former CSK executives, including the COO, CFO, controller and a supervisor, for their involvement in the alleged accounting misstatements.[2] The CFO and COO are also charged in a parallel criminal action. The controller and supervisor have each pleaded guilty to criminal charges of obstruction of justice.

Section 304 of Sarbanes-Oxley

Section 304 provides that if an issuer "is required to prepare an accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws," the CEO and CFO shall reimburse the issuer for any bonus or other incentive-based or equity-based compensation received, and any profits realized from the sale of the securities of the issuer, during the year following issuance of the original financial report. 15 U.S.C. § 7243.

Until now, the SEC only sought to apply Section 304 against CEOs and CFOs who were alleged to have been personally involved in wrongdoing leading to the restatement. For example, several early cases involved CEOs or CFOs who participated in option backdating and received backdated options.[3] Another case involved an officer who allegedly participated in a fraud and misappropriated company funds.[4]

The SEC's Complaint

In its latest complaint, the SEC does not allege that the CEO committed any violation of the securities laws. The SEC seeks a court order pursuant to Section 304 requiring the CEO to reimburse CSK and its shareholders more than \$4 million that he allegedly received in bonuses and stock sale profits in the period following the filing of annual financial statements that were ultimately restated.

The SEC's complaint recites in general the factual allegations of accounting improprieties contained in the SEC's earlier charging documents. The complaint further alleges that CSK was required to restate its annual financial reports for 2002-2004, due to CSK's material non-compliance with financial

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reporting requirements, "as a result of *its* misconduct." The complaint seeks reimbursement of approximately \$2 million in bonuses and \$2 million in profits realized from the sale of CSK stock in the relevant period.

Implications and Significance of the SEC's Action

The case against Mr. Jenkins, who is not accused of personally violating the securities laws or other "misconduct," extends the Commission's interpretation of Section 304, stands in stark contrast to prior cases and reflects the SEC's current willingness to adopt more expansive and aggressive legal interpretations. It also raises important legal and policy questions about the nature and applicability of Section 304, including whether such a case may be brought in the first instance, and if so, what the appropriate scope of the required "reimbursement" would be.

The threshold question is whether a Section 304 claim may be brought against an executive who did not participate in the alleged misconduct. Experts disagree on this point. Some argue that predicating liability on the misconduct of individuals other than the CEO and CFO would be consistent with a purpose of Section 304 to prevent senior officers from profiting from false or inaccurate financial statements and to encourage executive accountability. Other commentators counter that some level of culpability on the part of the CEO or CFO should be necessary before they are required to forfeit compensation, and argue that Congress aimed section 304 at senior officers who committed serious fraud. Having filed this complaint, the SEC may argue that, if Section 304 does not allow it to claw back compensation from officers who were not directly involved in the misconduct, then the provision does not add to its pre-existing disgorgement remedies.

The appropriate scope of the Section 304 remedy also will be at issue. In the *Jenkins* case, it appears that the SEC is trying to claw-back all of the CEO's bonuses and stock sale proceeds from the applicable timeframe. This raises the question of whether all qualifying compensation may be clawed-back regardless of the magnitude of the underlying misconduct, the size of the resulting restatement, and whether the incentive compensation was causally related to particular financial metrics that were subsequently restated.

The apparent effort to apply Section 304 to "no fault" executives raises a host of significant questions of statutory interpretation. What is "material noncompliance?" What is "misconduct?" Simply a failure to apply GAAP? Is fraud required? Is mere negligence sufficient? And misconduct by whom? The SEC's complaint bases its claim on CSK's alleged misconduct. But CSK can only act through individuals and, at present, no individual has admitted to any violations of the securities laws. In addition, it appears that the SEC's civil enforcement actions against the four individual executives and the SEC's clawback case against the CEO are pending before different district court judges in the District of Arizona, thus raising the possibility of divergent outcomes on the merits.

More broadly, this case raises significant legal questions. For example, is Section 304 constitutional, if it deprives an employee of property and contractual rights without any allegation of fault? Further, how does Section 304 relate to the officer's indemnification rights, which typically provide that a corporation may, and sometimes must, indemnify an executive against all losses, unless the executive is shown to have acted in bad faith and contrary to the best interests of the corporation?

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Finally, the use of a "no fault" clawback also raises significant public policy questions. Corporate governance experts have long sought to align the compensation of an executive with corporate performance. But if an executive's compensation can be forfeited because of the "misconduct" of others for which the executive is not at fault, then corporations and executives would have a powerful incentive to seek compensation that is not performance based, delinking corporate success and executive compensation.

[1] *In the Matter of CSK Auto Corporation*, Securities Act Release No. 9032 (May 26, 2009) (available at <http://www.sec.gov/litigation/admin/2009/33-9032.pdf>).

[2] *SEC v. Fraser, et al.*, Case No. 2:09-cv-00442-LOA (D. Ariz.); Litigation Release No., 20933 (March 6, 2009) (available at <http://www.sec.gov/litigation/litreleases/2009/lr20933.htm>).

[3] *See, e.g., SEC v. McGuire*, Civil Action No. 07-CV-4779-JMR/FLN (D.Minn. 2007); *see also* SEC Litigation Release No. 20387 (Dec. 6, 2007).

[4] *SEC v. Brooks*, Civil Action No. 07-61526-CIV-Altonaga/Turnoff (S.D.Fl. 2007).



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GIBSON, DUNN & CRUTCHER LLP

New York

Mark K. Schonfeld (212-351-2433, mschonfeld@gibsondunn.com)
Lee G. Dunst (212-351-3824, ldunst@gibsondunn.com)
George A. Schieren (212-351-4050, gschieren@gibsondunn.com)
Jim Walden (212-351-2300, jwalden@gibsondunn.com)
Lawrence J. Zweifach (212-351-2625, lzweifach@gibsondunn.com)
Alexander H. Southwell (212-351-3981, asouthwell@gibsondunn.com)

Washington, D.C.

Barry R. Goldsmith (202-955-8580, bgoldsmith@gibsondunn.com)
John H. Sturc (202-955-8243, jsturc@gibsondunn.com)
F. Joseph Warin (202-887-3609, fwarin@gibsondunn.com)
K. Susan Grafton (202-887-3554, sgrafton@gibsondunn.com)

Los Angeles

Debra Wong Yang (213-229-7472, dwongyang@gibsondunn.com)
Michael M. Farhang (213-229-7005, mfarhang@gibsondunn.com)
Douglas M. Fuchs (213-229-7605, dfuchs@gibsondunn.com)

Palo Alto

Timothy Roake (650-849-5382, troake@gibsondunn.com)

San Francisco

Charles R. Jaeger (415-393-8331, cjaeger@gibsondunn.com)

Denver

Robert C. Blume (303-298-5758, rblume@gibsondunn.com)

Dallas

M. Byron Wilder (214-698-3231, bwilder@gibsondunn.com)

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SEC ENFORCEMENT DIRECTOR ROBERT KHUZAMI EMPHASIZES CHANGES AND ACCOMPLISHMENTS IN FIRST 100 DAYS

To Our Clients and Friends:

In his first speech as Director of the SEC's Division of Enforcement, on August 5, 2009, Robert Khuzami announced changes underway in the Division's procedures and organization that are intended to strengthen the agency's enforcement program. Mr. Khuzami also discussed a number of cases filed in the last several months which have demonstrated the Enforcement Division's increased level of activity and focus on the financial crisis. Of greatest significance, the changes are intended to delegate greater discretion to the staff in the initiation of formal investigations, Wells notices and settlement demands, and to incentivize individuals to cooperate in investigations.

I. Increased Enforcement Activity

Mr. Khuzami began by noting the marked increase in enforcement activity under the new Administration. Comparing the period from the end of January to the present with the same period last year, the Division has opened 10% more investigations, has filed nearly 30% more actions, has been granted 118% more formal orders of investigation, and has filed 147% more temporary restraining orders. The Division has directed much of this increased activity at several priority areas identified by Mr. Khuzami, including the mortgage and credit crisis, Ponzi schemes, and cross-market misconduct. Later in his speech, Mr. Khuzami highlighted many of the recent significant cases in these priority areas.

As we have discussed previously, we have observed another noteworthy trend during the first six months of this year. While the number of cases filed and defendants charged is up, the percentage of defendants whose charges were settled at the time of filing is down significantly year over year, from 32% last year to 20% this year (*see* Gibson Dunn's Mid-Year Review of SEC Enforcement). This reflects not only increased enforcement activity, but particularly a willingness by the SEC to file cases against defendants in the absence of settlements. This may be partly a result of the recent number of Ponzi scheme cases, which are typically filed on an emergency basis. But, it also likely reflects a priority on bringing cases against individuals more quickly, without settlements and without awaiting the result of possible parallel criminal investigations.

II. New Initiatives

Mr. Khuzami outlined five new initiatives to reorganize the Enforcement Division and modify the process for investigations.

A. Specialized Units

The Division is creating five specialized units dedicated to particular areas of the securities industry and securities law. Each unit will be headed by a "unit chief" and comprised of staff from offices around the country. The staff in the units will receive specialized training, and the Division will also

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hire individuals with market experience or other expertise. At the outset, the five units will be as follows:

- The Asset Management Unit will focus on investment advisers, investment companies, hedge funds and private equity funds. This unit will address issues such as disclosure, valuation, portfolio performance, due diligence and diversification, transactions with affiliates, misappropriation and conflicts of interest.
- The Market Abuse Unit will focus on large-scale market abuses and complex manipulation schemes by institutional traders, market professionals and others. Mr. Khuzami expects the Division to build technological tools and screening programs to analyze trading across equities, debt securities and derivatives markets.
- The Structured and New Products Unit will focus on complex derivatives and financial products, including credit default swaps, credit default obligations and other securitized products.
- The Foreign Corrupt Practices Act Unit will focus on new approaches to identifying violations of the Foreign Corrupt Practices Act ("FCPA"). Mr. Khuzami intends to be more proactive in investigations, work more closely with its foreign counterparts, and take a more global approach to violations of the FCPA.
- The Municipal Securities and Public Pensions Unit will focus on offering and disclosure issues, tax and arbitrage-driven activity, unfunded or underfunded liabilities, and "pay-to-play" schemes.

Other existing working groups, such as the Subprime Working Group, which was created in 2007, will continue their work alongside these newly created specialized units.

B. Streamlining Management and Internal Processes

Mr. Khuzami is also streamlining the Division's management structure and processes. The Division will reduce the number of managers by redeploying the branch chiefs to conducting investigations. According to Mr. Khuzami, the goal of this flattening of the Division's management structure is to push more decision-making to the front-line staff.

In addition, the Division will change a number of its internal processes. First, the Commission has delegated to Mr. Khuzami as Division Director the authority to issue formal orders of investigation, which authorize the staff to issue subpoenas. Mr. Khuzami in turn intends to delegate that authority to "senior officers" throughout the Division (*i.e.*, Regional Directors and Associate Directors in Washington and the Regional Offices). Mr. Khuzami stated that, as a result of this change, if defense counsel resist or delay voluntary production of documents or witnesses, the staff will be able to serve a subpoena within a day, rather than weeks.

Second, the Division intends to streamline decision-making by delegating the authority to approve routine case decisions, such as issuing Wells notices or settlement demands, from the Deputy Director at the national level to the Division's senior officers located throughout the country. This represents a reversal of a trend under the prior Commission toward more centralized decision-making and a return to the practice as it existed until a few years ago.

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Third, the Division has changed its practice on tolling agreements. Going forward, the staff will be permitted to enter into a tolling agreement only with the Director's personal approval. Mr. Khuzami made clear that he intends to make granting tolling agreements the exception, rather than the rule.

Fourth, Mr. Khuzami reported that the staff's memoranda to the Commission recommending specific enforcement actions will be shorter, subject to fewer reviews, and turned around more quickly.

C. Fostering Cooperation by Individuals

Mr. Khuzami described a number of steps underway to create greater incentives for individuals to cooperate in enforcement investigations:

- creating a "Seaboard Report" for individuals -- that is, a public policy statement that will set forth standards under which to evaluate an individual's cooperation;
- expediting the process by which the Division Director is delegated authority to submit immunity requests to the Department of Justice;
- exploring ways to provide witnesses early on in appropriate cases an oral assurance that the Division does not intend to file charges against them; and
- recommending to the Commission, where appropriate, that the SEC enter into Deferred Prosecution Agreements, in which the Commission agrees to forego an enforcement action against a party subject to certain terms, including cooperation, waiver of statute of limitations and compliance with undertakings.

Mr. Khuzami emphasized, however, that the purpose of these tools is to reward only extraordinary cooperation, not simply responding to requests for information.

D. Commitment to Strategic Use of New Resources

Mr. Khuzami outlined areas to which the Division intends to devote greater resources. First, the Division has committed to triple its complement of fulltime paralegals and support personnel. Second, the Division has committed additional resources to a number of technology initiatives, including revamping how tips, complaints and referrals are handled and expanding the Division's document management, reporting and case management capabilities. Third, the Division will add litigators to its Trial Unit. Mr. Khuzami pointed to the Division's eight trial wins since April 2009 as evidence of the SEC's commitment to going to trial. Fourth, the Division will hire a Chief Operating Officer to manage information technology and oversee processes such as the distribution of Fair Funds to harmed investors, thus relieving staff attorneys of those responsibilities.

E. Office of Market Intelligence

Mr. Khuzami also announced the creation of an Office of Market Intelligence. This office will be responsible for collecting, analyzing, evaluating, triaging, referring and monitoring the many tips, complaints and referrals received by the Division.

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III. Conclusion

The initiatives announced by Mr. Khuzami present both a challenge and an opportunity to defense counsel. By reducing supervisory oversight, the flattening of the Division's organizational structure will place a greater burden on counsel to persuade and educate the front-line staff. On the other hand, the creation of standards for individual cooperation and for deferred prosecution agreements as well as the potentially greater availability of immunity orders suggest new opportunities for defendants who wish to resolve matters at the outset of an investigation.

Unquestionably, we are in an era of heightened enforcement. The greater level of discretion and autonomy being delegated to the staff and the effort to incentivize cooperation by individuals will likely continue to result in greater enforcement activity. In this environment, there will be greater emphasis than ever on insuring appropriate compliance by market participants and public companies.



Gibson Dunn is one of the nation's leading law firms in representing companies and individuals who face enforcement investigations by the Securities and Exchange Commission, the Department of Justice, the Commodities Futures Trading Commission, the New York and other state attorneys general and regulators, the Public Company Accounting Oversight Board (PCAOB), the Financial Industry Regulatory Authority (FINRA), the New York Stock Exchange, and federal and state banking regulators.

Our Securities Enforcement Group offers broad and deep experience. Our partners include the former Director of the SEC's prestigious New York Regional Office, a former Associate Director of the SEC's Division of Enforcement, the former Director of the FINRA Department of Enforcement, the former general counsel of the PCAOB, the former United States Attorney for the Central District of California, and former Assistant United States Attorneys from federal prosecutor's offices in New York, Los Angeles, and Washington, D.C.

Securities enforcement investigations are often one aspect of a problem facing our clients. Our securities enforcement lawyers work closely with lawyers from our Securities Regulation and Corporate Governance Group to provide expertise regarding parallel corporate governance, securities regulation, and securities trading issues, our Securities Litigation Practice Group, and our White Collar Defense Group.

Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you work or any of the following:

New York

Mark K. Schonfeld (212-351-2433, mschonfeld@gibsondunn.com)
Lee G. Dunst (212-351-3824, ldunst@gibsondunn.com)
George A. Schieren (212-351-4050, gschieren@gibsondunn.com)
Jim Walden (212-351-2300, jwalden@gibsondunn.com)
Lawrence J. Zweifach (212-351-2625, lzweifach@gibsondunn.com)
Alexander H. Southwell (212-351-3981, asouthwell@gibsondunn.com)

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Washington, D.C.

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John H. Sturc (202-955-8243, jsturc@gibsondunn.com)

F. Joseph Warin (202-887-3609, fwarin@gibsondunn.com)

K. Susan Grafton (202-887-3554, sgrafton@gibsondunn.com)

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Debra Wong Yang (213-229-7472, dwongyang@gibsondunn.com)

Michael M. Farhang (213-229-7005, mfarhang@gibsondunn.com)

Douglas M. Fuchs (213-229-7605, dfuchs@gibsondunn.com)

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Timothy Roake (650-849-5382, troake@gibsondunn.com)

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Charles R. Jaeger (415-393-8331, cjaeger@gibsondunn.com)

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M. Byron Wilder (214-698-3231, bwilder@gibsondunn.com)

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