

SECURITIES LITIGATION AND
REGULATORY ENFORCEMENT

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“Sufficiently Public” — How Widely
Available Does Information Need toBe to Defeat a Material
Omission Claim Under
the Securities Laws*By Jennifer Arnold, Associate*

Recently, more and more companies are defending against allegations of material omissions in their SEC filings by arguing that the alleged omitted information was publicly available and therefore not material. In the past, companies had a difficult time trying to prove that the information was “sufficiently public” to defeat a material omission allegation. However, recent cases indicate that the “sufficiently public” threshold may have been lowered, making it easier for companies to defend against material omission allegations brought by private parties and the SEC.

The issue of whether information is “significantly public” arises out of the conflict between the requirement that companies report all material information necessary to make required disclo- / continued page 2

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sure not misleading and the accepted principle that companies do not have a duty to disclose information that is already in the public domain. Rule 12b-20 of the Securities Exchange Act of 1934 (“Exchange Act”) requires all reporting companies to disclose any additional information necessary to make a required disclosure not misleading. A failure to include all such

leading information created by the alleged misstatements.” *See, e.g., In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1116 (9th Cir. 1989). Thus, in order for the company’s statements not to be misleading, the relevant public information must be widely distributed or available in order to defeat a material omission claim. Information widely reported in reputable newspapers and journals clearly satisfies this hurdle, while sporadic news coverage is insufficient. In addition,

The key inquiry was not whether the information was publicly available, but whether the information was “sufficiently public” such that further disclosure of the information by the company would not alter the total mix of information.

material, non-public information can provide the basis for a securities fraud claim under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. A material omission exists if there is a substantial likelihood that a reasonable investor would find that the omitted information would have significantly altered the “total mix” of information available.

On the other hand, courts have held that there is no duty to disclose information that is already well known to the public, finding that it would be “pointless and costly” to require companies to disclose information that is already publicly available. *See, e.g., Kapps v. Torch*, 379 F.3d 207, 215 (5th Cir. 2004) (citing *Wielgos v. Commonwealth Edison, Co.*, 892 F.2d 509, 517 (7th Cir. 1989)). Information that is sufficiently public does not alter the “total mix” of information and is therefore immaterial. The “total mix” of information includes SEC filings, as well as public news articles and all other information known to the general public.

In the past, simple public availability of the omitted information has not been enough to defeat an allegation of material omission. Instead, courts have looked to the scope of the public information (how well known the information is, how widely disseminated, etc.) to determine if it is sufficiently public enough to render an omission immaterial. Under this approach, courts have found that the omitted information must be conveyed to the public with a “degree of intensity and credibility sufficient to counter-balance effectively any mis-

mandatory electronic filing of most SEC filings through EDGAR and the ever increasing amount of information available on the internet are going a long way to making all publicly available information widely distributed.

In the most recent Court of Appeals decision addressing this issue, the Fifth Circuit held that material information included more than firm-specific, non-public information. *Kapps v. Torch Offshore, Inc.*, 379 F.3d 207 (5th Cir. 2004) The Court determined that the key inquiry was not whether the information was publicly available, but whether the information was “sufficiently public” such that *further* disclosure of the information by the company would not alter the total mix of information. In *Kapps*, the plaintiff alleged that the defendant’s prospectus was materially misleading because it failed to disclose that the price of gas had gone down immediately preceding the IPO. The Court dismissed the plaintiff’s claims, finding that the cautionary language in the company’s prospectus about the volatile nature of gas prices, coupled with public availability of the prices themselves, negated any duty on behalf of the company to disclose the information. The Court determined that given the cautionary language and publicly available prices, further disclosure would not have altered the “total mix” of information available, and thus, the alleged misstatements or omissions were immaterial.

Taking that motion a step further, the district court for the

Southern District of New York recently held that no material omission can occur when the underlying information is publicly known. In *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, the court dismissed the plaintiffs' material omission allegations, finding that the underlying information was publicly available. In *Merrill*, the plaintiffs alleged that Merrill failed to disclose that one of its mutual funds invested in companies to which Merrill provided investment banking services and that Merrill failed to disclose the inherent conflict of interest between its investment banking division and its research analysts. In its SEC filings, Merrill did not identify which companies held by its funds received investment banking support from Merrill. However, Merrill did disclose the Fund's holdings in its SEC filings, and the SEC filings of the (being held by the funds) companies disclosed the investment banking relationships. The Court dismissed the plaintiffs' allegations, finding that the alleged omitted information was available in the public domain. The Court held that because this information could be gleaned from publicly available documents, the plaintiffs could not be found liable for failing to disclose it. The Court also found that Merrill's failure to disclose the inherent conflicts between Merrill's research and investment banking departments was not a material omission because numerous articles had been published

SEC argued that determining whether information was sufficiently public "require[d] rejection of any bright line rules, and instead require[d] a case-specific analysis of whether [the] publicly available information [was] so widely disseminated in other sources that its omission from the defendant's disclosure was not materially misleading."

The Second Circuit has yet to reach a decision on the *Merrill* appeal. However, it is clear that the decision will impact what a company needs to disclose to satisfy the requirement that its statements not be misleading. If the district court's opinion is upheld, companies will receive a very potent precedent with which to combat material omission cases brought by both private litigants and the SEC.

In the meantime, it appears clear that courts will continue to dismiss material omission allegations where the alleged omitted information is widely known and generally available. Whether the courts will lower the burden necessary for a company to meet the "sufficiently public" standard still remains unclear, but it is starting to receive more judicial support. Now may be the time to push the envelope regarding required disclosure of publicly available information, as courts are beginning to appear more receptive to the idea that companies should not have to make repetitive disclosures of information already in the public domain.

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about the conflicts of interest between underwriters and analysts in brokerage firms. The plaintiffs have appealed the district court's ruling to the Second Circuit, *Merritt v. Merrill Lynch & Co.*, No. 03-7978 (2d Cir. filed Sept. 22, 2003).

The SEC filed an Amicus Brief in *Merrill* with the Second Circuit. In its brief, the SEC feared the potential widespread effects of this decision: "the principles enunciated by the district court and urged by the defendants could also restrict the disclosure obligations enforced by the Commission . . ." The

Practical Tip

When confronted with a material omission allegation, review all SEC filings connected with the allegation, newspaper and journal articles, and internet sources. If the alleged material information can be gained from these sources when considered (or even pieced) together, the company may have a strong defense to the material omission allegation. However, a complex mosaic of small snippets of public information linked together will not be enough. ☺

Due Diligence and Red Flags in Securities Offerings

By Michael H. Salsbury, Partner and Tamara L. Stevenson, Associate

The accounting fraud and subsequent bankruptcy of WorldCom, Inc. was one of several corporate scandals since 2000 that have resulted in enormous losses for investors, and in the emergence of a new environment for evaluating the conduct of companies and their legal and financial advisors in the resulting litigation for recovery of those losses.

Purchasers of WorldCom debt securities filed dozens of lawsuits in federal and state courts around the country, seeking to impose liability both on the underwriters of the offerings and on WorldCom's directors for material misstatements of WorldCom's financial condition in the registration materials for the offerings. The cases were consolidated before Judge Denise Cote in the Southern District of New York, and each group of defendants moved for summary judgment asserting that WorldCom's officers had concealed the accounting fraud from the defendants and that they were entitled to rely on the company's audited financial statements in discharging their obligations under the securities laws. Judge Cote's decisions denying summary judgment provide important guidance — and raise important questions — for securities professionals in today's environment.

The Legal Framework

The Securities Act requires full disclosure of material information concerning a public offering of securities. Registration statements for public offerings incorporate by reference disclosures and securities filings regarding the issuer's financial results and condition that have been certified by the offeror's directors, updated to the date of the offering. Underwriters of public offerings obtain the securities from an issuer at a discount and resell them to the public.

Section 11 of the Securities Act provides that any underwriter of an offering and any director of an issuer may be liable to purchasers of the securities if "any part of the registration statement, when such part became effective, contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or to make the statements therein not misleading." 15 U.S.C. § 77k(a). The statute further provides, however, that "as regards any part of the registration statement purporting to be made on the authority of an expert" — commonly called the "expertised" portion of a registration statement — a party will not be liable if "he had

no reasonable ground to believe and did not believe, at the time ... the registration statement became effective, that the statements therein were untrue." 15 U.S.C. § 77k(b)(3)(C). With respect to the "non-expertised" parts of a registration statement, a party will not be liable if *after reasonable investigation* he had reasonable ground to believe that the statements in those portions were true. 15 U.S.C. § 77k(b)(3)(A). The standard of reasonableness applicable to both provisions, which comprise what is known as the "due diligence" defense, is "that required of a prudent man in the management of his own property." 15 U.S.C. § 77k(c).

The WorldCom Plaintiffs' Claims

WorldCom made two public bond offerings pursuant to a shelf registration: a \$5 billion offering in May 2000, and an \$11.9 billion bond offering in May 2001. On June 25, 2002, WorldCom announced the first of a series of restatements of its 1999-2001 financial results that ultimately reduced its shareholders' equity from approximately \$50 billion to a negative \$20 billion. On July 21, 2002, WorldCom filed for bankruptcy protection.

Purchasers of the WorldCom bonds sued the underwriters of the offerings and WorldCom's directors at the time of the offerings primarily on the ground that the company's financial statements, incorporated by reference into the shelf registration and prospectuses, were plainly and dramatically inaccurate. The defendants moved for summary judgment, contending that they were entitled to rely on WorldCom's auditor's unqualified "clean" opinions for the company's 1999 and 2000 annual financial statements and the auditor's "comfort letters" regarding the company's interim financial statements at the time of the offerings. Under the statute they claimed they had no duty independently to investigate the reliability of the financial statements so long as they had "no reasonable ground to believe" they were untrue. The purchasers opposed the motions, asserting that the defendants had made virtually no independent investigation of

WorldCom's financial reports and should have been alerted to the need to investigate by a variety of "red flags" concerning the company's condition.

The Rulings

Judge Cote issued separate decisions regarding summary judgment for the underwriters, *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004), and the directors, No. 02 Civ. 3288DLC, 2005 WL 638268 (S.D.N.Y. Mar. 21, 2005), which, in view of the size and importance of the claims involved, may be regarded as watershed opinions on Section 11 liability and the due diligence defense.

First, after reviewing the SEC's statements and opinions during development of the integrated disclosure and shelf registration system as well as the differing standards for issuance of auditors opinion letters and reviews of unaudited financial statements, Judge Cote concluded that audit opinions constitute "expertised" portions of a registration statement, but that comfort letters with respect to interim financial results do not. In other words, the court determined that an underwriter must demonstrate that it conducted a reasonable investiga-

issuer's operations and finances for all offerings.

Second, Judge Cote ruled that while underwriters and directors generally are entitled to rely on the accuracy of expertised portions of registration statements, the purchasers' contention that "red flags" existed concerning WorldCom's financial statements were sufficient to create factual questions that precluded summary judgment based solely on such reliance, noting that "the existence of red flags can create a duty to investigate even audited financial statements." Although the claimed red flags must relate to items in the financial statements themselves and not to the individuals who prepared the statements (here, Arthur Andersen), the import of this ruling is that the summary judgment inquiry no longer depends on whether an alleged misstatement is in the expertised or non-expertised portion of a registration statement, but rather on the nature and extent of the underwriter or director's due diligence investigation. Audit opinions and comfort letters may support the reasonableness of an investigation *but are not by themselves sufficient to establish a due diligence defense.*

Judge Cote did draw a distinction between the investigative duties of insiders and of outside directors. Like underwriters,

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tion of an issuer's interim financial statements, even absent any reasonable ground for questioning their accuracy, in order to support a due diligence defense. Such an investigation typically involves meetings with the issuer's personnel in regard to business operations and plans, interviews with the issuer's major customers, suppliers and distributors, discussions with lenders and outside directors and, if any negative or questionable information is received, further and specific investigation as to its accuracy and importance. Given that public offerings necessarily involve reliance upon interim financial statements, the practical impact of the court's decision is to require underwriters to conduct *and document* a careful investigation of an

outside directors must show that they reasonably inquired as to the accuracy of unaudited financial statements and other non-expertised material in the company's disclosures, that they otherwise exercised due care, and that they had no reason to believe the company's public disclosures contained any material misstatements. Although what constitutes a reasonable inquiry by an outside director may be significantly less than that required of an underwriting firm, if red flags are present, outside directors are expected to inquire until they are satisfied with the integrity of the company's disclosures. However, the court found that the duty to investigate for *inside* directors is so stringent that it ques- / *continued page 6*

Due Dilligence

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tioned whether they ever could avoid liability for material misstatements by an issuer.

Conclusion

The *WorldCom* opinions underscore how seriously directors and underwriters must take their due diligence obligations. To obtain summary judgment, thereby avoiding the need to pay a settlement or face trial, underwriters and directors must conduct — and be able to show that they conducted — reasonable inquiries into the accuracy of an issuer’s public disclosures and, if they encounter red flags, must pursue them until they are satisfied that the disclosures are correct. They will not be protected from liability by reliance on an auditor’s opinion or on the honesty of corporate officers.

While Judge Cote asserted that her opinions did not increase the obligations of underwriters or directors, perhaps because until recently most misstatements have not been of sufficient magnitude to cause an issuer’s bankruptcy, the strict requirements of Section 11 have now been highlighted. The consequences of failing to satisfy those requirements also is

now apparent. The *WorldCom* underwriters paid in excess of \$6 billion and the company’s directors reportedly paid 20 percent of their respective net worth, excluding certain assets, to settle the purchasers’ claims.

Practical Tips

- ⊙ Perform due diligence with an eye toward spotting information which would strip one of his confidence in the accuracy of the information premised on the audited financial statements — these “red flags” require a more in-depth inquiry.
- ⊙ Underwriters must conduct a serious investigation, interviewing at a minimum issuer’s operating and planning personnel, lenders, and major customers.
- ⊙ Outside directors should meet with internal audit and other personnel without senior management present, and should consider whether the outside directors should have periodic discussions with outside consultants and principal lenders, again without the presence of management.
- ⊙ Make a record of the diligence conducted. It is not enough to simply accept representations of management at face value; instead, be prepared to show that a reasonable investigation was conducted. ⊙

New York’s High Court Finds Lead Underwriter Can Have Fiduciary Duty to Issuer

By Thomas J. Hall, Partner

In June 2005, New York’s highest court refused to dismiss an issuer’s breach of fiduciary duty claim against the lead underwriter of its initial public stock offering based on an alleged failure to disclose a conflict of interest. The Court found that where the underwriter also serves as an advisor to the issuer, it has a fiduciary obligation to disclose any conflicts to the issuer.

The Complaint

In 1999, eToys, Inc., which marketed children’s products on the internet, retained Goldman, Sachs & Co. as lead underwriter of its initial public offering. The underwriting agreement obligated eToys to sell 8,320,000 shares of its stock to Goldman Sachs which Goldman Sachs was to offer for public sale at an IPO price of \$20.00 per share. eToys asserted that Goldman Sachs was instrumental in setting this IPO price, and that

eToys relied on Goldman’s advice.

On the first day of the trading, eToys stock opened at \$79.00 per share and rose to a high of \$85.00. Following the bankruptcy of eToys almost two years later, the court-appointed Official Committee of Unsecured Creditors brought a lawsuit on behalf of eToys against Goldman Sachs.

In its complaint in *EBCI Inc. v. Goldman, Sachs & Co.*, the creditors alleged that in addition to retaining Goldman Sachs as

lead underwriter, eToys retained Goldman Sachs as an adviser and relied on Goldman Sachs's advice and expertise in pricing the IPO. It was further alleged that Goldman Sachs gave that advice to eToys without disclosing that it had a conflict of interest. Specifically, the complaint alleged that Goldman Sachs had entered into arrangements, which it allegedly failed to disclose to eToys, whereby Goldman's customers to whom shares were allotted in the IPO were obligated to "kick back" to Goldman a portion of any profits they made from the sale of

ing agreement with eToys should govern the relationship, the Court found that fiduciary "liability is not dependent solely upon an agreement or contractual relation between the fiduciary and the beneficiary but results from the relation." While the underwriting contract itself may not have created a fiduciary relationship, the Court found that the complaint "sets forth allegations that, apart from the terms of the contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone."

Apart from the terms of the contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone.

the allotted shares in after-market trading. Thus, the spread between the IPO price and the resale price allegedly determined the profit of which Goldman Sachs was entitled to a percentage. Because a lower IPO price would result in a higher profit to these customers upon resale, and thus a higher "kick back" to Goldman, the complaint alleged that Goldman Sachs had an incentive to advise eToys to underprice its IPO. Among other theories, the complaint alleged that Goldman Sachs's failure to disclose this alleged conflict of interest was a breach of its fiduciary duty to eToys. The complaint pointed to Goldman Sachs's pre-existing relationship with eToys, which included advising eToys on a preferred stock offering.

The Decision

The New York Court of Appeals, the state's highest court, explained that under common law a fiduciary duty "exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation." The Court continued that the finding of such a fiduciary relationship is necessarily fact-specific and "is grounded in a higher level of trust than normally present in the marketplace between those involved in arms-length transactions."

In rejecting Goldman Sachs's argument that its underwrit-

Specifically, the complaint alleged that an advisory relationship — independent of the underwriting agreement — existed between the parties, that eToys was induced to and did repose confidence in Goldman Sachs's knowledge and expertise to advise it as to a fair IPO price, that eToys hired Goldman Sachs to give it advice for the benefit of the company, and that Goldman Sachs thereby had a fiduciary obligation to disclose any conflict of interest concerning the pricing of the IPO. The Court made clear that a fiduciary duty does *not* attach to underwriters unless they *also* act as advisors.

The Court rejected Goldman Sachs's argument that there could be no fiduciary duty because eToys and Goldman Sachs functioned as a typical arms-length seller and buyer. Because eToys and Goldman Sachs agreed that Goldman Sachs would receive 7% of the offering proceeds, Goldman Sachs did not act as a typical buyer who attempts to purchase a product for the lowest possible price. Rather, the Court found that eToys had every reason to believe that "its interests and those of Goldman Sachs were aligned: the higher the price, the higher Goldman Sachs's 7 percent profit. Consequently, eToys allegedly had a further reason to trust that Goldman Sachs would act in eToys interest when advising eToys on the IPO price."

The Court of Appeals was not swayed by Goldman Sachs's argument that a finding of a fiduciary rela- / *continued page 8*

Fiduciary Duty

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tionship might have a significant adverse impact on the underwriting industry. The Court stressed “that the fiduciary duty we recognize is *limited* to the underwriter’s role *as advisor*. We do not suggest that underwriters are fiduciaries when they are engaged in activities other than rendering expert advice. When they do render such advice, the requirement to disclose to the issuers any material conflicts of interest that render the advice suspect should not burden them unduly.”

The Dissent

In a strongly worded dissent, one justice rejected the notion that a fiduciary relationship could exist here. The dissenting justice asserted that the terms of the underwriting agreement defined the rights and obligations of the parties, and noted that in the prospectus eToys acknowledged that the IPO price “has been negotiated” between eToys and the underwriters, and thus not “set” by Goldman. The dissent observed that the

Court historically had “refrained from injecting fiduciary obligations into sophisticated, counseled parties’ arms-length commercial dealings.” The dissenting justice continued that “[i]n allowing plaintiff’s claim for breach of fiduciary duty to go forward, the majority disregards that eToys was a sophisticated, well-counseled business entity.” The dissent expressed concern that the finding of a fiduciary duty “potentially conflicts with a highly complex regulatory framework designed to safeguard investors.”

Practice Tip

Where an underwriter advises an issuer on setting the IPO price, the underwriter must disclose any conflicts of interest. To avoid such disclosure obligation, an underwriter may need to either decline involvement in the price setting function, or suggest to the issuer that it should not rely on the underwriter to look out for the issuer’s best interest. As the latter seems inconsistent with the traditional role of an underwriter, full disclosure is likely the better — and perhaps the only — course. ©

The Supreme Court Rules That Stock Purchasers Must Show Direct Link Between Loss Suffered and Alleged Misrepresentation or Omission

By Scott S. Balber and Alan Ellman, Associates

In a recent unanimous decision in *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627 (2005), the Supreme Court held that a stock purchaser asserting a securities fraud claim must demonstrate a direct link between the loss suffered and the alleged misrepresentation or omission.

The Court rejected the Ninth Circuit’s holding that loss causation could be proven merely by alleging that the price of the security was inflated at the time of purchase, without regard to whether the defendant’s misrepresentation actually caused the plaintiff’s loss. The decision resolved a circuit split in favor of the United States Courts of Appeal for the Second, Third, Seventh, and Eleventh Circuits. This decision should bode well for companies facing securities fraud claims.

The Decisions Below

In their complaint, purchasers of Dura Pharmaceuticals stock

alleged that the company had made misrepresentations concerning (1) the profitability of sales of existing drugs and (2) the prospects of Food and Drug Administration (FDA) approval of a new asthmatic spray device. Purchasers claimed that on February 24, 1998, the last day of the class purchase period, Dura announced that its earnings would be lower than expected. The next day Dura’s shares lost almost half their value, falling from \$39 per share to approximately \$21. Eight months later, Dura announced that, contrary to its prior representations to shareholders, the FDA would not approve the new asthmatic spray device. Dura’s share price dropped the

next day but almost fully recovered within a week.

The District Court dismissed the complaint, holding that the purchasers had not adequately alleged that Dura acted knowingly with respect to the drug profitability claim, and had not adequately alleged loss causation with regard to the spray device claim because *the complaint did not allege that Dura's failure to obtain FDA approval of the spray device caused the February price drop*. Indeed, Dura's February earnings announcement did not contain any negative information about the prospects for spray device approval. Dura did not announce that the FDA declined to approve the spray device until eight months later.

the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value. Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong." In holding that the purchasers did not demonstrate loss causation — *i.e.*, that the company's alleged misrepresentation directly caused the decline in share price — the Court pointed out that "the lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or

The Court criticized the Ninth Circuit's statement of the law, noting that "to 'touch upon' a loss is not to cause a loss, and it is the latter that the law requires.

The Ninth Circuit Court of Appeals had held that purchasers "establish loss causation if they have shown that the price *on the date of purchase* was inflated because of the misrepresentation." Relying on Supreme Court precedent that "in connection with" under Rule 10b-5 only requires that the fraud "touch" the purchase transaction, the Court of Appeals reiterated its prior holdings that loss causation is satisfied if the purchaser "shows that the misrepresentation *touches upon* the reasons for the investment's decline in value." The court reasoned that, "for a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs *at the time of the transaction*." Because the complaint pleaded "that the price at the time of purchase was overstated," the court concluded that the allegations were legally sufficient.

The Supreme Court Rejected The Court of Appeals' Approach

The Supreme Court squarely rejected the Ninth Circuit's reasoning, holding that "as a matter of pure logic, at the moment

together account for some or all of that lower price." The Court criticized the Ninth Circuit's statement of the law, noting that "to 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires." The former approach would allow for recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss, thus providing investors with a form of broad insurance against market losses, rather than protecting them solely against those economic losses that fraudulent conduct actually causes.

Practical Tips

- The *Dura* Court's ruling that purchasers must provide a direct connection between the alleged misrepresentation or fraud and a decline in the company's stock price will typically mean that purchasers must plead that a corrective (changed) disclosure preceded a drop in the price of the security. But, there is no need for a formal disclosure from the company; rather, plaintiffs simply need to show that the market knows the truth, however the / *continued page 10*

Securities Fraud Claims

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truth comes to be revealed.

- ◎ The majority of Section 10(b) securities fraud lawsuits settle if plaintiffs survive a motion to dismiss, and the Court's decision in *Dura* reduces the likelihood of potential settlement windfalls for plaintiffs. The Court in *Dura* not only tightened the pleading standards for loss causation; it foreclosed an avenue of damages analysis that measured damages from the time of the purchase of the security. It would be virtually impossible to achieve consistent and fair results if damages were calculated based on the purchase date without reference to what caused the stock price to subsequently decline.
- ◎ The Supreme Court's decision in *Dura* does not impact the ability of the Department of Justice or the Securities and Exchange Commission to enforce the federal securities laws through criminal prosecutions or enforcement actions,

because loss causation (like reliance and damages) need not be demonstrated in cases brought by the government under Section 10(b) of the Exchange Act.

- ◎ *Dura* explicitly left the door open for a plaintiff asserting a securities fraud claim to argue that a share's higher price is lower than it would otherwise have been. For example, a company could simultaneously issue both a corrective disclosure and unrelated positive news, the latter offsetting a decline in the stock price. That notwithstanding, a plaintiff may still argue that there is a loss because the stock did not appreciate as it would have absent the fraudulent conduct. Of course, an unaffected price may reflect either counterbalancing information or simply the fact that investors were not influenced by the corrective disclosure. A plaintiff in such a case would have a difficult time *proving* loss causation even if he or she were able to adequately plead loss causation. ◎

Recent Challenges by D&O Insurers to Coverage Fall Short

By Robert A. Schwinger, Partner

Insurers who have written D&O coverage for corporations and their directors and officers have made increasing efforts in recent years to disclaim coverage when confronted after the fact with corporate financial scandals that threaten huge financial exposure. These challenges to coverage have been raised under a variety of theories.

As some recent decisions show, however, D&O insurers have experienced difficulties in their attempts to avoid exposure from the D&O policies that they wrote for companies who later became enmeshed in accusations of financial fraud. One recent case, *In re HealthSouth Corporation Insurance Litigation*, involved a challenge to coverage involving what is known as the "severability" clause in a D&O policy. Another recent case, *Federal Insurance Company v. Kozlowski, Tyco International Ltd., et al.*, arising from the corporate scandals at Tyco, involved the question of whether the D&O insurer can be compelled to advance defense costs for a director or officer on a current basis before there has been a final determination of the insurer's claim that the policy is subject to rescission or the coverage is subject to an exclusion. Both of these decisions rejected various insurer tactics to disclaim coverage at an early stage of the proceedings.

Severability Clauses

HealthSouth was a consolidated action in federal court in the Northern District of Alabama involving claims and counterclaims by ten insurance carriers seeking to rescind coverage or, alternatively, to obtain a declaratory judgment that their policies provided no coverage, to HealthSouth Corporation and various of its officers, directors, and employees named as insureds under those policies. Parallel actions by other insurers were also pending in Alabama state court.

The carriers in both the state and federal court litigations essentially alleged that HealthSouth used materially false and misleading financial information to procure insurance coverage, and that the company's D&O insurance policies were therefore void *ab initio*. The insurance carriers pointed to the SEC's investigation of HealthSouth's financial filings, and to

the numerous guilty pleas entered by former HealthSouth officers and employees who admitted they participated in a scheme to alter company financial reports to meet Wall Street expectations. The insureds (including former HealthSouth CEO Richard Scrushy, represented by Chadbourne & Parke LLP litigation partners Thomas Sjoblom and Robert Schwinger) moved for partial summary judgment seeking a determination that the “severability clauses” in the D&O policies precluded rescis-

Thus, the severability clause read together with the representations clause provides that [the insurer] can only rescind as to an insured person who personally made a knowing misrepresentation in the written application on which [the insurer] relied to issue the policy.”

The Court rejected the insurers’ argument that they could base rescission on misrepresentations other than in the written application for the policy, such as in publicly filed and certi-

If the companies can rescind coverage because of misstatements or misleading statements in HealthSouth SEC filings, without showing that the individual insured knew of the misstatement, then coverage under the D&O policies would be totally illusory.

sion of coverage as to all insureds under the primary policies. In a March 2004 ruling, the federal court ruled in the insureds’ favor, and a parallel favorable ruling was issued in the companion state court actions.

By statute or policy language, a D&O policy often can be rescinded (or be subject to an exclusion) if it has been procured through a material misrepresentation during the application process. When a single policy covers multiple insureds, “severability clauses” deal with the issue of whether a misrepresentation by one insured can taint and void the coverage for a fellow insured who may be ignorant of the misrepresentation and/or innocent of any alleged corporate wrongdoing underlying the misrepresentation.

The federal court concluded that the language of the primary HealthSouth D&O policy waived innocent misrepresentations as a basis for rescission of the coverage. It held that the severability clause, which was contained in the same provision as the representations clause, unambiguously provided that the rights of *each* insured as to coverage must be separately determined, and that no representations or knowledge of any insured person would be imputed to any other insured person. Such a provision “effectively negates innocent misrepresentations as a basis for rescission,” concluded the Court. “Only statements made with personal knowledge of their falsity can be used by the carrier for the purpose of denying coverage.

fied financials that were allegedly tainted by fraud. The Court held that this argument was inconsistent with policy language because “[t]he severability clause makes knowledge of each individual insured relevant for rescission purposes as to each insured.” Thus, “[w]ithout proof that an individual insured had knowledge of any false statements by HealthSouth, the severability clause precludes rescission as to that insured.” “If an insurance company meant to say that knowledge of the Insured Organization was to be imputed to Insured Persons,” said the Court, “it could have provided so in the policy.”

The Court also noted that public policy concerns argued against allowing insurers to rescind coverage indiscriminately to all insureds in circumstances such as these. “If the companies can rescind coverage because of misstatements or misleading statements in HealthSouth SEC filings, without showing that the individual insured knew of the misstatement, then coverage under the D&O policies would be totally illusory,” thus injuring directors and officers who were completely innocent of any wrongdoing and in no position to know that any misrepresentation had ever been made during the D&O coverage application process. Allowing such a result “would violate the manifest intent of the policy, and would ignore the motivation for obtaining officers and directors coverage in the first place — to protect officers and directors from liability for actions of the corporation.” The Court concluded that / *continued page 12*

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“without such coverage, or under the interpretation urged by the [insurers], finding qualified persons to serve on a board of directors would be next to impossible.”

Advancement of Defense Costs

The second case, *Federal Insurance*, presented the increasingly seen situation where a D&O insurer who believes that a policy is properly subject to rescission on the grounds that it was procured through fraud, or that coverage is properly subject to an exclusion, refuses to cover the D&O’s defense costs even before there has been a formal adjudication of those issues. In *Federal Insurance*, the Appellate Division of the Supreme Court of the State of New York affirmed a lower-court ruling that in such circumstances the D&O insurer must continue to defend or advance defense costs on a current basis until the issues of rescission or exclusion are adjudicated in the insurer’s favor, at which time the insurer would be able to seek recoupment of any prior payments that in retrospect were never owed.

Federal Insurance involved a D&O insurer’s claims against Tyco and various of its officers, including its former CEO Dennis Kozlowski. The company and its directors and officers were

lying legal proceedings. Tyco became embroiled in securities litigation raising claims that Tyco and Kozlowski had engaged in misrepresentations that had artificially inflated Tyco’s share price. Additionally, Kozlowski and others were charged with breaches of fiduciary duty as to certain ERISA plans and were criminally indicted for stealing from Tyco. After the insurer learned of these claims against Tyco and Kozlowski, it issued a notice purporting to rescind the policy on the grounds that there were misrepresentations in the company financial statements upon which the insurer claimed it had relied in issuing the policies. The insurer also filed suit seeking a declaration that the policies were rescinded and void, and that coverage relating to the criminal prosecution could be denied under the “personal profit” exclusion.

Kozlowski responded by moving for partial summary judgment, seeking a declaration that the D&O insurer was required to defend him in the ERISA action and pay his defense costs in the securities litigation and the criminal prosecution. The trial court held that until the insurer’s rescission claims were litigated and determined in its favor, the policy obligation to defend or pay for a defense remained in effect, although if the insurer ultimately prevailed on its rescission claim, it could seek to recover the costs of the defense it had provided

The D&O insurer must continue to defend or advance defense costs on a current basis until the issues of rescission or exclusion are adjudicated in the insurer’s favor, at which time the insurer would be able to seek recoupment of any prior payments that in retrospect were never owed.

covered by two policies, one providing Executive Liability and Indemnification (ELI) coverage and the other providing Fiduciary Liability coverage. The Fiduciary Liability policy contained a duty-to-defend provision while the ELI policy had no duty-to-defend provision but simply a provision requiring the insurer to pay defense costs. The ELI policy also contained certain exclusions, including one for claims involving the insured’s “having gained in fact any personal profit, remuneration or advantage to which such Insured Person was not entitled.”

The challenges to coverage arose because of several under-

Kozlowski. The lower court also held that since the claims in the criminal case did not fall “solely and entirely” within the “personal profit” exclusion, the insurer could not rely on that exclusion to withhold paying Kozlowski’s criminal defense costs.

The New York Appellate Division, in a March 2005 ruling, affirmed. The Appellate Division described the primary issue presented on the appeal as “whether [the insurer] . . . may avoid its obligations by electing to rescind by notice on the grounds of material misrepresentations and omissions in the

information provided for the issuance of the policies.” While the Appellate Division first noted that the insurer had failed to meet its *factual* burden for establishing the grounds for rescission for misrepresentation (particularly in light of severability provisions which required the insurer to show Kozlowski’s own participation in the alleged fraudulent inducement), it went on to point out important *legal* principles beyond that.

The Appellate Division held that, even apart from the sub-

Kozlowski did not directly profit), the applicability of the personal profit exclusion to the criminal prosecution was “properly rejected” by the lower court.

Insofar as a policy with a *duty to defend* is involved, the Appellate Division explained that “the obligation to defend is readily understood and its requirement is clear — the insurer must afford a defense to the insured for covered as well as non-covered claims if the latter are intertwined with covered

Insofar as a policy with a duty to defend is involved, the “the obligation to defend is readily understood and its requirement is clear — the insurer must afford a defense to the insured for covered as well as non-covered claims if the latter are intertwined with covered claims.”

stantive merits of the D&O insurer’s claim for rescission, the insurer could not simply “avoid the policy’s defense obligations by the assertion of a common-law rescission by notice, based on fraudulent inducement, without the need of a judicial determination to that effect” — at least when the insurer gave such notice unilaterally, two years after the policy in question had gone into effect, and after claims under the policy already had been asserted. The Appellate Division concluded that “in such circumstances, a rescission by notice cannot, without legal sanction, have retroactive effect and serve to suspend, even temporarily, obligations that — absent a basis for rescission — have accrued under the policy.” However, held the Appellate Division, “as to any claim of obligation under the policy not yet incurred, [the D&O insurer’s] rescission by notice would be prospectively effective.”

The Appellate Division also concluded that the D&O insurer could not at this time withhold coverage based on its view that ultimately the “personal profit” exclusion from coverage would be found to be applicable to certain of the claims in the criminal action. Noting that “the duty to defend is broader than the duty to indemnify,” the Appellate Division held that because the allegations in each of the lawsuits demonstrated that the claims asserted did not solely and entirely fall within the personal profit exclusion (*e.g.*, they included making false entries to facilitate loans for other Tyco employees, from which

claims.” The situation was slightly more nuanced, however, when it came to policy provisions that simply *reimbursed* defense costs but did not include a duty to defend, particularly in regard to the timing of when the insurer would be required to provide reimbursement to the director or officer who was running up defense costs.

“Under a directors and officers liability policy calling for the reimbursement of defense expenses,” said the Court, “insurers are required to make contemporaneous interim advances of defense expenses where coverage is disputed, subject to recoupment in the event it is ultimately determined no coverage was afforded.” The Court explained that “the contemporaneous payment of defense costs is required because the only reasonable interpretation of the loss clause in the . . . D&O Policy is that the insurer’s obligation to pay accrues when the insured incurs the obligation, not after it has paid a judgment.”

However, “while [the D&O insurer] must pay defense costs as they are incurred in the securities action and the criminal proceeding, its ultimate liability for such costs is only with respect to such liabilities as fall under the coverage provided. To the extent such liabilities are excluded from coverage by the personal profit exclusion, [the D&O insurer] is not required to pay for defense costs.” Thus, as a practical matter, “since this allocation cannot be made at this juncture and the duty to defend is broader than the duty to indem- / *continued page 14*

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nify, [the D&O insurer] must pay all defense costs as incurred, subject to recoupment when Kozlowski's liabilities, if any, are determined."

In sum, the recent rulings in *HealthSouth* and *Federal Insurance* provide powerful tools for protecting the ability of

corporate officers and directors to rely on D&O coverage to fund a defense — particularly in the early stages of cases of alleged fraud in company financial statements or claims of personal enrichment. These rulings will play important practical roles in crafting the defense of directors and officers who must face expensive litigation over claimed financial improprieties at companies. ©

Gemstar Article — Addendum

By James Lee, Associate

In the last issue of the Newswire, we discussed the recent decision of the Court of Appeals for the Ninth Circuit, *SEC v. Gemstar-TV Guide Int'l, Inc.*, in which the Ninth Circuit reversed the lower court's ruling that the Securities and Exchange Commission could escrow termination payments made to a corporation's officers as "extraordinary payments" under Section 1103 of the Sarbanes-Oxley Act of 2002.

The Ninth Circuit concluded that the SEC had failed to demonstrate that the termination payments at issue were extraordinary, and based its decision on the SEC's failure to present any evidence as to what would constitute an "ordinary payment under the same or similar circumstances." The SEC petitioned for and was granted en banc review of the *Gemstar* decision.

By decision dated March 22, 2005, the Ninth Circuit on rehearing affirmed the district court decision and ruled that the SEC could escrow termination payments totaling over \$37 million to be made to two corporate officers pursuant to Section 1103 of the Sarbanes-Oxley Act. *See SEC v. Gemstar-TV Guide Int'l, Inc.*, 401 F.3d 1031 (9th Cir. 2005). Section 1103, codified in Section 21C(c)(3) of the 1934 Exchange Act, provides that:

[w]henever, during the course of a lawful investigation involving possible violations of the Federal securities laws by an issuer of publicly traded securities or any of its directors, officers, partners, controlling persons, agents, or employees, it shall appear to the Commission that it is likely that the issuer will make **extraordinary payments** (whether compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days. (Emphasis added.)

The Ninth Circuit ruled en banc that the determination as to whether a corporation's intended payments to its officers were "extraordinary" could be made by "using as a measure what ordinarily goes on in the process of the issuer's business." *Gemstar*, 401 F.3d at 1046. In so doing, the Court affirmed the district court's avoidance of any "one litmus test" and focus on "the nature, purpose, and circumstances of the payments" in determining that the payments were unrelated to the company's "ordinary business." For example, the Court noted that the termination payments to the two officers were five and six times greater than their respective base salaries. The Court also noted that the terms and elements of the termination packages were benefits of the type not expected "to be flowing from corporate assets to executives resigning under fire from key management positions." The Court even took into account the fact that one of the executives refused to testify regarding the termination agreements when questioned by the SEC, choosing instead to plead the Fifth Amendment. The Court found these facts sufficient to establish that the intended payments were "clearly unusual and extraordinary."

The dissenting opinion criticized the majority for, in effect, rewriting the text of Section 1103 from allowing the SEC to escrow extraordinary payments to allowing escrow of any payments made under extraordinary circumstances. Under the majority decision, the dissent claims that escrow is available to the SEC any time "a company under investigation gives a departing executive not a golden parachute, but a mere gold

watch (or, even, a gold-plated watch).” The dissent favored an approach of considering an intended payment in relation not to simply the corporation itself, but rather to other similarly situated corporations.

Practical Tips

In view of the majority’s interpretation of Section 1103, however, the following practice tips bear repeating:

- ⊙ To the extent possible, determine termination or severance

- packages for officers in similarly situated companies;
- ⊙ Termination or severance payments should be reasonably consistent with prior years’ salaries and bonuses;
- ⊙ Officers with similar experience and levels of responsibility should receive similar termination or severance packages; and
- ⊙ Officers should make such severance terms part of their employment agreement. SEC will have to litigate whether such terms of employment are extraordinary. ⊙

Best Execution and Amended Regulation NMS

Dennis Dumas, Counsel, and Stelio Tellis, Summer Associate

In recent years securities markets have undergone significant and ever accelerating changes, ranging from the implementation of new technologies and the development of hybrid markets, to trading in penny increments.

In *The Securities Act Amendments of 1975*, Pub. L. No. 94-29 (1975) (1975 Act Amendments), Congress passed legislation to encourage the establishment of a national market system (NMS) together with a system for nationwide clearing and settlement of securities transactions. Among the reasons stated for the amendments, Congress stated in Section 2 of the Exchange Act that one purpose was:

“[T]o remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto.”

To achieve this objective, the 1975 Amendments granted the SEC the authority to oversee the NMS’s development and implement necessary rules.

Consequently, the SEC conducted a broad and systematic review that sought to determine how best to keep the NMS compliant with these objectives, including, among other enhancements, optimizing the quality of execution (best execution). Earlier, the SEC had concluded that best execution only could be achieved where open competition between markets provides investors with a *central, liquid market* through which to route their trades. *See, e.g., Securities and Exchange Commission Market 2000 Report: Study V, Best Execution*, 1994 SEC LEXIS 136 (January 1994). (Emphasis added.)

Historical Best Execution

Historically, the Commission based its analysis of a broker’s best execution obligation on several factors, including execution price, speed of execution, size of the order, trading characteristics of the security involved, availability of accurate information and of technological aids to process such information that affect choices as to the most favorable market center for execution, and the cost and difficulty associated with achieving an execution in a particular market center. *See Newton v. Merrill Lynch*, 135 F.3d 266, 270 n.2 (3d Cir. 1998) (citing Securities Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934 (Oct. 13, 1993)).

The duty of best execution requires that a broker-dealer execute securities transactions for clients in such a manner that the client’s total costs or proceeds from each transaction is most favorable under the circumstances. *See In re Sage Advisory Services LLC, As Successor To Standard Asset Group LP, And Standard Group Holdings LLC, As Successor to Standard Asset Group, Inc., Respondents.*, Release No. 33, 7997, Release No. 34, 4460, Release No. 7997, Release No. 44600, Release No. IA - 1954, 74 S.E.C. Docket 1073, 2001 WL 849405 (S.E.C. Release No. 2001). This duty of best execution predates the federal securities laws and has its roots in common law obligations of undivided loyalty and reasonable care. Although it never was codified by Congress or promulgated in a specific rule by the SEC, the duty of best execution later was / continued page 16

Best Execution

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incorporated into SRO rules. See, e.g., *NASD Conduct Rule 2320*; *New York Stock Exchange Rule 123A.41*. Moreover, SEC decisions and exchange proceedings hold that a broker-dealer's failure to fulfill its best execution obligation is actionable under the antifraud provisions of the federal securities laws. *Order Execution Obligations*, Exchange Act Release No. 37619A, 61 Fed. Reg. 48,290 (Sept. 6, 1996). See also *In re E.F. Hutton & Co., Inc.*, Exchange Act Release No. 25887, 41 SEC Docket (CCH) 413, 418 (July 6, 1998).

For example, the SEC found that customer orders routinely executed at the national best bid or offer when superior prices are reasonably available can violate the duty of best execution. See *In re Geman*, Security and Exchange Commission Release Notice, Release No. 34, 43963, Release No. 43963, Release No. IA - 1924, 74 S.E.C. Docket 852, 2001 WL 124847 (S.E.C. Release No.

receive the most favorable terms. *NASD Notice to Members 02-73*, 2002 WL 31408879 (Oct. 18, 2002).

The best execution standard is also implicated by practices such as trading ahead and interpositioning. A district court held that a broker-dealer acted improperly when it filled a customer order through a proprietary trade for its own account and thereby improperly "traded ahead" of the other customer order. As a result, the other customer order was disadvantaged because it was executed at a price inferior to the price received by the dealer account. *United States v. Oakford Corp.*, 79 F. Supp. 2d 357 (S.D.N.Y. 1999); See also *Opper v. Hancock Securities Corp.*, 250 F. Supp. 668 (S.D.N.Y. 1966). In addition, the SEC found that certain specialists improperly interpositioned themselves between a buy and sell order when they bought stock for their firm dealer account from a customer sell order, and then filled another customer's buy order by selling from the dealer account at a higher price, thereby realizing a profit for the firm

This duty of best execution predates the federal securities laws and has its roots in common law obligations of undivided loyalty and reasonable care.

2001). The SEC concluded that the potential for price improvement must be considered when inquiring into best execution obligations. The SEC also found a violation of the best execution standard where an investment advisor required a customer to pay higher commissions than were otherwise available. The SEC was critical of the investment advisor's failure to seek more reasonable execution terms. *In re Sage Advisory Services LLC, As Successor to Standard Asset Group LP, And Standard Group Holdings LLC, As Successor to Standard Asset Group Inc., Respondents.*, Release No. 33 - 7997, Release No. 34 - 44600, Release No. IA - 1954, 75 S.E.C. Docket 1073, 2001 WL 849405 (2001). In addition, the NASD extended the best execution standard to securities futures products because the NASD wanted to ensure that where a customer's order may be executed in more than one market, its members used reasonable diligence to find the market in which the order would

dealer account at the expense of the firm's two customers involved in the transaction. See, e.g., *In re Fleet Specialists, Inc.*, Security and Exchange Act Release No. 34, 49499, 2004 SEC LEXIS 744 (April 15, 2005). In these trading ahead and interpositioning cases, the broker-dealers benefited at the customer's expense, without the customer's contemporaneous knowledge or consent.

Regulation NMS

On June 9, 2005, the SEC promulgated extensive groundbreaking rules under Regulation NMS (Reg. NMS), effective August 29, 2005, with implementation dates varying for differing provisions, some on its effective date, and most, due to their complexity and related systems and compliance issues, phased in during the period ending September 1, 2006. See Regulation NMS, Release No. 34-51808, File No. S7-10-04, 2005

WL 1364545 (June 9, 2005). Reg. NMS reflects the SEC's apparently continuing belief that a *central liquid market* is necessary in order to achieve its Congressional statutory mandate, including investor protections like seeking to further enhance best execution. However, consistent with a government imposed a single, static, centralized market structure, Reg. NMS subjects market participants to extraordinarily extensive SEC rules, controls and SEC staff micromanagement, as detailed in the Commission's daunting 523-page Reg. NMS release.

Two highly analytic and respected Commissioners, Cynthia A. Glassman and Paul S. Atkins, both voted against the adoption of Reg. NMS. Simultaneously with the Commission's adoption of Reg. NMS, they issued a formal Dissenting Opinion (the Dissent). The Dissent states that the Commission failed to comply with its statutory mandate:

We support Regulation NMS' overarching goal of enhancing the efficiency of our markets. We do not believe, however, that Regulation NMS will achieve this goal, and we are concerned about its detrimental impact on competition and innovation. In our view, Regulation NMS is at odds with Congress' goal, expressed in the 1975 Act Amendments, of protecting competition within the national market system. In analyzing Regulation NMS and voting to dissent from its adoption, we have been guided by Congress' clear preference that competitive forces, rather than unnecessary regulation, guide the development of the national market system. With the adoption of Regulation NMS, the majority's arbitrary notions and unfounded assumptions about how markets and investors should interact have taken unwarranted precedence over the interplay of competitive forces within the marketplace. We believe that Regulation NMS turns back Commission policy regarding competition and innovation and sets up roadblocks for our markets.

Dissent, at pp. 1 – 2 (Footnote citations omitted.)

Consistent with the objectives of Section 11A of the Securities Exchange Act of 1934, which predates Reg. NMS, the NASDAQ market provided investors with the ability to determine where they can obtain the best price and provides linkages that allow them to obtain the best price available. This permitted market participants to comply with their best execution duty discussed above under "Historical Best Execution."

Ironically, Reg. NMS's "one size fits all" approach to best execution likely will reduce this quality of execution. Reg. NMS introduces the "Order Protection Rule" (NMS Rule 611), which establishes intermarket protection against "trade-

throughs" for all National Market System (NMS) stocks. A "trade-through" occurs when one trading center executes an order at a price that is inferior to the price of a protected quotation (a quotation displayed and immediately accessible through automatic execution), which often represents an investor limit order displayed by another trading center. Accordingly, Reg. NMS requires market professionals to comply with the trade-through prohibition — which radically changes the market structure generally by requiring market professionals to base execution decisions *only* upon price. Professionals now must be ever cognizant of order flow in other market centers. However, the SEC asserts in the promulgating release that Reg. NMS does not change existing best execution standards. As described earlier, best execution standards require proper consideration and appropriate action based on factors including, (i) execution price, (ii) speed of execution, (iii) size of the order, (iv) trading characteristics of the security involved, (v) availability of accurate information and technological information processing aids that affect choices as to the most favorable market center for execution, and (vi) the cost and difficulty associated with achieving an execution in a particular market center. Thus, the SEC's questionable assertion about Reg. NMS' failure to change existing best execution obligations may well encourage regulators and customers to sue market professionals for not complying with best execution, asserting, e.g., that manual quotes and depth of book should have been considered and properly reflected in execution.

Practical Tips

The Order Protection Rule appears at odds with historical best execution duties, and the SEC comment that such duties have not changed can be problematic unless the SEC adopts a rule with the force of law that addresses best execution after Reg. NMS. Market professionals and their firms may wish to consider disclosing to and obtaining customer acknowledgment of the Reg. NMS Order Protection Rule's impact on execution, and customer agreement that Reg. NMS compliance necessarily fulfills the best execution duty. ☺

This article solely expresses the authors' overview of the topics covered, and does not constitute legal advice. The narrow topics covered include certain aspects of best execution as potentially impacted by certain Reg. NMS Order Protection Rule provisions (other details and extensive, material Reg. NMS provisions are beyond this article's scope).

Blocking the Avenues to Mutual Fund Market Timing

By *Tamara L. Stevenson, Associate*

Although professional investors, particularly hedge funds, have been market timing mutual funds for years, the actions taken by prosecutors in the latest round of market timing scandals may signal the demise of the practice, as prosecutors have now effectively blocked both major avenues to market timing.

First came the market timing scandals that began in 2003, with New York Attorney General Eliot Spitzer's prosecution of mutual fund companies that had entered into undisclosed agreements with hedge funds to allow the timing of their funds. This is exemplified by the now infamous hedge fund, Canary Capital Partners LLC, and the mutual fund companies that granted it timing capability — most notably Bank of America's Nations Funds. The payment by the mutual fund companies of hundreds of millions of dollars to settle the charges against them signal the end of this route to market timing. Next, regulators targeted traders and the broker-dealers who hire them, in an effort to obstruct the second major path to market timing — that is timing, "under the radar", in which the mutual fund companies are not complicit in the timing, and in most instances, do not even know it is occurring. The recent revocation of the state-issued trader registrations of the CBS Group, three Merrill Lynch advisers, and the \$13.5 million in fines paid by Merrill to settle charges against it, indicate that this avenue to market timing is also being closed. The clear message to hedge fund companies, mutual fund companies, traders and broker-dealers is that all major routes to mutual fund market timing have now been roadblocked with liability landmines.

Mutual fund market timing is a form of arbitrage in which mutual fund shares are bought and sold on a very short-term basis in order to exploit inefficiencies in mutual fund pricing. It works because the price of a mutual fund share, the Net Asset Value or NAV, is updated once per day based on the closing price of the securities in the fund. If the prices of the securities in the fund are "stale," in that they don't reflect their fair market value at the time the NAV is calculated, the pricing differential creates an arbitrage opportunity for savvy market-timers. This can happen, for example, where large pricing gaps exist in international funds due to time zone differences.

While market timing is not itself illegal, it is considered by the regulators to be a shady practice. This is because it benefits the timers, usually hedge funds, and sometimes the mutual fund companies themselves if they have exchanged the right to time their funds for lucrative incentives, at the expense of long-term

investors. The arbitrage profit that is captured by effective timing comes dollar-for-dollar out of long-term investors' pockets. In addition, timers impose their transaction costs on long-term investors, and trades necessitated by timer redemptions can lead to the realization of taxable gains at undesirable times or the selling of funds into a falling market.

Because of the deleterious effects of market timing, fund managers, as fiduciaries, are obligated to take precautions to curb market timing. Large movements in and out of funds are easy to spot and some mutual funds even employ "timing police" to detect timing. Other steps that fund managers can take to deter timing include rejecting timers' purchases, instituting short-term trading fees (i.e., penalties) that effectively wipe out the arbitrage opportunity, giving the NAV a fair value (i.e., updating it at the end of the day when there have been moves that might render the NAV stale), keeping cash on hand to pay out the timers' profits without having to sell stock, and entering into investments in an attempt to hedge against timing activity.

Fund managers are aware of the harmful effects of market timing; they have a fiduciary obligation to protect their investors from it; and they are armed with a bevy of tools with which to mount their anti-timing war. In spite of this, mutual fund timing has occurred for years. It has proceeded along two well-trodden paths. The first avenue to timing is through undisclosed agreements with mutual funds in which the funds permit, and sometimes facilitate, the timing in exchange for incentives from the timer. The second route to market timing is through the timer's actions to conceal the timing activity from the mutual fund and others who will not sanction it, so-called "timing under the radar." This article discusses both of these avenues to market timing and examines the actions taken by regulators since 2003 to effectively block them by charging those involved, whether they are complicit in the timing or merely fail to adequately supervise their employees, with wrongdoing.

Timing Through Undisclosed Agreements

First, market timing can occur through secret agreements in

which the mutual fund company agrees to selectively permit certain investors to time its shares in exchange for incentives — essentially, it sells the right to time its fund. The price for timing capability may be the timer’s promise to keep the funds within the fund “family,” which enables the fund manager to collect fees on the trades. Another common incentive is the timer’s offer to park long-term investments, so-called “sticky assets,” in one of the fund manager’s financial vehicles in exchange for timing capability. These sticky assets also produce fees for the fund manager. Selling timing capability in this fashion becomes problematic, however, when the mutual fund has publicly disclosed that timing is not permitted and that it will take steps to prevent it. In fact, by selling timing capability to select hedge funds in contradiction of their public disclosures prohibiting *all* timing, mutual fund companies make themselves susceptible to a fraud action.

Beginning in 2003, the SEC and state regulators aggressively targeted mutual fund companies that secretly sell timing capability to certain hedge funds in violation of their disclosures that all timing will be prohibited. As one of the most notable examples, the SEC and state regulators prosecuted some of the largest mutual fund companies — Bank of

settle the charges against them. Thus, by targeting mutual fund companies that enter secret timing agreements despite their representations against timing, regulators have effectively blocked this avenue to market timing.

Timing Under the Radar

CBS Group’s market timing scheme exemplifies the second way in which mutual fund timing occurs — timing under the radar — in which actions are taken to conceal the timing activities. In violation of Merrill Lynch’s policy against short-term trading of mutual funds, during 2002 and 2003, three Merrill advisors, Christopher Chung, Kevin Brunnock, and William Savino, known as the “CBS Group,” used Merrill’s system to place 12,457 trades in at least 521 mutual funds and 63 mutual fund sub-accounts on behalf of hedge fund client, Millennium Partners L.P. Over half of those funds and sub-accounts made profits, from which Millennium earned about \$60 million. These earnings represented the skimming of short-term gains which were siphoned off to the detriment of long-term investors.

Rather than being complicit in CBS Group’s timing scheme, Merrill Lynch and most of the mutual fund companies involved were themselves defrauded. CBS Group took elaborate steps to conceal their short-term trades from the mutual funds it timed

The fraudulent conduct involved splitting up trades among multiple accounts and transferring investments through different accounts to avoid detection and gain additional capacity.

America’s Nations Funds, Bank One Corp., Janus Capital Group, Inc. and Strong Funds — for claiming in their prospectuses that they did not permit timing and disclosing their policies and procedures aimed at quelling it, only to sell the right to time the funds to the Canary Capital hedge fund. According to regulators, these disclosures were material misrepresentations constituting a fraudulent scheme in violation of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and/or their state-law counterparts. The mutual fund companies paid hundreds of millions of dollars to

and from the broker-dealer it used to effectuate its trading schemes. The group’s fraudulent conduct involved splitting up trades among multiple accounts in order to avoid detection of the short-term moves and transferring investments through different accounts at Merrill in order to avoid detection and gain additional capacity. Despite Merrill’s anti-timing policies and its “timing police” aimed at ferreting out timers, CBS Group placed over 12,457 short-term trades through Merrill’s platform. When mutual fund companies alerted Merrill to the timing activity, Merrill responded with steps aimed at stop- / *continued page 20*

Mutual Fund Market Timing

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ping the timing, including insisting that the timing stop and that CBS Group take itself off as broker of record and stay at arms-length from the trading activity, allowing the group to accept only liquidating orders from Millennium, conducting an internal investigation, and eventually firing the group.

The administrative complaint against CBS Group alleged that the group violated New Jersey's Blue Sky laws by making material misrepresentations and defrauding mutual fund companies and their investors. In addition to seeking civil monetary penalties, the New Jersey Attorney General revoked the broker registrations of CBS Group. Merrill was also targeted in the investigation for failing to properly supervise the group and take adequate follow-up actions once they were notified of the timing activities. Merrill paid a total of \$13.5 million to settle the charges against it and agreed to implement and enforce strict policies aimed at detecting and deterring market timing by its traders. As a warning to all

Conclusion

In conclusion, hedge funds, and other sophisticated investors, have timed mutual funds for years — a trading strategy that has never been per se illegal. In order to gain this timing capacity, hedge funds have either bought timing capability with sticky assets or other incentives, or have timed under the radar by concealing their activities. By charging mutual fund companies that enter into timing agreements with fraud and pulling the license of traders who engage in short-term mutual fund trading while fining and sanctioning the broker-dealers who hire them, regulators have targeted all possible parties and have obstructed all routes to market timing. In addition, in light of the large fines and penalties that have befallen those who have timers amongst their midst, mutual funds and broker-dealers are now charged with ferreting out and deterring market timers. The clear message is that timing will not be tolerated and that the mutual funds, hedge funds, traders, and broker-dealers who traverse the traditional market timing paths now face a very risky and expensive journey.

In light of the large fines and penalties that have befallen those who have timers amongst their midst, mutual funds and broker-dealers are now charged with ferreting out and deterring market timers.

broker-dealers who, wittingly or not, have timers amongst their midst, Susan Merrill, the chief of regulatory enforcement at the NYSE, explained that “[w]hen a firm discovers that brokers have engaged in misconduct, the exchange expects and demands that the firm will heighten supervision and take all necessary action to ensure that the conduct has ceased.” Even though Merrill was itself a victim of CBS Group's fraud, and even though the broker-dealer took steps to stop the timing, it was punished to the tune of \$13.5 million for not being able to stop the timers from flying under its radar. Thus, by revoking the traders' licenses and charging them with fraud, and imposing sharp penalties upon the broker-dealer who hired them, regulators have underscored the risks inherent in both timing under the radar and in being duped by such a scheme. In doing so, regulators have placed substantial obstacles along this path to mutual fund timing.

Practical Tips

- ⊙ Maintain adequate records of mutual fund trading and look for red flags of market timing such as rapid in-and-out trading.
- ⊙ Investigate any potential market-timing activities and communicate findings to boards and shareholders.
- ⊙ Apply policies aimed at deterring market timing fairly and consistently — do not enter into undisclosed market timing agreements with select entities.
- ⊙ Limit frequent trading.
- ⊙ Charge short-term trading fees or practices to eliminate the arbitrage opportunity and deter market timing.
- ⊙ Give the NAV a fair value at the end of the day to counteract moves that might render it stale.
- ⊙ Reject discovered timers' purchases and/or ban them from trading the funds in the future. ⊙

SEC Enforcement Division Loses Significant Case Involving CLASS B Mutual Fund Shares

By Scott S. Balber, Associate and John G. Moon, Counsel

An initial decision of administrative proceeding, *In the Matter of IFG Network Securities, Inc., et al.*, File No. 3-1179 (decision issued Feb. 10, 2005), is sure to give the Division of Enforcement pause before it plans to bring more cases for the sale of so-called “B shares.”

In this matter, brokers were charged with violating, and aiding and abetting violations of, the anti-fraud provisions of the Securities Act, the Exchange Act and the Investment Advisors Act. After a hearing lasting more than 21 days, Administrative Law Judge Carol Fox Foelak dismissed all charges, finding that the brokers’ *failure to disclose* to customers that purchasing Class A shares would have produced higher returns than Class B shares was *not actionable* because there were certain circumstances in which Class B shares could have outperformed Class A shares.

Background

This enforcement proceeding involved the sale of Class B mutual fund shares to retail customers of three registered brokers. The Division of Enforcement alleged that between 1998 and 2000, the brokers recommended that customers invest \$250,000 or more in Class B mutual funds “without disclosing...that Class A shares of the mutual funds that they were purchasing would have produced materially higher returns than Class B shares of the same mutual fund.” The Division further alleged that, because of the availability of break points and lower annual expenses for Class A shares, and because sales of Class B shares generated significantly higher commissions, the brokers violated the anti-fraud provisions of the federal securities laws by not disclosing the advantages of Class A shares.

The respondents did not dispute that they failed to tell their customers that investments of \$250,000 or more in Class A shares would have produced materially higher returns than Class B shares of the same mutual fund. However, the brokers established that, in certain circumstances, Class B shares outperform Class A shares. Furthermore, the brokers were able to argue that the prospectuses they provided to their customers described the features of each share class, which included the relative expense ratios for Class A and Class B shares, as well as the break points that were available in the purchase of Class A shares.

In order to understand Judge Foelak’s decision, one must appreciate the difference in fee structures between Class A and Class B mutual fund shares. For Class A shares, the purchaser incurs an initial sales charge (commonly known as a “front-end load”) when the shares are purchased. As a result of this front-end load, the amount of the investment that can be “put to work” in the market is reduced. In contrast, when an investor purchases a Class B share, all of the investor’s money is put into the market. For class B shares, instead of an upfront charge, the broker is paid: (1) a charge known as a contingent deferred sales charge (“CDSC”) that is imposed on the redemption of shares at a percentage rate that declines over time; and (2) a portion of an ongoing asset-based fee known as a 12b-1 fee. Such fees are ordinarily used to defray the costs of marketing, sales and distribution of fund shares. NASD rules limit 12b-1 fees to 0.75% of average assets per annum.

Further blurring the distinction between fees that impact the relative investment performance of Class A and Class B shares, it is common practice for mutual funds to offer discounts that reduce the initial sales charge for large investments in Class A shares. Such discounts are known as “break points.” In the *IFG Networks* case, the maximum front-end load on Class A shares was between 4.75% and 5.5%, depending on the fund. At the \$250,000 break point, the charge dropped to between 2% and 3%, again depending upon the fund.

The deferred sales charge for the funds involved in the administrative proceeding were initially between 4% and 5%, depending on the fund, and these sales charges declined to zero over a period of six years. Therefore, after six years, the B shares ostensibly converted to A shares, thereby eliminating the difference in expenses resulting from the 0.75% paid annually in 12b-1 fees imposed on B shares.

Other mutual fund industry practices added variables that impacted relative share performance. For example, break points were not available for the purchase of B / *continued page 22*

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shares. Furthermore, a sales charge was not imposed on the appreciated value of the fund shares, nor was it imposed on shares purchased with dividends or capital gains distributions. Finally, the CDSC was not imposed on redemptions made according to a plan of systematic withdrawal of up to 10 or 12% per year, depending on the fund.

Findings of Fact

In light of the variety of factors determining how fees would be charged against Class A or Class B shares, it is not surprising that the Administrative Law Judge found that an investment of \$250,000 in Class A shares will generally, but not always, outperform Class B shares. Relative investment performance between Class A and Class B shares were found to be impacted by several variables. These include the holding period, tax con-

The Division of Enforcement had argued that “the complete story required disclosing that Class A shares would likely outperform the Class B shares at the \$250,000 investment level because of the reduced sales charges and lower monthly expenses.” However, the court found this argument did not comport with its earlier allegations that the respondents sold Class B share mutual funds “without disclosing...the Class A shares of the mutual funds that they were purchasing would have produced material higher returns than Class B shares of the same mutual funds.”

A “secondary” legal conclusion of the court is even more interesting with respect to its probable impact on the Commission’s enforcement program. The brokers had argued that the marketing of Class A and Class B mutual fund shares should be addressed through “prospective” rule making rather than through “retrospective” enforcement actions. While noting the well-settled rule that an administrative agency retains the dis-

The Division of Enforcement had alleged that, for an investment of \$250,000 or more, “Class A shares of the mutual funds . . . would have produced materially higher returns than Class B shares of the same mutual funds.” That simply was not supported by the record.

siderations, the rate of systematic withdrawal, and the rate of return. For example, systematic withdrawals may yield higher returns for Class B shares than Class A shares, particularly if withdrawals commence soon after the investment.

Furthermore, when the mutual fund waives the sales charges in the event of a death or disability, Class B shares outperform Class A shares if the death or disability occurs within the first several years of the investment.

Legal Conclusions

Judge Foelak concluded that the Division of Enforcement failed in its proof. The Division of Enforcement had alleged that, for an investment of \$250,000 or more, “Class A shares of the mutual funds . . . would have produced materially higher returns than Class B shares of the same mutual funds.” That simply was not supported by the record. Moreover, Class A shares will not outperform Class B shares in all circumstances.

cretion to choose whether to proceed through particularized litigation or by general rule, the Administrative Law Judge (“ALJ”) commented that the Commission has published for comment and considered, but has failed to adopt, rule changes that would regulate the way Class A and Class B shares are marketed. (The ALJ was referring to the Notice of Proposed Rulemaking, Prohibition On The Use Of Brokerage Commissions To Finance Distribution, File No. S7-09-04, 82 SEC Docket 986 (March 1, 2004), and Confirmation Requirements And Point Of Sale Disclosure Requirements For Transactions In Certain Mutual Funds And Other Securities, And Other Confirmation Requirement Amendments, And Amendments To The Registration Form For Mutual Funds, File No. S7-06-04, 82 SEC Docket 6 (Feb. 10, 2004)).

The ALJ held that “in light of the conclusion that A shares do not always outperform B shares at the \$250,000 level and in light of the Commission’s rule making proceedings regarding

sales loads and disclosure, it is concluded that none of the registered representatives violated the anti-fraud provision in regard to disclosure about the relative performance of A and B shares.”

Conclusion

There is a certain tension within Judge Foelak’s opinion. On the one hand, it is well recognized that the SEC has the option to carry out its regulatory functions either through rulemaking or through adjudication. On the other hand, the ALJ found it significant that the Commission had issued a notice of proposed rule-

making on the matter. The court did not go so far as to hold that the issuance of a notice of proposed rule making negated the intent of the brokers that was necessary to find a violation. While we understand that the Division of Enforcement is appealing to the full Commission the ALJ’s initial decision as to three of the brokers, in light of the SEC’s and NASD’s broad “industry sweeps” that involve the sale of B shares, it can be expected that this opinion will, at least for the time being, cause the Division of Enforcement’s Staff to reconsider its negotiation position with market participants. ©

NASD and SEC Focus on Gifts and Gratuities

By Lauren S. Goodstein, Partner

When it comes to gifts and gratuities on Wall Street, the NASD and SEC have become anything but charitable. In fact, at the Securities Industry Association’s annual conference this past April, both the NASD and SEC identified gifts and gratuities as items on their “Top 10 List” of enforcement matters for the upcoming year.

It has long been the case that employees of an NASD member firm are prohibited from making gifts or payments in excess of \$100 per year to any client or business associate if the gift or payment is “in relation to the business” of the recipient’s employer. The intent of the rule is to protect against any conflict of interest that might arise if, for example, a member firm tried to secure business as a *quid pro quo* for one or more inappropriate gifts; after all, it is axiomatic that investment advisors should direct stock trades to brokerage firms that can offer the best price and best execution, rather than to those that give the best “perks.” As many industry participants are quick to point out, however, the long-standing restriction on excessive gifting and entertainment is often ignored, and has rarely taken center stage on the NASD’s or SEC’s agenda. Until now.

Rumors Give Rise to Sweep

Last fall, amidst rumors that brokers were furnishing mutual fund traders with extravagant boondoggles, Super Bowl tickets and other lavish gifts in order to attract business, the NASD and SEC commenced an industry-wide inspections sweep of the gift and entertainment practices on Wall Street. The first example to come to light involved a host of improper gifts made by a broker at Jefferies & Co. to traders at Fidelity Investments; however, accounts were rampant of similar gift-giving practices industry-

wide. Recent press reports indicate that regulators are focusing on tickets that Fidelity Chairman and CEO Edward C. Johnson III received from another Wall Street firm to attend a figure skating event with his wife at the 2002 Winter Olympics. In all, as many as two dozen major brokerage firms and mutual fund companies have now come under informal investigation, and at least two firms, Fidelity Investments and Lazard Ltd., have been contacted by the U.S. Attorney’s office in Boston.

In general, the focus of the sweep has been to determine whether investment advisers have directed trades and commissions to broker-dealers in return for frequent or excessive gifts. However, regulators have also been examining the policies and procedures that member firms have in place in order to monitor and recognize any potential conflicts of interest.

NASD Rule 3060: The “Gifts and Gratuities” Rule

The NASD rule at issue, NASD Conduct Rule 3060(a), “Influencing or Rewarding Employees of Others,” provides that:

No member or person associated with a member shall, directly or indirectly, give or permit to be given anything of value, including gratuities, in excess of one hundred dollars per individual per year to any person, principal, proprietor, employee, agent or

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representative of another person where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity. A gift of any kind is considered a gratuity.

Rule 3060(b) provides a limited exception for amounts paid under a contract of employment, or as compensation for services rendered, so long as, prior to the time of employment or before the services are rendered, there is a written agreement in effect between the NASD member and the person who is to perform such services. The written agreement must include the nature of the proposed employment, the amount of the proposed compensation, and the written consent of the person's employer or principal. Rule 3060(c) requires members to keep records of all payments or gratuities, regardless of amount.

The scope of Rule 3060 was clarified by an interpretive letter issued by NASD Regulation in 1999, which explained that the rule was not intended to limit "ordinary and usual business entertainment" by an NASD member. See June 24, 1999 Interpretive Letter responding to a request for guidance submitted by Henry H. Hopkins and Sarah McCafferty, T. Rowe Price Investment Services, Inc. (the "Interpretive Letter"). According to the Interpretive Letter, "when a member or its associated persons are *hosting* clients and their guests at an occasional meal, sporting event, theater production or comparable entertainment event, the [NASD Regulation] staff would not regard such business entertainment as governed by Rule 3060 *so long as it is neither so frequent nor so extensive as to raise any question of propriety*" (emphasis added). The letter further advised that in observing the \$100 limit, gifts or gratuities must be "valued at cost, and may not be discounted on the theory that they would not otherwise be used."

On its face, the 1999 Interpretive Letter established a two-pronged test for *exceptions* to the NASD's gift-giving restriction: (1) the gift-giver must actually be present (*i.e.*, "hosting") at the event, and (2) the entertainment must not be unduly frequent or extensive. However, the second prong of the test created something of a trap for the unwary (or, more to the point, the un-stingy), since a determination as to when repeated client entertainment might raise questions of propriety is inherently subjective. Far from offering clear and prophylactic guidance on application of the rule, the 1999 Interpretive

Letter invites a member firm to exercise its own judgment in distinguishing between permissible and impermissible business entertainment.

A second interpretive letter, issued in March of 2001, underlined that Rule 3060 applies only to payments or gratuities relating to the business of the recipient's *employer*. See March 15, 2001 Interpretive Letter responding to a request for guidance submitted by Charles Wiegert, NFP Securities. At issue in the 2001 letter was whether a registered representative was permitted to reimburse a client for (1) airfare, hotel, food or travel expenses incurred by the client to attend a business meeting with the registered representative to discuss its estate and financial planning matters, and/or (2) its estate planning fees. The letter concluded that since the payments at issue were to be made in connection with the financial and estate planning of the *client itself*, and did not relate to the business of the client's employer, the payments were *not* subject to the limitations of Rule 3060(a).

Past Enforcement of NASD Rule 3060

In the recent past, when the NASD's rule on gratuities has made headlines, the violations at issue have not in fact involved "close calls" or issues of subjective judgment. For example, in May of 2004, the NASD announced that Phua Young, a former managing director and senior research analyst with Merrill Lynch, had been fined \$225,000 and suspended for one year in connection with a series of NASD rule violations, including a violation of Rule 3060. Mr. Young, who had been the senior Merrill analyst providing research coverage of Tyco International Ltd., had developed a close relationship with Tyco's then chief executive officer, Dennis Kozlowski. Among his other transgressions, according to the NASD, Mr. Young gave Mr. Kozlowski a case of wine valued at over \$4,500, clearly in excess of the \$100 limit.

A unique application of the gratuities rule surfaced one year earlier, in March of 2003, when the NASD charged Frank Quattrone, formerly head of the technology sector investment banking unit (Tech Group) at Credit Suisse First Boston (CSFB), with a series of infractions including the "spinning" of IPO shares and resulting violations of Rule 3060. According to the NASD's complaint, in order to win and retain investment banking business, Mr. Quattrone's Tech Group routinely would make the shares of certain coveted initial public offerings available to select technology company insiders who had the ability to influence their employers' choice of investment bankers. The Tech Group would then generate enormous and virtually risk-free profits for these strategically selected individuals by establishing

discretionary trading accounts in their names, allocating various hot IPO shares to their accounts, and then quickly “flipping” the shares in the aftermarket. Based on NASD accounts, this practice resulted on at least one occasion in profits of more than \$1.3 million. The NASD concluded that the handing out of such profits to industry insiders was tantamount to the making of cash gifts in excess of \$100, and therefore violated Rule 3060’s prohibition on excessive gifts and gratuities.

Chilling Effect of Sweep

In light of the heightened focus by the NASD and SEC on the gratuities rule and its abuses, firms now appear leery of making extravagant expenditures with respect to client entertainment, and many on Wall Street have decided to “play it safe” by instituting policies akin to BYO (“bring your own”) when it comes to once lavish events such as firm-sponsored PGA golf tournaments. Moreover, some companies are undertaking their own internal reviews in order to tackle any excessive gifting issues proactively. Lazard Ltd. has reported that, in the aftermath of its own internal review, several employees from its capital markets group have now left the firm. Moreover, as a result of its internal investigation, Fidelity Investments disciplined at least 16 employees for violating the company’s policies on conflicts of interest, and at least five traders have left the firm. In a press release issued in December of last year, Fidelity announced that it had strengthened its gift policies and procedures by restricting the instances in which business-related gifts may be accepted and by modifying its reporting requirements; the company also said that it was in the process of enhancing its management and oversight of trading operations. / continued page 26

Another Win for Selective Waiver

By Lauren S. Goodstein, Partner

With the recent decision in *In re Natural Gas Commodity Litigation*, No. 03 Civ. 6186 (VM)(AJP), 2005 U.S. Dist. LEXIS 11950 (S.D.N.Y. June 21, 2005), anyone keeping score can chalk up another victory for the proponents of selective waiver. In finding that defendants American Electric Company, Inc. (AEP) and Aquila Merchant Services (Aquila) were entitled to work product protection with respect to documents they had previously turned over to the Commodity Futures Trading Commission (CFTC), the Federal Energy Regulatory Commission (FERC) and other governmental agencies, Magistrate Judge Peck in the Southern District of New York added fuel to the continuing debate over the selective waiver doctrine.

Defendants AEP and Aquila had been the subject of inquiries by the CFTC and FERC into instances of inaccurate reporting of natural gas transactions by certain of their employees. In connection with these inquiries, each of the defendants had retained outside counsel to conduct an internal investigation, and each of their respective counsel had engaged an expert consultant to assist in analyzing the relevant data.

In the course of the investigations and settlement negotiations, each of AEP and Aquila had been asked to provide the CFTC and other agencies (FERC and the Department of Justice, in the case of AEP; and the FBI, in the case of Aquila) with materials summarizing or otherwise reflecting analyses undertaken by and at the direction of the defendants’ outside legal counsel. However, prior to turning over any “work product” materials to the governmental agencies, each defendant had entered into explicit, written confidentiality and non-waiver agreements securing each agency’s commitment to keep the privileged information confidential, and asserting the selective and limited nature of the disclosure and waiver being made. In most cases, defendants also requested confidential treatment of their documents under the Freedom of Information Act.

On the basis of defendants’ prior disclosures to the governmental agencies, the plaintiffs in *In re Natural Gas* moved to compel production of these documents in their case as well, claiming that defendants’ prior production of the materials constituted a complete waiver of any applicable privilege, and that, in any event, plaintiffs’ “substantial need” overcame any protection for the factual material contained therein. The court disagreed.

The selective waiver doctrine was first established by the Eighth Circuit in *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1978) (en banc), which applied the rule even though the privileged materials at issue had been disclosed without a confidentiality agreement in place. However, since then, other circuits have / continued page 27

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Practical Tips

It remains to be seen what will come of the ongoing gifts and gratuities investigations, but the NASD is considering revisions to Rule 3060 in light of the conflicts of interest that have already been uncovered. It is likely that any amendments to the rule will aim to provide a more objective measure of what constitutes “excessive” entertainment; it is equally likely that regulators will begin to require more thorough disclosure of any payments made, and will expect management to exercise greater responsibility with respect to the amount and type of entertainment provided to clients. While awaiting the outcome of the sweep:

- ⊙ Management of all NASD member firms — even those not currently under scrutiny — should assess their own policies and procedures to determine whether they have sufficient controls in place to ensure compliance with NASD Rule 3060. If such controls are found to be either lacking or deficient, management should develop and implement programs which will more effectively detect and prevent any gift-related conflicts of interest.
- ⊙ NASD member firms and employees that provide gifts and business entertainment to industry colleagues should employ a common sense approach in determining “how much is too much”; if it would seem excessive to an outsider looking in, the NASD and SEC would likely agree.
- ⊙ Individuals should be mindful of ways in which permissible business entertainment can transform into an impermissible gift. The NASD’s 1999 Interpretive Letter advised that ordinary and usual business entertainment must be hosted by the individual (or firm) footing the bill. If a broker who has invited a mutual fund trader to join him at an NBA playoff game later learns that he is unable to make it to the game, he should find someone from his firm to go in his place; offering up his ticket so that the trader can bring his wife may convert what otherwise might have qualified as permissible business entertainment into a violation of Rule 3060.
- ⊙ Similarly, firms should avoid handing out expensive tickets to sporting or theatrical events on the theory that the tickets would otherwise “go to waste”; the gratuities rule applies even if the items given would otherwise go unused.
- ⊙ In order to avoid any inadvertent violation of Rule 3060 in connection with a bona fide business arrangement between one NASD member firm and the employee of another, the terms of the parties’ arrangement — including, for example, the nature of any services to be performed and the amount to be paid — should be memorialized in writing before any services are performed or any payments made. In addition, the parties should obtain in advance the consent of the employee’s firm or principal.
- ⊙ Finally, in order to avoid both the appearance of and any actual conflicts of interest, traders, investment advisers and other employees of NASD member firms that receive entertainment or gifts from other industry participants should perform regular self-assessments in order to ensure that, in making investment decisions on behalf of their customers, they rigorously follow best execution and suitability practices and are not influenced in any way by gifts or entertainment that they might receive. ⊙

Variable Annuities: In the Regulatory Crosshairs

by Dennis R. Dumas, Counsel

Regulatory and enforcement officials are focusing unprecedented attention on variable annuity and variable life insurance products (collectively, “variable insurance products”) and the people who distribute and market them. These products are hybrid investment products combining securities (typically mutual fund) features and life insurance features.

Regulatory and enforcement action has targeted some of the same abuses that have been found in the mutual fund industry — market timing and late trading. In addition, the complex product design of variable insurance products, the high level of charges and expenses imposed through variable insurance

products compared to conventional mutual funds and the high level of compensation paid to the people who distribute and market variable insurance products — all have led to heightened scrutiny relating to sales practices. Moreover, the overlapping federal securities and state insurance regulatory schemes

governing variable insurance products pose particular compliance challenges, where individuals marketing them are less familiar with one of the two schemes. As a result, issuers and distributors of variable insurance products must step up their compliance efforts to meet this new regulatory and enforcement scrutiny.

During the last year, there has been significant regulatory activity in terms of both new guidelines for sales practices and enforcement. The Securities and Exchange Commission and the National Association of Securities Dealers conducted a joint study of sales practices relating to variable insurance products. The results of this joint study were published in June 2004 in the Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (the "Joint SEC/NASD Report"), which detailed weak and sound practices with respect to suitability determinations, supervisory procedures, disclosure, maintenance of books and records and training. At the same time, the NASD proposed a new rule imposing specific sales practices standards and supervisory requirements on members in connection with the sale of deferred variable annuities. In June 2005, the SEC staff published a greatly expanded consumer bulletin entitled "Variable Annuities: What You Should Know," in an effort to increase consumer awareness of the decisions they must confront when they consider an investment in these products. Taken as a whole, the volume of new guidelines reflect concerns by the regulators that there is widespread confusion among investors with respect to these products, and serious weaknesses in the compliance programs of firms distributing and marketing these

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found a complete waiver of attorney-client and work product protection even in the presence of a confidentiality agreement; such was the case in the Sixth Circuit's decision in *In re Columbia/HCA Healthcare Corp.*, 293 F.3d 289 (6th Cir. 2002), *cert. dismissed*, 539 U.S. 977 (2003). The Delaware Chancery Court took an intermediate approach in *Saito v. McKesson HBOC, Inc.*, No. Civ. A. 18553, 2002 WL 31657622 (Del. Ch. Nov. 13, 2002), *aff'd*, 870 A.2d 1192 (Del. 2005), adopting a selective waiver rule for disclosures that are made to law enforcement agencies pursuant to a confidentiality agreement.

The Second Circuit's position on selective waiver was articulated in *In re Steinhardt Partners*, 9 F.3d 230 (2d Cir. 1993), which held that the defendant had waived its work product protection with respect to a privileged memorandum that had been turned over to the SEC without a confidentiality agreement in place. In so holding, the *Steinhardt* court cautioned that "[c]rafting rules relating to privilege in matters of governmental investigations must be done on a case-by-case basis. Establishing a rigid rule would fail to anticipate situations in which the disclosing party and the government may share a common interest in developing legal theories and analyzing information, or situations in which the SEC and the disclosing party have entered into an explicit agreement that the SEC will maintain the confidentiality of the disclosed materials." *Id.* at 236 (citations omitted) (emphasis added). This language has been viewed as leaving open the door for a finding of selective waiver in cases in which a confidentiality agreement *has* been employed, and in the wake of *Steinhardt*, district courts in the Second Circuit have focused on the presence or absence of a confidentiality agreement in considering whether to uphold the selective waiver doctrine on a given set of facts.

Consistent with this approach, Magistrate Judge Peck's decision in *In re Natural Gas Commodity Litigation* focused on the fact that both defendants had entered into explicit, written confidentiality and non-waiver agreements with each of the governmental agencies before turning over their privileged documents. However, the court did not find the existence of the confidentiality agreements to be dispositive. Rather, the court further relied on its finding that both defendants had already produced to the plaintiffs all of the same underlying factual documents used and relied upon by defendants' counsel and experts in rendering the work product analyses at issue. This distinguished the plaintiffs' situation from one in which, for example, the underlying materials consisted of oral information or information that had not been provided and was no longer available. Given that plaintiffs and their experts could perform their own analyses of the relevant data, the court held that plaintiffs had failed to demonstrate a substantial need for those performed by defendants' experts and counsel. For these reasons, taken together, the court denied the plaintiffs' motion to compel and upheld defendants' assertion of selective waiver. ©

Variable Annuities

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products. These conditions also are a precursor to regulatory enforcement opportunities, reflected by the stepped-up level of activity in this area.

Joint SEC/NASD Report

The Joint SEC/NASD Report states that it is “not a comprehensive roadmap for compliance with respect to the sale of variable insurance products Firms should consider the information in

and other increased expenses resulting from such switches or replacements. Supervisory procedures that fail to detect such unsuitable recommendations are cited as weaknesses. In the area of disclosure, the Joint Report advocates specific firm-approved disclosures concerning the features and risks of variable insurance products in addition to delivery of a current prospectus for a recommended variable insurance product. The Joint Report also details sound books and records keeping and training practices that would be wise to emulate.

The NASD proposed a new rule that would make mandatory the “best practices” that it had previously identified with respect to the sale of deferred variable annuities.

this report in assessing their own systems and procedures and in implementing improvements that are tailored to and work best for their firm.” Like many such statements from regulators, there is a risk in reading the qualifying introduction too literally, and failing to detect the compulsory nature of the balance of the statement. Any organization involved in the distribution and marketing of variable insurance products acts at its own peril if it does not (i) review the *weak* practices, policies and procedures identified in the Joint Report, and make a concerted effort to root out and eliminate any similar practices, and (ii) review the *sound* practices, policies and procedures identified in the Joint Report, and assure itself that its own practices, policies and procedures are conforming or, if they are not, adapt its own practices, policies and procedures to conform to those identified in the Joint Report as sound.

The Joint SEC/NASD Report identifies many concerns with respect to the suitability of recommendations to purchase variable insurance products in light of the age, financial or tax status, investment objectives, sophistication, risk tolerance, liquidity requirements, need for insurance and ability to benefit from the tax-deferred nature of variable insurance products. This report also identifies abuses in terms of recommendations of switches or replacements of variable insurance products with newer variable insurance products without regard to surrender charges

Proposed NASD Rule

In Notice to Members 04-45 (June 2004), the NASD proposed a new rule that would make mandatory the “best practices” that it had previously identified with respect to the sale of deferred variable annuities in Notice to Members 99-35 (May 1999). The proposed rule sets forth standards for suitability determinations, disclosure, principal review and supervisory and training procedures. The proposed rule’s key provisions include:

Appropriateness/Suitability. The proposed rule would require members and persons associated with members to make the following determinations when recommending a deferred variable annuity transaction: (1) the customer has been informed of the unique features of the deferred variable annuity; (2) the customer has a long-term investment objective; and (3) the deferred variable annuity as a whole and the underlying sub-accounts are suitable for the particular customer. These determinations would have to be documented and signed by the associated person who makes the recommendation and performs the required analysis.

Disclosure and Prospectus Delivery. The proposed rule would require members and associated persons to provide the customer a current prospectus and a separate, brief, “plain English” risk disclosure document that highlights the main features of

the particular variable annuity transaction, including, but not limited to: (1) liquidity issues, such as potential surrender charges and the IRS penalty; (2) sales charges; (3) fees, such as mortality and expense charges, administrative fees, charges for riders or special features and investment advisory fees; (4) federal tax treatment of variable annuities; (5) any applicable state and local government premium taxes; and (6) market risk.

Principal Review. No later than one business day following the date of execution of the deferred variable annuity application, a registered principal would be required to review and approve the transaction, regardless of whether the transaction had been recommended. In addition, when the member or an associated person has recommended the transaction, a registered principal would be required to review and approve the suitability analysis document no later than one business day following the date of execution of the deferred variable annuity application. Finally, when the transaction involves an exchange or replacement of a deferred variable annuity, regardless of whether the transaction has been recommended, a registered principal would need to review and approve a separate exchange or replacement document (which would cover issues specific to exchanges or replacements) no later than one business day following the date of execution of the deferred variable annuity application.

Supervisory Procedures. Members would be required to establish and maintain specific written supervisory procedures rea-

SEC Consumer Brochure And Enforcement

As noted above, on June 1, 2005, the SEC issued a revised and expanded consumer bulletin giving detailed guidance on what investors should know about variable annuities. The recently revised SEC bulletin increases the amount of information investors “should know” from the previous 2004 SEC guidance — by a factor of ten.

This increase in information is significant. It provides investors with a list of questions to consider, and a number of resources to learn more information. In addition, it provides detailed information on a number of different aspects of variable annuities. Among the key points highlighted in the bulletin are:

Death Benefits. The bulletin gives detailed examples of how various scenarios will work, and the stepped-up death benefit feature of some variable annuities. It also discusses guaranteed minimum income benefit and long-term care insurance, and explicitly cautions a potential investor to understand the fees associated with such benefits.

Variable Annuity Charges. The bulletin gives examples and details of various charges and cautions that such charges lower both the value of the account and the return on your investment. It explains surrender charges and how surrender periods work, mortality and expense risk charges, administrative fees, underlying fund expenses, and other potential fees. In addition, it provides clear examples of each such charge.

The recently revised SEC bulletin increases the amount of information investors “should know” from the previous 2004 SEC guidance — by a factor of ten.

sonably designed to achieve and evidence compliance with the standards set forth in the proposed rule.

Training. Members would need to develop and document specific training policies or programs designed to ensure that associated persons who effect, and registered principals who review, transactions in deferred variable annuities comply with the requirements of the proposed rule and that they understand the unique features of deferred variable annuities, including liquidity issues, sales charges, fees, tax treatment, and market risks.

1035 Exchanges. The bulletin explains how tax-free Internal Revenue Code Section 1035 exchanges work and cautions about surrender charges customers may have to pay. It advises careful comparison between the two annuities involved in the exchange, due to the imposition of a new surrender charge period. The bulletin also warns about how such exchanges may inadvertently result in a tax imposition.

Bonus Credits. The bulletin discusses bonus credits, a feature offered by certain insurance companies that / *continued page 30*

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add a bonus to the contract value based on a percentage of the purchase price. It warns that such variable annuities may have higher expenses that outweigh the benefit of the bonus credit involved, and highlights a number of typical charges that may be higher than typical variable annuities.

SEC Enforcement Actions

In recent months, there has been significant SEC enforcement activity centered on variable annuities. In *In the Matter of Putnam Investment Management, LLC*, the Securities and Exchange Commission reached a \$40 million settlement with Putnam over allegations that the Boston fund company had “shelf space” arrangements with broker-dealers. In a cease-and-desist order from March 23 of this year, the SEC stated that from at least 2000 through 2003, Putnam failed adequately to disclose that its fund distribution arm, Putnam Retail Management,

that in fact, for some investors, Hawes never bought the policies but rather took the policy “premium” for himself. For other investors, the complaint alleged that Hawes initially purchased the annuities but later liquidated them without the clients’ knowledge or authorization, keeping the proceeds for himself. Hawes then hid his fraud from these investors by sending false account statements to the investors showing inflated balances and omitting the unauthorized fee deductions. The SEC barred Mr. Hawes from association with any broker, dealer or investment adviser, and he was convicted in a federal court of criminal charges resulting in a sentence of 98 months in prison and an order to pay restitution in the amount of over \$2.5 million.

Finally, the SEC has given heightened scrutiny to market timing of mutual funds through the sale of variable annuities. The first enforcement action charging insurance companies with securities fraud for facilitating market timing through variable annuities came on August 9, 2004 against subsidiaries of Conseco, Inc. (CIHC, Inc., Conseco Services, LLC, and Conseco Equity

The SEC has proposed rules, which if adopted will vastly increase point-of-offer, pre-sale and confirmation disclosure concerning all forms and amounts of brokerage firm and registered representative compensation relating to any mutual fund product.

agreed with more than 80 broker-dealers that they promote the sale of Putnam funds that underlie variable annuities. More than 60 broker-dealers improperly got directed brokerage commissions from Putnam in return, according to the SEC. The \$40 million SEC settlement with Putnam will be distributed to shareholders of the affected funds.

The SEC, in conjunction with the Department of Justice, also is focusing upon other areas related to variable annuities. The Commission instituted an administrative proceeding against a financial planner for fraud related to variable annuities. In *In the Matter of Bryan James Hawes*, filed March 15, 2005, the SEC alleged that Hawes, individually and through entities he controlled, misappropriated at least \$1.2 million when he falsely told certain investors that he had purchased, as they had directed, annuity policies as investment vehicles. The complaint alleged

Sales, Inc.), the company to which Conseco sold its variable annuity business in 2002, Inviva, Inc., and Inviva’s subsidiary, Jefferson National Life Insurance Company. In *In the Matter of CIHC, Inc., et. al.*, the defendant insurance companies agreed to settlements that included a total payment of \$20 million in disgorgement and penalties plus mandatory compliance reforms. The SEC found that the prospectuses concerning the variable annuities at issue misleadingly represented, among other things, that the annuities were “not designed for professional market timing organizations.” However, according to the Commission: (i) the insurance companies affirmatively marketed and sold the annuities to professional market timers; (ii) eventually, market timing assets constituted the majority of assets invested in the variable annuity products; and (iii) the insurance companies profited by the fees earned from the sales of the annuities to the market timers.

NASD Enforcement Actions

In a complaint filed in January 2004, the NASD charged Waddell & Reed, Inc., with violating its obligations under the NASD's suitability rule by failing to take reasonable steps to ensure that recommended variable annuity exchanges were in the best interests of customers. The NASD alleged that Waddell undertook an aggressive campaign to switch clients from one variable annuity, offered by United Investors Life Insurance, to another, offered by Nationwide Insurance. According to the NASD, the Nationwide annuity paid Waddell more, and the firm failed to take reasonable steps to make sure the annuity was in its clients' best interests. Under terms of the April 29, 2005 settlement of the NASD case against Waddell, Waddell will pay a \$5 million NASD fine, plus \$2 million to state regulators. Because investors were obligated to pay so-called "surrender charges" when they switched annuities, Waddell may be required under the April 29, 2005 NASD settlement to pay as much as \$11 million in reimbursement to clients who paid fees as part of the switching campaign.

The NASD also has turned a watchful eye to variable universal life insurance policies (VULs) — a type of life insurance policy that allows the owner to direct the investment of premiums among various mutual fund subaccounts, similar to a variable annuity. On March 16 of this year, the NASD fined Jefferson Pilot Variable Corporation over \$560,000 for failing to have an adequate supervisory system in place to prevent market timing and excessive trading in the sub-accounts of its VULs. The NASD found that, despite having an electronic system theoretically designed to recognize and block sub-account transfers in excess of policy limits, Jefferson Pilot failed to determine whether the system was functional. Given the firm's exclusive reliance on this system to monitor sub-account transfers, such follow-up and review was essential in the NASD's view. Because of this failure, 292 policyholders were permitted to exceed the 20-transfers-per-policy-year limit described in the prospectus, and two VUL policyholders were allowed to engage in market timing in the shares of three different funds, which resulted in additional profits of \$238,697.

Another NASD action related to a single registered representative who recommended and executed one unsuitable sale and purchase of variable annuities, where the customer incurred a large penalty for liquidating one variable annuity to purchase a different variable annuity. The NASD found that the representative violated a variety of NASD rules by recommending transactions to the customer without having a reasonable basis for believing that the transactions were suitable. In connection with

the *one* sale, the NASD suspended the representative for six months, imposed a fine of \$5,000, and ordered the representative to pay the customer's entire liquidation penalty.

SEC & NASD Proposed Rulemaking

Introduction. The SEC has proposed rules, which if adopted will vastly increase point-of-offer, pre-sale and confirmation *disclosure* concerning *all* forms and amounts of brokerage firm and registered representative compensation relating to any mutual fund product. This change is intended to plainly inform customers of facts that may cause any potential conflict of interest impacting the brokerage firm and its registered representatives. If adopted, for example, the SEC rule will require unambiguous customer disclosure, pre-sale, that a registered representative's recommendation also pays the highest "all in" sales compensation. This ought to prompt further customer questions about comparable mutual funds with lower compensation, and require the representative to justify the recommendation by demonstrating the superiority to the customer of the recommendation versus competing products with lower aggregate sales compensation. If a representative is unable to do so, then presumably the potential customer either refuses the recommendation, or accepts the recommendation. As these required facts also are available to the firm's supervisors and compliance department, if the firm's system of supervision does not detect and prevent repeated instances of such situations, the SEC may well bring an enforcement action against *both* the representative (for making unsuitable recommendations) *and the firm* (for failure to supervise). If adopted, the rule will apply to most variable insurance products, since typically they include a mutual fund feature.

In contrast, the NASD proposal, if adopted, absolutely prohibits (i) *all non-cash compensation* arising from the sale and distribution of any security (including variable insurance products with mutual fund or securities features), and (ii) *all product-specific "sales contests."* This may well adversely impact new product roll outs by firms, which often utilize these practices to encourage quick and thorough representative familiarity with new products (including variable insurance products normally including securities features).

SEC Proposed Disclosure Rule. On January 29, 2004, the Commission proposed new rule 15c2-2 under the Exchange Act, which, among other things, would govern the obligations of broker-dealers to disclose transaction-related information in confirmations or other documents when customers buy or sell certain investment company securities. The Commission also proposed new rule 15c2-3, which would govern the obligation of broker-

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dealers to disclose information to investors prior to effecting transactions in those securities.

According to the SEC, the proposed new rules respond to concerns that investors in mutual fund shares, Unit Investment Trust ("UIT") interests (including certain insurance company separate accounts that issue variable insurance products) and municipal fund securities used for education savings lack adequate information about certain distribution-related costs, as well as certain distribution arrangements, that create conflicts

to the sale and distribution of any security or type of security. NASD also proposes to prohibit all product-specific cash and non-cash "sales contests" as defined by the proposed rule.

If adopted, this proposal vastly expands current NASD restrictions. Today, the NASD currently restricts the payment and acceptance of non-cash compensation in connection with the sale of variable insurance contracts, direct participation programs, investment company securities, and public offerings of real estate investment trusts and other securities. The NASD currently also prohibits internal non-cash sales contests in connection with the sale of variable insurance contracts or investment

In June 2005 Notice to Members 05-40, the NASD proposes to expand the prohibitions of non-cash compensation to the sale and distribution of any security or type of security.

of interest for brokers, dealers, municipal securities dealers, and their associated persons. The SEC expressed the belief that disclosure of information about those costs and conflicts can help investors make better-informed investment decisions.

Proposed rule 15c2-2 would require specific confirmation disclosure of information about front-end and deferred sales fees ("loads") and other distribution-related costs that directly impact the returns earned by investors in mutual fund shares, UIT interests and 529 plan securities. It also would require brokers, dealers and municipal securities dealers to disclose their compensation for selling those securities, and to disclose information about revenue sharing arrangements and portfolio brokerage arrangements that create conflicts of interest for them. Moreover, the proposed rule would require brokers, dealers and municipal securities dealers to inform customers about whether their salespersons or other associated persons receive extra compensation for selling certain fund shares or fund share classes.

Through early September 2005, the SEC received over 5,000 comments concerning this proposal.

NASD Proposed Sales Contest and Non-Cash Compensation Prohibition. In June 2005 Notice to Members 05-40, the NASD proposes to expand the prohibitions of non-cash compensation

company securities unless they meet certain criteria, including that those contests are based on principles of total production and equal weighting.

While this article went to press, neither the SEC nor NASD adopted these proposed rules.

Practical Tips

Companies involved in the issuance, distribution or marketing of variable insurance products may wish to consider the adequacy of their systems and controls in light of all the recent government and regulatory activity. This activity should include the issues discussed in the Joint SEC/NASD Report, the NASD's proposed rule, the SEC's June 1, 2005 bulletin, and other recent regulatory guidance and enforcement actions. Such companies also should consider testing their systems and controls to determine whether they actually perform as intended. It may be advisable to outsource some testing and consideration to a third party, to provide management with an independent view and a perspective similar to that of a regulator later examining a potential problem or complaint. This may help prevent management from first learning about a deficiency as the result of a regulatory investigation, which may lead to threatened enforcement, or worse. ©

The Intersection of Parallel Criminal and Civil Proceedings: Departure From the Proper Administration of Criminal Justice

By Benjamin Ogletree, Associate

In the wake of recent high-profile corporate scandals, “parallel proceedings,” *i.e.*, concurrent or subsequent civil proceedings by an administrative agency (like the SEC) and a criminal proceeding or investigation targeting the same defendant by a U.S. Attorney or other criminal prosecutor, are increasingly common.

Although properly conducted parallel proceedings are generally not forbidden, they are inherently susceptible to abuse by prosecutors who may manipulate simultaneous civil and criminal matters to the government’s tactical advantage at the expense of a defendant’s constitutional rights. In some cases, the government has undermined constitutional safeguards applicable in criminal matters by misusing broad civil discovery powers to conduct a *de facto* criminal probe and obtain evidence for a subsequent criminal prosecution.

An elusive aspect of parallel proceedings is the problem of identifying the point at which simultaneous civil and criminal investigations improperly merge, and thus cease to be legitimate parallel proceedings. Although largely unnoticed in the aftermath of the recent acquittal of HealthSouth Corporation’s former Chief Executive Officer, Richard M. Scrushy, an April 15, 2005 ruling by the district judge in that case offers insight into this important but relatively undeveloped area of the law. *United States v. Scrushy*, 366 F. Supp. 2d 1134 (N.D. Ala. 2005). In its ruling, the district court dismissed three perjury counts against Mr. Scrushy that were predicated upon allegedly false testimony he gave in connection with an SEC investigation. The district court concluded that the U.S. Attorney’s Office could not prosecute Mr. Scrushy for perjury based on his SEC testimony because Mr. Scrushy had not been told at the time of that civil testimony that he was a target of an ongoing, parallel criminal investigation and because the government in other respects had “manipulated the simultaneous investigations for its own purposes.” The district court’s decision, which the government has decided not to appeal, furnishes much-needed guidance in answering the important question of what distinguishes a legitimate, parallel investigation from an improper one.

Scrushy’s SEC Testimony

In connection with the SEC’s ongoing investigation into HealthSouth, Neil Seiden, a senior accountant with the SEC’s Division of Enforcement, and other SEC investigators made arrangements to take Mr. Scrushy’s testimony on March 14, 2003 at the SEC’s offices in Atlanta, Georgia. But on March 12, 2003, two days before Scrushy’s scheduled testimony, Mr. Seiden and his SEC colleagues received a telephone call from the U.S. Attorney’s Office for the Northern District of Alabama. At that time, prosecutors informed the SEC investigators that HealthSouth executives Weston Smith and Bill Owens had told the U.S. Attorney’s Office about a billion dollar accounting fraud that purportedly was underway at HealthSouth and that Mr. Scrushy was aware of it.

During the March 12, 2003 telephone call, the U.S. Attorney’s Office enlisted the SEC’s assistance in the criminal investigation in several respects. *First*, Mr. Seiden was asked to participate with federal prosecutors in their upcoming interviews of Messrs. Smith and Owens so that the U.S. Attorney’s Office could have the benefit of Mr. Seiden’s accounting expertise in connection with the criminal investigation.

Second, during the March 12, 2003 conference call, prosecutors asked Mr. Seiden to move Mr. Scrushy’s testimony from Atlanta to Birmingham, Alabama so that Mr. Seiden would be available to participate in the U.S. Attorney’s Office’s interviews of Smith and Owens in Birmingham, and so that Mr. Scrushy could be prosecuted there if he were to perjure himself at his SEC testimony. According to one of the senior prosecutors who participated in the conference call, moving the deposition to Birmingham would ensure that “if [Mr. Scrushy] lies, then he will be lying in our district.” Although Mr. Scrushy’s attorneys themselves had requested that the testimony take place in Birmingham, prior to the March 12, / *continued page 34*

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2003 conference call, the SEC's preference was to depose Mr. Scruschy in Atlanta and SEC investigators knew of no reason to move the site of the testimony to Birmingham.

Third, during the March 12, 2003 conference call, the assistant U.S. Attorneys specifically asked Mr. Seiden not to question Mr. Scruschy at his deposition about certain HealthSouth accounting issues that the government was investigating. Mr. Seiden asked the federal prosecutors if he could ask Mr. Scruschy about HealthSouth's income statements and earnings per share and was told that he could not do so.

As directed by the U.S. Attorney's Office, Mr. Seiden waited for Mr. Scruschy's counsel to raise again their request that the testimony be moved to Birmingham (rather than raise the issue himself) because prosecutors did not want to give Scruschy's lawyers any reason to suspect that the government had uncovered and was investigating HealthSouth's financial fraud. As anticipated, Mr. Scruschy's lawyers made the request. At Mr. Scruschy's March 14, 2003 testimony, Mr. Seiden did not inform Mr. Scruschy or his lawyers that the SEC was cooperating with the U.S. Attorney's Office, or that Messrs. Smith and Owens also were cooperating with prosecutors and had accused Mr. Scruschy of criminal wrongdoing. After Mr. Scruschy's testimony was completed, Mr. Seiden went directly to the U.S. Attorney's Office in Birmingham and, over the next two days, participated in the government's interviews of Messrs. Smith and Owens.

The U.S. Attorney's Office charged Mr. Scruschy with three counts of perjury based on his SEC testimony. Mr. Scruschy and his lawyers, however, did not learn of the SEC's cooperation with the U.S. Attorney's Office in connection with Mr. Scruschy's testimony until two years later, when Mr. Seiden testified at Mr. Scruschy's criminal trial on April 5, 2005. Mr. Scruschy's lawyers thereafter filed a motion asking the district judge to suppress Mr. Scruschy's SEC deposition so that the U.S. Attorney's Office could not use it as evidence of perjury at the criminal trial.

The Merger of Parallel Criminal and Civil Proceedings “Departs From the Proper Administration of Justice”

The district court observed that evidence obtained in a civil action normally may be introduced by the government in a later criminal prosecution unless the defendant shows that such use would “depart from the proper administration of jus-

tice.” The court acknowledged that, even in the absence of a constitutional violation, the government's use of evidence it obtained by improperly manipulating parallel civil and criminal proceedings would constitute a “departure from the proper administration of justice.” The central issue raised by Mr. Scruschy's motion — on which neither the district judge nor the parties could find any controlling legal authority — was how to distinguish “a legitimate, parallel investigation from an improper one.”

As Chadbourne lawyers had persuaded another district judge in the Northern District of Alabama during the May 2003 SEC asset freeze hearing, *SEC v. HealthSouth Corp.*, 261 F. Supp. 2d 1298 (N.D. Ala. 2003), the district court presiding over the criminal case was equally persuaded that the U.S. Attorney's Office had improperly manipulated the parallel criminal and civil investigations, effectively merging them together in connection with Mr. Scruschy's SEC testimony for its own tactical purposes. Consequently, the court ruled that the government's utilization in the criminal case of Mr. Scruschy's SEC testimony departed from the proper administration of justice and, therefore, a perjury prosecution could not be predicated on that testimony. The court explained that, “[t]o be parallel, by definition, the separate [criminal and civil] investigations should be like the side-by-side train tracks that *never intersect*.” As noted, however, the district court determined that the SEC's civil enforcement investigation and the U.S. Attorney's Office's criminal probe did intersect, and thus ceased to be legitimate “parallel” proceedings.

Improper “Cloak And Dagger” Tactics. A crucial factor in the district court's analysis was that, at the request of federal prosecutors, the SEC did not tell Mr. Scruschy at the time of his SEC testimony that he was the focus of a related criminal investigation and that his testimony had been moved to Birmingham at the behest of federal prosecutors. Moreover, during the March 12, 2003 telephone call, prosecutors specifically instructed Mr. Seiden to take careful steps to change the location of Mr. Scruschy's testimony without alerting his attorneys that the government had uncovered HealthSouth's accounting fraud. The district court pointed out that “[w]hen a defendant *knows* that he has been charged with a crime, or that a criminal investigation has targeted him, he can take actions to prevent the providing of information in an administrative or civil proceeding that could later be used against him in the criminal case. When a defendant does not know about the criminal investigation, the danger of prejudice increases.” Because Mr. Scruschy was kept in the dark about the existence of the gov-

ernment’s overlapping criminal investigation, the court concluded that he was unfairly deprived of an opportunity to refrain from providing civil testimony that could be used against him in a subsequent criminal prosecution. The district judge candidly remarked that “[o]ur justice system cannot function properly in the face of such cloak and dagger activities by those charged with upholding the integrity of the justice system.”

Notice And Input. The district court pointed to the fact that the U.S. Attorney’s Office had advance notice of Mr. Scruschy’s SEC testimony and direct input into the manner in which it was conducted as further indications that the civil and criminal investigations had improperly coalesced as of March 12, 2003. Specifically, the court noted that during the March 12, 2003 conference call, “Mr. Seiden received explicit directions from the U.S. Attorney’s office concerning tailoring his examination of Mr. Scruschy,” and was asked to move the

had merged with the Department of Justice’s criminal probe. Indeed, during the March 12, 2003 conference call, prosecutors emphasized that one of the reasons the government preferred that Mr. Scruschy’s SEC testimony be taken in Birmingham was so that Mr. Seiden could participate in the interviews of Weston Smith and Bill Owens. In light of Mr. Seiden’s agreement to participate in the Government’s criminal investigation, the district court concluded that “he crossed over to the criminal investigation.”

The District Court Rejected The Government’s Arguments

In opposing Mr. Scruschy’s motion to suppress, the U.S. Attorney’s office contended that Mr. Seiden’s taking of Mr. Scruschy’s civil testimony could not be imputed to law enforcement because the SEC and the U.S. Attorney’s Office are distinct and separate entities of the U.S. Government.

Because Mr. Scruschy was kept in the dark about the existence of the government’s overlapping criminal investigation, the court concluded that he was unfairly deprived of an opportunity to refrain from providing civil testimony that could be used against him in a subsequent criminal prosecution.

site of the testimony from Atlanta to Birmingham, “thus changing the venue of the subsequent perjury charges from the Northern District of Georgia to the Northern District of Alabama.” Also, as a result of the March 12, 2003 conference call, the district court noted that Mr. Seiden avoided asking questions of Mr. Scruschy regarding HealthSouth’s accounting and finances and specifically included in his examination other questions that would not have been asked had the U.S. Attorney’s Office not contacted the SEC and discussed the criminal investigation. In short, the government’s demonstrated control over the civil agency process persuaded the district court to conclude that the civil and criminal investigations had in fact improperly merged.

Recruiting The SEC’s Help In The Criminal Investigation. The district court determined that the government’s recruitment of Mr. Seiden to participate in the criminal investigation further supported the conclusion that the SEC civil investigation

Characterizing this argument as “disingenuous at best,” the district court, stressed that Mr. Seiden, as a member of the SEC’s Division of Enforcement, “is employed by the United States Government — the same United States Government whose Department of Justice is prosecuting this case.” Moreover, because the SEC investigation had crossed over to the criminal investigation as a result of the March 12, 2003 conference call, the court concluded that Mr. Seiden’s actions in connection with the SEC testimony “are properly imputed to the Government for purposes of” Mr. Scruschy’s motion to suppress.

The district court also rejected the U.S. Attorney’s Office’s contention that it did not act in bad faith because “it did not outright lie to Mr. Scruschy about the existence of the criminal investigation.” In refusing to accept the government’s “limited view of bad faith,” the district court pointed out that the SEC had moved the testimony at the request of the U.S. / continued page 36

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Attorney's Office and that during the March 12, 2003 conference call, one of the government's veteran prosecutors had commented that by moving Mr. Scrushy's testimony to Birmingham, "if he lies, he lies in our district." The court explained that "such a comment by a seasoned assistant U.S. attorney who certainly knew the ramifications of venue raises more than an inference that the deposition was moved so that any possible perjury charges could be brought in this district." As further evidence of the government's bad faith, and reminiscent of the judge's findings during the SEC asset freeze hearings, the district court noted that the civil and criminal investigations "were no longer parallel but were commingled and thus improper," as demonstrated "by Mr. Seiden's immediate involvement in the criminal investigation, although he had previously been involved in the SEC civil investigation."

Lessons Learned

The district court's decision is unique in its effort to articulate and apply a workable standard for identifying the point at which overlapping civil and criminal investigations cease to be permissible parallel proceedings. As the court observed, simultaneous proceedings are "parallel," and thus permissible, only if they proceed "like the side-by-side train tracks that never intersect." But, as the district court noted, when contiguous civil and criminal investigations intersect — which occurs when the government improperly manipulates them for tactical purposes — the government departs from the proper administration of justice, and thus forfeits its ability to utilize for criminal prosecution evidence obtained in a civil proceeding. Whether other courts will follow and continue to develop the standard announced by the district court in this case remains to be seen. ☺

Document Destruction: Obstruction of Justice in SEC Investigations

By Benjamin Ogletree & Alan Ellman, Associates

On May 31, 2005, a unanimous United States Supreme Court overturned the 2002 criminal conviction of Enron Corporation's former auditor, Arthur Andersen LLP, handing the Department of Justice a resounding defeat in a high-profile case that previously had been heralded as one of the government's biggest victories in combating the recent wave of corporate financial scandals.

The Supreme Court held that the federal district judge who presided over the trial gave *overly broad legal instructions* to the Houston jury that found Arthur Andersen guilty of obstruction of justice for destroying Enron-related documents on the eve of a Securities and Exchange Commission probe into Enron's financial fraud in 2001. The justices ruled that due to the *erroneous jury instructions*, Arthur Andersen was wrongly convicted without proof that its shredding of documents was knowingly and intentionally aimed at obstructing the SEC's looming investigation.

Although many view the *Andersen* decision as a laudable attempt by the Supreme Court to remedy a case of prosecutorial overreaching, the victory is a hollow one for Arthur Andersen, a once highly regarded international accounting partnership that already had been decimated by its criminal indictment and conviction. Moreover, the *Andersen* ruling may

have little lasting impact on future obstruction prosecutions, given that a newly enacted obstruction of justice statute passed as part of the Sarbanes-Oxley Act of 2002 eliminated key legal requirements the government was obligated to prove under the obstruction statute that Arthur Andersen was charged with violating. Under the new statute, it will be easier for the government to obtain convictions for destruction of documents in future obstruction prosecutions. Now more than ever, corporations must implement sound document retention and management policies that ensure the preservation of documents and records that might be pertinent to a contemplated governmental regulatory proceeding.

The Andersen Indictment

As Enron's mounting financial improprieties became public in the Fall of 2001, Arthur Andersen directed its employees on its

Enron audit team to dispose of documents pursuant to Arthur Andersen's document retention policy. By early October 2001, Arthur Andersen's senior staff and in-house counsel had formed an Enron "crisis-response team" and were bracing for an SEC investigation that was thought to be "highly probable." Yet, the document destruction continued during this time in accordance with Arthur Andersen's document policy until the SEC subpoenaed Arthur Andersen and Enron for records and documents on November 8, 2001. Once the SEC subpoenas were issued, document destruction stopped.

In March 2002, Arthur Andersen was indicted on one count of violating 18 U.S.C. § 1512(b), which makes it a crime to "knowingly . . . corruptly persuade" another person to withhold or alter documents for use in an "official proceeding." The indictment alleged that in the thirty days leading up to the SEC's November 2001 issuance of subpoenas, Arthur Andersen "did knowingly . . . and corruptly persuade" other persons, *i.e.*, its own employees, to destroy documents material to the looming governmental regulatory and criminal proceedings.

The Faulty Jury Instructions

The Houston jury voted for conviction. The Supreme Court ruled, however, that the instructions the district judge gave to the jury failed to convey properly the elements of "corrupt persuasion" under section 1512(b) in several key respects.

"Consciousness" Requirement

The Supreme Court first explained that the district judge erred by failing to instruct the jury that section 1512(b) requires the government to prove that Arthur Andersen *knew* that it was breaking the law in ordering the destruction of Enron documents. The Court pointed out that the statute, by its terms, punishes only those who "*knowingly . . . corruptly persuade*" another. Noting that the term "knowing" is normally associated with awareness, understanding, or consciousness, the Court reasoned that in the context of section 1512(b), "[o]nly persons conscious of wrongdoing can be said to 'knowingly . . . corruptly persuade.'" The district court's jury instructions, the Supreme Court concluded, "simply failed to convey the requisite consciousness of wrongdoing" because the jury was told that "even if [Arthur Andersen] honestly and sincerely believed that its conduct was *lawful*, you may find [Arthur Andersen] guilty."

"Corruptly" Means "Dishonestly"

The Supreme Court also faulted the district court's instructions for improperly diluting the meaning of "corruptly." The district

court based its instruction on the definition of that term found in pattern jury instructions for another obstruction law that defined "corruptly" as "knowingly and *dishonestly*, with the specific intent to subvert or undermine the integrity" of a proceeding. The district court, however, in its instructions to the jury excluded "dishonestly" and added "impede" to the phrase "subvert or undermine." Thus, the jury was told to convict if it determined that Arthur Andersen intended to "subvert, undermine, or impede" the government's investigation by directing its employees to abide by Arthur Andersen's document retention policy.

The Supreme Court concluded that elimination of any type of "dishonesty" necessary to a finding of guilt was erroneous because, pursuant to the district court's instructions, it was enough for the jury to find that Arthur Andersen "innocently impeded" the government's fact-finding ability. The Supreme Court determined that this instruction did not comport with the plain language of section 1512(b), which specifically incorporates the term "corruptly" to make certain that innocent actors cannot be criminally liable under the statute.

"Official Proceeding" Requirement

Finally, the Supreme Court concluded that the district court's instructions were defective because they led the jury to believe that it could convict Arthur Andersen of violating section 1512(b) in the absence of "*any* nexus between the 'persua[sion]' to destroy documents and any particular proceeding." In other words, the jury was wrongly told to find Arthur Andersen guilty even if it did not know that Enron documents being shredded by its employees in the weeks prior to the SEC's issuance of subpoenas someday could be material to a particular official proceeding. Although the Court acknowledged that under section 1512(b) an official proceeding need not be pending or imminent at the time of the offense, it rejected the government's sweeping contention that "a proceeding need not even be foreseen." The Court rationalized that "[a] 'knowingly . . . corruptly persuade[r]' cannot be someone who persuades others to shred documents under a document retention policy when he does not have in contemplation any particular official proceeding in which those documents might be material." The Court concluded that if a defendant lacks knowledge that his actions are likely to affect an official proceeding, the defendant "lacks the requisite intent to obstruct."

Congress Reacts: A New Obstruction Statute

Although the *Andersen* decision was an unwelcome embarrassment to the Department of Justice, it is / continued page 38

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unlikely to impair the government's ability to obtain obstruction convictions in future document destruction cases. To ameliorate the difficulties that section 1512(b) posed for the government in the *Andersen* prosecution, Congress enacted as part of Sarbanes-Oxley a new obstruction provision, 18 U.S.C. § 1519, that will make obstruction convictions for document destruction much easier to obtain. Section 1519 makes it illegal to merely knowingly alter, falsify or destroy a document with the intent to impede, obstruct, or influence the investigation or

involved in the destruction of documents was unaware that someone else in the company knew of the violation of law.

In its brief to the Supreme Court in *Andersen*, the Department of Justice advised that from now on, most document destruction prosecutions will be charged under section 1519, including cases in which a defendant persuaded or aided subordinates in destroying documents. Because section 1519 already has lowered the bar erected by section 1512(b), under which *Andersen* was charged with obstruction of justice, the Supreme Court's *Andersen* decision may have little impact on future obstruction prosecutions.

Section 1519 also contains no requirement that a proceeding actually be pending or foreseen at the time of the offense.

Instead, the new statute requires only that the destruction or falsification of records occurs “in relation to or contemplation of any such matter or case.”

proper administration of any matter or case. Among other significant changes, the new law relieves the government of having to prove that the destruction was done “corruptly.” Now, the destruction need only be carried out “knowingly” (meaning that a defendant must only be aware that he or she is disposing of documents), but *without* a showing that the defendant knew his or her actions were *unlawful*. Section 1519 also contains no requirement that a proceeding actually be pending or foreseen at the time of the offense. Instead, the new statute requires only that the destruction or falsification of records occurs “in relation to or *contemplation* of any such matter or case.” Thus, knowledge by an officer or employee of a preliminary inquiry by the SEC, before subpoenas are issued, may be enough to trigger liability under the statute, even if the company itself has not been officially notified of such preliminary inquiry.

Further, section 1519 places *corporations* in a particularly difficult and vulnerable position because a corporate entity is deemed under the “collective corporate knowledge” doctrine to know everything known to each of its individual agents and employees. (See *Tamara L. Stevenson, “A Notion of Collective Science,” Chadbourne & Parke LLP’s Securities Litigation and Enforcement Newswire 12 (April 2005)*). Thus, under the new obstruction law, a corporation can be guilty of obstruction of justice for destroying documents even if the corporate employee

Practical Tips

- ⊙ Under section 1519's new regime — in which even innocent actors potentially can become ensnared in an obstruction violation — a carefully devised and implemented document retention policy is essential. In *Andersen*, the Supreme Court went out of its way to point out that “[d]ocument retention policies, which are created in part to keep certain information from getting into the hands of others, including the Government, are common in businesses,” and that “[i]t is, of course, not wrongful for a manager to instruct his employees to comply with a valid document retention policy under ordinary circumstances.”
- ⊙ It is important for a corporation to incorporate into its document retention policy effective measures that ensure that document destruction ceases as soon as information is received by the company that an investigation is reasonably contemplated or anticipated. In that circumstance, it is imperative that all corporate agents who might possibly destroy documents be told to discontinue such activities and to preserve all potentially relevant records, including documents and records kept in electronic format or on backup tapes or diskettes that are erased or overwritten in the normal course of business. ⊙

Deferred Prosecution Agreements: Resolving Corporate Criminal Investigations Without Actual Prosecution

By Benjamin Ogletree, Associate

Do you remember the last time you heard about a large corporation actually being criminally prosecuted for financial or other business improprieties? Indeed, it has been a while.

Here's a reminder and an explanation why: Indicted in March 2002 for obstruction of justice in its dealings with Enron Corporation, Arthur Andersen LLP still is virtually the only major business organization to have been criminally prosecuted in the recent wave of high-profile corporate financial scandals. Since that debacle, both defense counsel and prosecutors have pressed for deferral of such traumatic consequences. Thus, a significant factor in the dramatic decline of corporate criminal prosecutions is the increasing use of deferred prosecution agreements, or "DPAs," as they are called, to resolve corporate investigations.

Under a typical DPA, a company is criminally charged but prosecution of the charges is "deferred" to a later date (or permanently) in exchange for the company's agreeing not to contest the alleged violations and to make significant reforms to its policies and procedures. If the company adheres to the terms of the DPA to the prosecutor's satisfaction and maintains "good behavior" for a specified time period (usually at least eighteen months), the criminal charges are dismissed. During the period in which the DPA is in effect, however, any further violations of law or noncooperation by the corporation will trigger a swift reinstatement of a previously deferred criminal proceeding. Since 2003, federal prosecutors have signed DPAs with a growing number of corporations, including MCI, AIG, Merrill Lynch & Co. and Bristol-Myers Squibb.

Origin of DPAs In Corporate Cases

First developed and used by local prosecutors in minor cases against first-time, non-violent individual offenders, the advent of DPAs in the corporate context emerged in January 2003, when then-Deputy Attorney General Larry Thompson issued revised Department of Justice guidelines regarding the prosecution of corporations. Mr. Thompson advised U.S. Attorneys that in making criminal charging decisions, "[c]orporations should not be treated leniently because of their artificial nature." Mr. Thompson made clear that federal prosecutors should consider indicting a corporation itself if its executives

and directors failed to promptly and voluntarily cooperate with federal investigators. Among other policy changes, however, the revised DOJ guidelines encouraged the use of DPAs to resolve corporate criminal investigations. The revised guidelines also encouraged tailoring a DPA to the offender and the infraction(s) at issue, such as requiring restitution, community service, and formal acceptance of responsibility.

Standard Provisions of DPAs

Although the components of DPAs vary depending upon the offender and the offense, several provisions increasingly are becoming standard features of DPAs.

Ongoing cooperation with the government. DPAs often require a corporation to continue to cooperate with the government in investigating and prosecuting criminal offenses committed by others, including the corporation's own executives. Such cooperation may also include broad waivers of the attorney-client and work-product privileges. Corporate cooperation is almost always a prerequisite to the government's consideration of a deferred prosecution.

Acceptance of responsibility. DPAs usually require a corporation to accept responsibility for the underlying misconduct. Sometimes DPAs expressly bar a corporation from making public statements that contradict or are inconsistent with an agreed-upon statement of facts, including in subsequent civil litigation in which the corporation may be precluded from raising certain factual defenses.

Monetary fines and restitution. Many DPAs require corporations to pay hefty monetary fines, forfeitures and restitution.

Third-party monitors. DPAs may require the installation of corporate monitors. Ordinarily, a monitor is selected by the parties, compensated by the corporation, and directed to review and participate in corporate decision-making regarding the company's business and financial affairs. Monitors also are required to periodically inform the government of the corporation's business and compliance with the DPA and other legal obligations.

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DPAs

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Policy/Procedural Reforms. DPAs often require a corporation to make specific reforms to its internal policies and procedures. For example, some DPAs have required changes to the structure and memberships of the board of directors (or specific committees thereof), termination of certain officers, directors and employees, improved internal financial controls and ethics procedures, retention of new outside auditing firms, and establishment of business oversight and review committees.

Benefits of DPAs

The growing popularity of DPAs as an alternative means to resolve corporate criminal investigations is due in large part to the substantial benefits of DPAs to both the government and corporations. From the government's perspective, DPAs are advantageous because they allow prosecutors to obtain most of their sought-after remedies – including the collection of fines and restitution – without having to engage in a lengthy, costly and outcome-uncertain litigation. And, because DPAs involve the filing of criminal charges, they allow the government to express its condemnation of corporate misdeeds in a public forum and to deter other would-be offenders from engaging in similar misconduct.

From the companies' perspective, the most significant benefit is avoidance of the most detrimental collateral consequence of a corporate prosecution: the demise of the company itself. DPAs also

permit profitable businesses to remain in operation and avoid the harsh result of punishing an entire company (including numerous employees who had no involvement in any wrongdoing) for the sins of only a few errant individuals. For these reasons, DPAs often garner the support of corporate investors and other stakeholders.

Practical Tips

- A corporation hoping to avail itself of a DPA must determine early on whether it has committed any violation of law that could expose the company to a potential criminal prosecution, and thus make its pursuit of a DPA worthwhile. Accordingly, the first step in evaluating corporate criminal exposure is to commission an immediate and thorough internal investigation. Chadbourne attorneys have a wealth of experience and expertise in conducting internal investigations and in working closely with companies and government agencies to resolve these types of issues.
- Cooperation with federal investigators is perhaps the most important factor in the government's decision to enter into a deferred prosecution agreement. As part of that cooperation, explore with the Department of Justice the possibility of a DPA as early in the process as appropriate.
- Once obtained, adhere to the terms of the DPA, monitoring compliance and adopting strict disciplinary measures for breaches, including terminations of employment if need be. ●

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