2013 Mid-Year Securities Litigation and Enforcement Highlights

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Table of Contents

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Welcome to the 2013 Mid-Year Report from the BakerHostetler Securities Litigation and Regulatory Enforcement Practice Team. Its purpose is to provide a periodic survey, apart from our team Executive Alerts, on matters we believe of interest to sophisticated general counsel, chief compliance officers and compliance departments, legal departments and members of the securities and commodities industries at financial institutions, private investment funds and public companies.

We issue this Securities Litigation and Enforcement Highlights Report at mid-year and shortly after year end. We hope you find the information and commentary useful and welcome your comments and suggestions. We encourage you to contact any of the practice team members listed at the end of the Report.

I. Supreme Court Case Review (October 2012 Term)

The first half of 2013 provided the following significant guidance from the U.S. Supreme Court with respect to securities litigation proceedings:

- In *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*,[1] the Court held that proof of materiality was not required to certify a class of claimants under SEC Rule 10b-5, where those claimants sought to invoke the "fraud-on-the-market" presumption of reliance adopted by the Court in *Basic Inc. v. Levinson*;[2]

- In *Comcast Corp. v. Behrend*,[3] the Court overturned a class certification based on a lack of predominance of common issues—specifically damages; and

- In *Gabelli v. SEC*,[4] the Court refused to apply a discovery rule to extend the five-year statute of limitations applicable to SEC enforcement actions seeking civil penalties for violations of the Investment Advisers Act of 1940.

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[1] 133 S. Ct. 1184, 1189 (2013).

[2] 485 U.S. 224 (1988).

[3] 133 S. Ct. 1426 (2013).

[4] 133 S. Ct. 1216, 1217-1218 (2013).

From the decisions in *Amgen* and *Comcast*, it is clear that the Court continues to refine the requirement for class certification pursuant to the Federal Rules of Civil Procedure ("FRCP") and as heightened by the Court's recent decision in *Wal-Mart Stores, Inc. v. Dukes*.[5] Both majority opinions in *Amgen* and *Comcast* followed *Dukes*'s holding that a class certification analysis may go beyond the pleadings when it overlaps with the merits. Yet the similarities between the two decisions end there. While the majority opinion in *Comcast* (like *Dukes*) appeared to heighten class certification standards by requiring an evidentiary showing of predominance with respect to damages, the majority opinion in *Amgen* appeared to lessen those requirements by excluding materiality from the class certification calculus where fraud on the market is alleged. Meanwhile, the *Gabelli* decision made it more difficult for the SEC to bring an enforcement action seeking a civil penalty by finding that the statute of limitations runs from the time of the violation, and not when the violation was discovered by the SEC.

***Amgen*: Proof of Materiality Not Required for Class Certification**

The *Amgen* decision arose out of a class action alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder filed by Connecticut Retirement Plans and Trust Funds on behalf of a putative class of Amgen shareholders against Amgen and several of its officers and directors alleging that Amgen failed to disclose safety information about two of its products. The complaint alleged that the misstatements artificially inflated the price of Amgen stock when it was purchased by the plaintiff and then fell when Amgen made corrective disclosures.

Amgen opposed plaintiff's motion for class certification under FRCP 23(b)(3) on the ground that, among other things, each plaintiff would need to prove his or her own reliance on any alleged misrepresentations or omissions. Because reliance would thus be an individualized inquiry, Amgen argued that the FRCP 23(b)(3) predominance requirement could not be met. The plaintiff contended that reliance could be presumed under the "fraud-on-the-market" theory articulated by the Court in

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[5] 131 S. Ct. 2541 (2011).

Basic, which posits that, in open and developed stock markets, stock prices are a function of all material information about a company and its business such that there is a causal link between any misstatement and any stock purchaser.

The U.S. District Court for the Central District of California agreed with the plaintiff and certified the class.[6] On appeal, the U.S. Court of Appeals for the Ninth Circuit affirmed, holding that the "fraud-on-the-market" presumption was triggered so long as the plaintiff demonstrated (1) the security was traded in an efficient market, (2) the alleged misrepresentations were public and (3) the plaintiff alleged that the misstatements were material. The Ninth Circuit further held that Amgen was not entitled to present "truth-on-the-market" rebuttal evidence at the certification stage but could present that evidence at summary judgment.[7]

The Court granted certiorari to address two issues (1) whether a Rule 10b-5 plaintiff was required to present proof of materiality for a class to be certified based on the "fraud-on-the-market" presumption and (2) whether a defendant's rebuttal evidence on the same issue must be considered before certifying a class.

The Court's majority opinion affirmed the Ninth Circuit's decision and held that plaintiffs seeking certification of a class under Rule 10b-5 do not need to prove materiality to receive the benefit of the "fraud-on-the-market" presumption at the class certification stage. While the majority opinion agreed that materiality was a necessary element of the "fraud-on-the-market" presumption, it found that it was not necessary to prove materiality to warrant class certification. Rather, the majority opinion reasoned that the only issue under FRCP 23(b)(3) is whether common questions predominate over individual questions. Because materiality is an objective inquiry—determining what would have been important to a "reasonable investor"—the question was necessarily amenable to class-wide resolution. Even if the statements were ultimately deemed immaterial, that determination would

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[6] *Connecticut Ret. Plans & Trust Funds v. Amgen Inc.*, No. 07-CIV-2536, 2009 WL 2633743 (C.D. Cal. Aug. 12, 2009).

[7] *Connecticut Ret. Plans & Trust Funds v. Amgen Inc.*, 660 F.3d 1170 (9th Cir. 2011).

effectively end the case, such that there would never be a risk of individual issues predominating later in the litigation.

The majority opinion also agreed with the Ninth Circuit that any evidence defendants might have to rebut the “fraud-on-the-market” presumption must wait for the merits phase of the case, at least so long as that rebuttal evidence related to the issue of materiality.

Comcast: Class Certification Requires Evidence of Common Damages

The *Comcast* decision arose out of a class action filed by certain cable subscribers alleging monopolization in violation of Section 2 of the Sherman Act by a cable company that used an anticompetitive “clustering strategy” that drove up prices in the Philadelphia media market. Plaintiffs sought to certify a FRCP 23(b)(3) class and, to satisfy the predominance element, had to prove both that (1) the existence of individual injury resulting from the antitrust violation (antitrust impact) could be proven with evidence common to the class and (2) damages to the class were measurable on a class-wide basis using a “common methodology.”

Plaintiffs argued that the challenged “clustering strategy” raised cable subscription rates via four theories of antitrust impact. To show that damages could be measured on a class-wide basis, plaintiffs relied upon a statistical regression model that measured the effect of the four antitrust impacts on cable prices. Ultimately, the U.S. District Court for the Eastern District of Pennsylvania accepted only one of the four theories.

The defendant argued that plaintiffs failed to prove that damages resulting from one antitrust impact could be calculated on a class-wide basis. Plaintiffs' model was designed to measure damages from all four antitrust impact theories and did not isolate damages resulting from the single allowed theory. The District Court rejected defendant's argument and certified the class. The U.S. Court of Appeals for the Third Circuit affirmed and found that inquiring into the merits of plaintiffs' damages calculation methodology was inappropriate at the certification stage and that plaintiffs were not required to "tie each theory of antitrust impact to an exact calculation of damages."

The Supreme Court's majority opinion reversed and held that plaintiffs must "affirmatively demonstrate," with evidentiary proof, that they have satisfied the FRCP 23 requirements for class certification. The majority opinion found that plaintiffs fell "far short of establishing that damages are capable of measurement on a class-wide basis," because plaintiffs' statistical model could not separately measure the pricing injury caused by the one antitrust theory that was allowed. The majority opinion also held, like *Dukes*, that a district court may consider as much of the merits of a claim as necessary to determine whether a putative class of plaintiffs meets the certification requirements of FRCP 23. While *Dukes* only addressed the four elements of FRCP 23(a), *Comcast* specifically extended that rule to FRCP 23(b), reasoning that a district court's duty to undertake a "rigorous analysis" of whether plaintiffs have satisfied FRCP 23(a) certification requirements applies with equal force to FRCP 23(b) requirements, uniquely FRCP 23(b)'s predominance requirement.

Although the dissenting opinion cautioned that "the decision should not be read to require, as a prerequisite to certification, that damages attributable to a class-wide injury be measurable on a class-wide basis," the majority opinion's broad language announced "the proper standard for evaluating certification" without expressly limiting it to the certification of antitrust classes.

Going forward, defense counsel can use *Comcast* as an example of just how important it is for a putative class to show that both liability and damages can be measured on a class-wide basis and that common questions are not overwhelmed by individualized determinations. This is true for all class actions, regardless of context. The holding also provides defense counsel with another tool to emphasize a district court's broad authority to analyze the merits of underlying claims in determining class certification, particularly when analyzing whether a proposed measure of damages is applicable class-wide based on common evidence.

While *Comcast* clarified the standard of proof for all FRCP 23(b)(3) class actions, specifically in relation to predominating damages issues, the Court gives fairly little guidance to lower courts as to how plaintiffs must satisfy that burden with respect to damages—an important question, given that, as the dissent points out, courts have in the past certified classes that raise individualized damages issues.

The majority opinion also did not explicitly address whether a district court must conduct a *Daubert* evidentiary analysis, which examines whether expert evidence is admissible when considering a motion to certify a class. Both sides had briefed and presented oral arguments on whether a *Daubert* analysis should be required for certification. It appears that *Comcast's* lack of guidance on this issue may have been caused by an unforeseen procedural defect in the case. After oral argument in the case, the Court determined that it could not decide that precise question because the defendant did not object to the admissibility of the plaintiffs' expert's testimony, thereby failing to preserve the issue for appellate review.

***Gabelli*: No Discovery Rule Tolling for SEC Actions Seeking Civil Penalties**

Gabelli involved a civil action by the SEC against the COO and portfolio manager for the mutual fund, Gabelli Funds, LLC, a registered investment adviser. The SEC claimed the individuals had allowed a fund investor to engage in “market timing”—a strategy that takes advantage of time delays in the valuation systems mutual funds utilize. The complaint alleged claims for aiding and abetting violations of Sections 80b-6(1) and (2) of the Investment Advisers Act of 1940 and requested the imposition of civil penalties.

Defendants moved to dismiss the complaint as untimely, invoking the five-year statute of limitations under 28 U.S.C. § 2462, which provides: "an action . . . for the enforcement of any civil fine, penalty, or forfeiture . . . shall not be entertained unless commenced within five years from the date when the claim first accrued." The U.S. District Court for the Southern District of New York agreed with defendants and dismissed the action, and the Second Circuit reversed.

The Supreme Court unanimously reversed the Second Circuit's decision finding that Section 2462's statute of limitations begins to run when the violation takes place—not when the violation was or should have been discovered. The Court held that the most natural reading of Section 2462's language "when the claim first accrued" is when the fraud in fact occurred.

Although the decision in *Gabelli* was definitive, it was also quite narrow because it applies only to civil penalties.[8] Indeed, the District Court held that Section 2462's statute of limitations did not apply to equitable remedies aimed at protecting the public or remedying past wrongs, including the remedies of injunction and disgorgement.[9] Because the Court did not revisit these holdings and its ruling addressed only actions for civil penalties, it will not impact most SEC enforcement actions, which seek injunctive relief.

Gabelli is also limited to the application of a discovery rule because the Court did not address other tolling mechanisms. For example, the Court explicitly excluded any consideration of the application of the fraudulent concealment doctrine to Section 2462.[10] Thus, it is possible the SEC could salvage claims brought more than five years after the conduct at issue took place by arguing that the defendant fraudulently concealed its actions. However, many of the policy considerations supporting the Court's decision in *Gabelli* may also apply to a fraudulent concealment argument—those considerations being that it is the government's job to work diligently to uncover fraudulent behavior, and it is important to place a definitive time limit on penalty actions. Thus, though

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[8] *Gabelli*, 133 S. Ct. at 1220 n.1.

[9] *SEC v. Gabelli*, No. 08-CV-3868, 2010 WL 1253603, at *5 (S.D.N.Y. Mar. 17, 2010)

[10] *Gabelli*, 133 S. Ct. at 1220 n.2.

Gabelli limits the government's reach, it also leaves unanswered questions for another day.

II. Rule 10b-5 Cases

In the past six months, a number of cases have weighed in on significant Rule 10b-5 issues, including the relevance of intent in a parallel claim for violation of Section 11 of the Securities Act of 1933, the standard for demonstrating a fraudulent statement for loss causation, and the relevance of materiality in certification of securities-fraud classes.

Indiana State District Council of Laborers v. Omnicare, Inc.

On May 23, 2013, the U.S. Court of Appeals for the Sixth Circuit ruled that a defendant's knowledge and state of mind are not relevant for the purposes of a Section 11 claim because consideration of intent is not necessary for liability.[11] Section 11 provides a remedy for investors who acquired securities under a registration statement that was materially misleading or omitted material information by imposing liability on issuers and the signers of registration statements, including directors and certain officers.[12]

The plaintiffs, all investors in Omnicare, Inc., alleged that Omnicare and several of its officers and directors violated Section 11 of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder because Omnicare's registration statement allegedly contained material misstatements that concealed Omnicare's fraudulent scheme involving the submission of false claims to Medicare and Medicaid. The U.S. District Court for the Eastern District of Kentucky dismissed the complaint finding that, because the plaintiffs' claim "sound[ed] in fraud," they had failed to plead that defendants had knowledge of the falsity.

The plaintiffs appealed arguing that it was improper for the District Court to require them to plead knowledge because, unlike Section 10(b) of the Exchange Act, Section 11 of the Securities Act provides for strict liability. The Sixth Circuit agreed, finding that Section 11 does not require a plaintiff to

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[11] *Indiana State District Council of Laborers v. Omnicare, Inc.*, No. 12-CV-5287, 2013 WL 2248970 (6th Cir. May 23, 2013).

[12] 15 U.S.C. § 77k(a).

plead a defendant's state of mind. This decision is significant because it highlights the legal risk of making broad assurances of legal compliance in a registration statement. Also notable is that the Sixth Circuit declined to follow Second and Ninth Circuit cases that impose a knowledge-of-falsity requirement upon Section 11 claims. As a result, should Omnicare seek certiorari, the Supreme Court likely may decide to hear this case to resolve the apparent circuit split.

Meyer v. Greene

In *Meyer v. Greene*, the U.S. Court of Appeals for the Eleventh Circuit was the first circuit court ever to hold that a decline in a company's stock price after an announcement of an SEC investigation is insufficient to plead loss causation.[13] The Eleventh Circuit also held that a third-party analyst presentation is not a corrective disclosure for the purposes of pleading loss causation so long as the presentation is based on publicly available information.

This decision arose out of an investor complaint alleging violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder against St. Joe Company, a real estate development corporation, for material misstatements and omissions in its SEC filings with respect to the value of its real estate holdings. The complaint alleged that the truth about these overstatements was revealed to the market on three occasions. First, St. Joe's stock price declined approximately

[13] *Meyer v. Greene*, 710 F.3d 1189 (11th Cir. 2013).

20% on “unusually high volume” during the two days following a prominent hedge fund investor’s suggestion at an investor conference that St. Joe’s assets were significantly overvalued. Second, St. Joe’s stock price declined approximately 7% on the day that it disclosed that the SEC had initiated an informal inquiry into its “policies and practices concerning impairment of investment in real estate assets.” Third, St. Joe’s stock declined 9% on the day that it disclosed that the “SEC had issued an order of private investigation regarding St. Joe’s compliance with federal anti-fraud securities provisions and ownership reporting requirements, in addition to its books, records and internal controls.” The district court granted St. Joe’s motion to dismiss on the grounds that, among other things, plaintiffs failed to allege loss causation because the third-party analyst presentation was based solely on publicly available information and the SEC investigations indicated only a risk of accounting problems. Shortly after this dismissal, St. Joe’s announced a new business strategy resulting in the impairment of $325-375 million in assets for the fourth quarter of 2011. Plaintiffs moved to alter or amend the judgment in light of this “newly discovered evidence,” but their motion was denied.

On appeal, the Eleventh Circuit affirmed the district court’s decision and held that plaintiffs failed to plead loss causation.

The Eleventh Circuit found that plaintiff’s reliance on the “fraud on the market” theory to establish reliance was “fatal” to their claim of loss causation relating to the third-party analyst presentation because it was based on information that was “obtained from publicly available sources.” The Eleventh Circuit similarly rejected plaintiffs’ argument that the presentation constituted a corrective disclosure because it provided “expert analysis of the source material,” reasoning that “the mere repackaging of already-public information by an analyst or short-seller is simply insufficient to constitute a corrective disclosure.”

The Eleventh Circuit also found that “the commencement of an SEC investigation, without more, is insufficient to constitute a corrective disclosure” to establish loss causation, explaining that: “The announcement of an investigation reveals just that—an investigation—and nothing more. . . . To be sure, stock prices may fall upon the announcement of an SEC investigation, but that is because the investigation can be seen to portend an added *risk* of future corrective action. That does not mean that investigations, in and of themselves, reveal to the market that a company's previous statements were false or fraudulent." The Eleventh Circuit also pointed out that the SEC "never issued any finding of wrongdoing or in any way indicated that the Company had violated the federal securities laws."

Amgen Inc. et al. v. Connecticut Retirement Plans and Trust Funds

As fully discussed in Section I above, the Supreme Court's decision in Amgen held that no proof of materiality was required to certify a class of claimants under SEC Rule 10b-5, where those claimants sought to invoke the "fraud-on-the-market" presumption of reliance adopted in Basic.

III. Investment Adviser and Hedge Fund Cases

This year has already been an active one for the SEC investigating, examining and bringing enforcement actions against registered investment advisers and hedge funds During the SEC Speaks conference in February, the SEC's Division of Market Abuse Unit emphasized that investigations into insider trading at hedge funds would continue to be a high priority for the Enforcement Division. Also during the conference, Andrew Calamari, the regional director of the New York Regional Office, highlighted the Enforcement Division's continuing concerns surrounding financial disclosures, particularly with respect to the valuation of instruments and funds. March was an especially busy month for the SEC with a number of important actions being brought and settled, including two that involved S.A.C. Capital Advisors. Below is a discussion of some noteworthy cases.

SEC v. CR Intrinsic Investors, LLC

On March 15, 2013, the SEC announced that CR Intrinsic Investors, LLC, a hedge fund advisory firm and an affiliate of S.A.C. Capital Advisors, agreed to settle insider trading charges for more than $600 million, making it the largest settlement ever for an insider trading case.[14] Specifically, CR

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[14] Press Release, U.S. Securities and Exchange Commission, CR Intrinsic Agrees to Pay More than $600 Million in Largest-Ever Settlement for Insider

Intrinsic agreed to pay $274,972,541 in disgorgement, $51,802,381.22 in prejudgment interest and a $274,972,541 penalty for its alleged role in an insider trading scheme based on details about a clinical trial for an Alzheimer's drug being developed jointly by Elan Corporation and Wyeth.

The SEC alleged in its complaint that Mathew Martoma, a portfolio manager at CR Intrinsic, was introduced through an expert network firm to Dr. Sidney Gilman, a medical consultant for Elan and Wyeth, and the chairman of the committee overseeing the clinical trial for the jointly developed Alzheimer's drug. Dr. Gilman allegedly provided details to Martoma about negative results in the clinical trial for the Alzheimer's drug before such information was disclosed to the public. Martoma allegedly then tipped CR Intrinsic and S.A.C. Capital, which resulted in several of their managed hedge funds to sell more than $960 million in Elan and Wyeth securities between July 21 and July 30, 2008, for a benefit of approximately $275 million in illicit profits (from selling securities short) and avoided losses as a result of the trades. Many of the same allegations were made against Martoma in a criminal case brought against him in November 2012.[15]

The SEC charged CR Intrinsic, Martoma and Dr. Gilman with violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder as well as Section 17(a) of the Securities Act. In addition, S.A.C. Capital Advisors and four hedge funds managed by CR Intrinsic and S.A.C. Capital were also charged as relief defendants as a result of the benefits they received from the alleged scheme. The settling parties, including CR Intrinsic and S.A.C. Capital Advisors, neither admitted nor denied the allegations against them.

On April 16, 2013, Judge Victor Marrero of the U.S. District Court for the Southern District of New York conditionally approved the settlement upon the outcome of the Second Circuit's decision in *SEC v. Citigroup Global Markets, Inc*. In 2011, Judge Jed Rakoff, also of the Southern District, rejected the settlement between Citigroup and the SEC on the grounds that there was no admission by Citigroup to support the court's

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Trading Case, Release No. 2013-41 (Mar. 15, 2013), http://www.sec.gov/news/press/2013/2013-41.htm.

[15] *United States v. Martoma*, No. 12-CR-2985 (S.D.N.Y. Nov. 19, 2012) (complaint).

ability to decide whether such a settlement was fair, reasonable, adequate and in the public interest. Because Citigroup and the SEC appealed Judge Rakoff's decision, the CR Intrinsic settlement now awaits the Second Circuit's decision, which, based on the SEC's frequent reliance on "no admission" settlements, undoubtedly will have significant implications beyond these two matters.

SEC v. Sigma Capital Management, LLC

Also on March 15, 2013, the SEC brought a settled case against hedge fund advisory firm Sigma Capital Management and two affiliated hedge funds, Sigma Capital Associates and S.A.C. Select Fund, for alleged insider trading in violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[16] The SEC alleged that Jon Horvath, a former analyst at Sigma Capital, provided portfolio managers with nonpublic details about key quarterly earnings of Dell and Nvidia securities that he learned through communication with a group of hedge fund analysts. Based on this information, which was provided in advance of earnings announcements and differed substantially from market predictions, Sigma Capital allegedly traded its Dell and Nvidia securities, reaping more than $5.2 million for Sigma Capital Associates and allowing S.A.C. Select Fund to avoid losses of greater than $1 million.

Sigma Capital did not admit or deny the charges, but agreed to settle the case and pay approximately $14 million, including disgorgement of approximately $6.4 million, prejudgment interest of approximately $1.1 million and a penalty of approximately $6.4 million. Sigma Capital was enjoined permanently from fraud violations of the federal securities laws. Unlike the *CR Intrinsic* settlement, the *Sigma Capital* settlement was unconditionally approved.

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[16] Press Release, U.S. Securities and Exchange Commission, SEC Charges Hedge Fund Firm Sigma Capital with Insider Trading, Release No. 2013-42 (Mar. 15, 2013), http://www.sec.gov/news/press/2013/2013-42.htm.

In the Matter of Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management, LLC

In early March, the SEC settled with two registered investment advisers, Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management, LLC (collectively, the "Oppenheimer Advisers"), over charges of misleading investors about valuation methodologies and the internal rate of return for Oppenheimer Global Resource Private Equity Fund I, L.P. ("OGR Fund"), one of the funds that they managed.[17] The OGR Fund is a fund-of-funds that invests in other private equity funds, with its largest holding invested in Cartesian Investors, LLC.

The SEC alleged that from October 2009 to June 2010, the Oppenheimer Advisers "disseminated misleading quarterly reports and marketing materials stating that the fund's holdings of other private equity funds were valued 'based on the underlying managers' estimated values.'" Instead, the portfolio manager of the OGR Fund was allegedly valuing the assets of the fund's investment in Cartesian at a significant markup. This resulted in OGR Fund's internal rate of return for the quarter ended June 30, 2009, to jump from approximately

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[17] Press Release, U.S. Securities and Exchange Commission, SEC Charges New York-Based Private Equity Fund Advisers with Misleading Investors about Valuation and Performance, Release No. 2013-38 (Mar. 11, 2013), http://www.sec.gov/news/press/2013/2013-38.htm.

3.8% to 38.3%. Specifically, the SEC's allegations emphasized that Oppenheimer Asset Management made the following three misrepresentations to potential investors: (1) the increase in Cartesian's value was due to Cartesian's performance when the increase was actually because of the portfolio manager's new valuation method; (2) the value of Cartesian was marked up by an independent valuation firm; and (3) OGR Fund's investments were audited by independent third-party auditors when, in fact, Cartesian was not. Moreover, the SEC alleged that the Oppenheimer Asset Management's valuation policies and procedures "were not reasonably designed to ensure that valuations provided to prospective and existing investors were presented in a manner consistent with written representations to investors and prospective investors."

Oppenheimer Asset Management was charged with violating Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 206(4) of the Investment Advisers Act, and Rules 206(4)-7 and 206(4)-8 thereunder. The Oppenheimer Advisers settled with the SEC without admitting or denying the charges, and agreed to pay a $617,579 penalty and return $2,269,098 to those who invested in the OGR Fund during the roughly two-year period that the misrepresentations were made. Additionally, the Oppenheimer Advisers were censured, ordered to cease and desist from violating the relevant sections and rules of the Securities Act and Investment Advisers Act, and required to hire a consultant to review their valuation policies and procedures. Finally, the Oppenheimer Advisers agreed to pay a $132,421 penalty to the Commonwealth of Massachusetts to settle a related action brought by the Massachusetts Attorney General.

SEC v. Teeple

In an action brought in late March, the SEC charged Matthew Teeple, a hedge fund analyst, with insider trading, alleging that Teeple, David Riley and John Johnson violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[18] The SEC sought a final

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[18] Press Release, U.S. Securities and Exchange Commission, SEC Charges California-Based Hedge Fund Analyst and Two Others with Insider Trading, Release No. 2013-47 (Mar. 26, 2013), http://www.sec.gov/news/press/2013/2013-47.htm.

judgment ordering them to disgorge their ill-gotten gains plus prejudgment interest and to pay financial penalties, and permanently enjoining them from future violations of these provisions of federal securities laws. Additionally, the SEC sought to prohibit Riley from serving as an officer or director of a public company.

Before the official public announcement, Riley, the chief information officer at Foundry Networks Inc., purportedly told Teeple that Foundry would be acquired by Brocade Communication Systems Inc. for approximately $3 billion. Teeple supposedly led his hedge fund advisory firm to buy large amounts of Foundry shares, reaping millions of dollars in profits. Teeple also shared the information with a friend, Johnson, who made illegal trades based on the information. Because Riley also notified Teeple before at least two other major announcements, Teeple's firm allegedly traded Foundry's securities in order to increase profits and avoid losses.

IV. Settlements

On June 18, 2013, SEC Chair Mary Jo White announced that the SEC would seek to extract admissions of wrongdoing from defendants in some settlements, departing from the agency's long-standing practice of allowing defendants to settle without admitting or denying liability. According to SEC Chair White, these cases would involve egregious intentional misconduct, widespread harm to investors or efforts to obstruct an SEC investigation. This change to the SEC's policy came while the SEC awaits a ruling from the U.S. Court of Appeals for the Second Circuit regarding U.S. District Judge Jed Rakoff's decision to strike down Citigroup's $285 million settlement of charges that it misled investors about collateralized debt obligations. Judge Rakoff criticized that settlement as "neither reasonable, nor fair, nor adequate, nor in the public interest" and held that the court could not determine the adequacy of the settlement because Citigroup did not admit to any of the SEC's allegations, depriving the court of "any proven or admitted facts."[19] The SEC's "no admit, no deny" policy has

[19] *SEC v. Citigroup Global Mkts, Inc.*, 827 F. Supp. 2d 328, 331 (S.D.N.Y. 2011).

come under increased scrutiny as more federal judges questioned the practice.[20]

Even with this change in policy, SEC Chair White told reporters that the SEC will likely continue to settle the majority of its cases with defendants neither admitting nor denying any wrongdoing.[21] However, it will be interesting to see if there will be any effect on the number of SEC settlements in this next year as the SEC begins to implement its new policy. Given the significant collateral consequences of a defendant admitting wrongdoing—both in terms of business reputation and use by other parties in related litigation—the likely result of this new policy will be more cases going to trial rather than settling.

We highlight some of the noteworthy settlements from the first half of 2013 and their import below.

Civil Settlements

In re: Merck & Co. Inc. Vytorin/Zetia Securities Litigation, No. 2:08-CV-02177, 2012 WL 4482041 (D.N.J. Sept. 25, 2012); *In re: Schering-Plough Corp. Enhance Securities Litigation*, No. 2:08-CV-00397, 2009 WL 2855457(D.N.J. Sept. 2, 2009)

On February 14, 2013, Merck & Co. agreed to pay $688 million to settle two class action lawsuits alleging that Merck and its subsidiary Schering-Plough defrauded their investors by withholding adverse test results of a clinical trial of the anti-cholesterol drugs Vytorin and Zetia. Plaintiffs alleged that a 2006 clinical drug trial, known as Enhance, found that Vytorin, a Merck-Schering joint venture that was touted as a breakthrough treatment, was no more effective in reducing atherosclerosis as compared to Zocor alone. Plaintiffs further

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[20] *See, e.g.*, *SEC v. Koss Corp.*, No. 11-CV-991, at *3 (E.D. Wis. Dec. 20, 2011) (Judge Rudolph Randa questioned the settlement and requested that the SEC "provide a written factual predicate for why the agency believes the court should find that proposed final judgments in an enforcement action alleging that a company prepared materially inaccurate financial statements and lacked adequate financial controls are fair, reasonable, adequate, and in the public interest" before he approved the settlement.); *SEC v. CR Intrinsic Investors LLC*, No. 12-CV-8466, 2013 WL 1614999, at *1 (S.D.N.Y. Apr. 16, 2013) (Judge Victor Marrero conditionally approved a $600 million consent judgment conditioned upon the outcome of the Second Circuit's decision in *Citigroup*).

[21] Sarah N. Lynch, *Update – U.S. SEC to Seek Admissions in Some Settlements – White*, REUTERS (June 18, 2013), http://www.reuters.com/article/2013/06/19/sec-settlements-idUSL2N0EU24E20130619.

alleged that the results from Enhance were not released for a year in order to protect the companies' stock prices. When news of Vytorin's poor performance became public, both companies' stock prices plummeted.

The settlement is the largest securities class action settlement against a pharmaceutical company and ranks among the top 25 securities class action settlements of all time.

Luther v. Countrywide, No. 2:12-CV-05125 (C.D. Cal.); *Western Conference v. Countrywide,* No. 2:12-cv-05122 (C.D. Cal.); *Maine State v. Countrywide*, No. 10-CV-00302 (C.D. Cal.)

On April 17, 2013, Bank of America settled three California class actions related to the purchase of mortgage-backed securities issued by Countrywide Financial Corp. The announced settlement of $500 million is the largest mortgage-backed securities class settlement to date. (The previous record for a settlement of class action claims related to mortgage-backed securities was Merrill Lynch's $315 million settlement in November 2011.) The consolidated lawsuit sought damages regarding $351 billion in downgraded Countrywide mortgage-backed securities after the subprime market collapsed in 2007. The *Luther* lawsuit, filed in Los Angeles in November 2007, was the first to challenge the underwriting standards of subprime loans that were packaged into mortgage-backed securities.

This case is not covered by the 2011 $8.5 billion settlement between Bank of America and 22 institutional investors. AIG is currently challenging that settlement in New York State court.

Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., No. 1:08-CV-07508 (S.D.N.Y.); *King County, Wash. v. IKB Deutsche Industriebank AG,* No. 1:09-CV-08387 (S.D.N.Y.)

On April 29, 2013, Morgan Stanley & Co. Inc., Moody's Investor's Service and Standard & Poor's Rating Services agreed to pay $225 million to settle lawsuits regarding two structured investment vehicles ("SIV") named Cheyne and Rhinebeck. An SIV is an entity that issues short-term commercial paper and medium-term notes to then buy long-term assets such as mortgage-backed securities. Plaintiffs alleged that Morgan Stanley, which designed Cheyne and Rhinebeck, and the ratings companies misled investors by claiming that the SIVs were highly rated and safe when they were partly composed of risky mortgage-backed securities. The two lawsuits sought more than $700 million in combined lost principal and interest.

Credit ratings agency Fitch Ratings Inc. settled out of the *King County* case in March 2013. The terms of the settlement were not disclosed.

MBIA Insurance Corp. v. Countrywide Home Loans, Inc., No. 602825/2008 (N.Y. Sup. Ct.)

On May 6, 2013, Bank of America agreed to pay the equivalent $1.7 billion to settle claims from bond issuer MBIA Insurance Corp that Bank of America's Countrywide Home Loans Inc. misled MBIA about the quality of its mortgage securities. The bank will pay MBIA $1.6 billion in cash and remit $137 million worth of MBIA senior notes. The bank will also offer MBIA a $500 million line of credit and can purchase a 4.9% stake in MBIA at a price of $9.59 per share. MBIA claimed that Countrywide did not follow its own underwriting guidelines which caused MBIA to pay more than $1.4 billion in insurance guarantees when 15 Countrywide mortgage-backed securities it insured began to default in 2007 and 2008.

ABN Amro Bank NV v. MBIA Inc., No. 601475/2009 and *ABN Amro Bank NV v. Dinallo*, No. 601846/2009 (N.Y. Sup. Ct.)

On May 8, 2013, MBIA Insurance Corp. reached a $350 million settlement with Societe Generale SA regarding claims that MBIA fraudulently restructured $5 billion of Societe Generale's cash and securities to avoid coverage obligations. Societe Generale was the last plaintiff remaining in a lawsuit brought by 18 major financial institutions that challenged MBIA's decision to split its structured finance unit and its municipal bond business. The banks claimed that the restructuring left MBIA unable to pay out on policies insuring the banks' structured finance policies.

SEC Enforcement Settlements

SEC v. CR Intrinsic Investor LLC, No. 1:12-CV-08466, 2013 WL 1614999 (S.D.N.Y. Apr. 16, 2013)

As discussed fully in Section III, on March 15, 2013, the SEC announced that hedge fund advisory firm CR Intrinsic

Investors, a unit of hedge fund SAC Capital Advisors LP, agreed to pay $600 million to resolve allegations that it traded on inside information about an experimental Alzheimer's drug.[22] The SEC claimed that one of the firm's portfolio managers learned about confidential details from a source who was overseeing the drug research that the treatment, being developed jointly by Elan Corp. and Wyeth, was not meeting expectations. The SEC alleged that CR Intrinsic sold, and caused several hedge funds to sell, $960 million in stock of those two companies, while going short against them, resulting in $276 million in profits. The settlement is the largest ever in an insider trading suit. The settlement, in which the allegations were neither admitted nor denied, was conditionally approved by U.S. District Judge Victor Marrero on April 13, 2013.

Municipal Bond Cases

In the Matter of Harrisburg, PA, Proc. No. 3-15316

On May 6, 2013, Harrisburg, Pennsylvania, without admitting or denying allegations, agreed to settle charges brought by the SEC that the city issued misleading public statements regarding its deteriorating financial condition to its bondholders.[23] The SEC alleged that Harrisburg's misleading statements were made in the city's annual and midyear financial statements, its budget reports and its state-of-the-city address. This was the first time that the SEC has charged a municipality for misleading statements it made outside of its securities disclosure documents. Harrisburg, which is currently under state receivership, was ordered to cease-and-desist from violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. As discussed fully in Section VII (below), the SEC considered Harrisburg's cooperation and remedial measures in entering into the settlement.

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[22] Press Release, U.S. Securities and Exchange Commission, CR Intrinsic Agrees to Pay More than $600 Million in Largest-Ever Settlement for Insider Trading Case, Release No. 2013-41 (Mar. 15, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513308#.UelkOmbD8dU.

[23] Press Release, U.S. Securities and Exchange Commission, SEC Charges City of Harrisburg for Fraudulent Public Statements, Release No. 2013-82 (May 6, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514194#.UeigzmbD8dU.

In the Matter of City of South Miami, FL., Proc. No. 3-15329

On May 22, 2013, the SEC charged the city of South Miami, Florida, with defrauding bond investors by misrepresenting the tax-exempt status of offerings used to finance a mixed-use retail and parking structure being built in its downtown commercial district.[24] The city agreed to settle the charges and retain an independent third-party consultant to oversee and review its policies, procedures and internal controls for municipal bond disclosures for the next three years. In entering into the settlement, South Miami neither admitted nor denied the SEC's allegations.

In the Matter of Neil M.M. Morrison, Proc. No. 3-15049

On May 23, 2013, the SEC announced that Neil M.M. Morrison, a former Goldman Sachs & Co. investment banker, agreed to pay $100,000 and a five-year securities industry ban to settle claims that his work on a Massachusetts gubernatorial campaign resulted in municipal underwriting business for Goldman Sachs.[25] The fine is the largest individual penalty for violating the Municipal Securities Rulemaking Board ("MSRB") rules and is also the first time an individual has been barred for violating "pay-to-play" rules. Morrison worked on then-state Treasurer Timothy Cahill's campaign from 2008 to 2010, which should have disqualified Goldman from participating in the underwritings of some Massachusetts municipal issuers. In entering into the settlement, Morrison neither admitted nor denied the SEC's allegations. In September 2012, Goldman Sachs paid $7.6 million in disgorgement, $670,000 in prejudgment interest and a $3.75 million penalty—the largest ever imposed for violating MSRB rules—on the basis of these allegations, which Goldman Sachs neither admitted nor denied.

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[24] Press Release, U.S. Securities and Exchange Commission, SEC Charges City of South Miami with Defrauding Investors about Tax-Exempt Status of Municipal Bonds, Release No. 2013-91 (May 22, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514424#.UeiT7mbD8dV.

[25] *In the Matter of Morrison*, Exchange Act Rel. No. 69627, Order Making Findings And Imposing Remedial Sanctions And A Cease-And-Desist Order Pursuant To Sections 15(b)(6), 15B(c)(4) and 21C Of The Securities Exchange Act Of 1934, And Section 9(b) Of The Investment Company Act Of 1940 (May 23, 2013), http://www.sec.gov/litigation/admin/2013/34-69627.pdf.

Enforcement Actions against Exchanges

In the Matter of The Nasdaq Stock Market LLC and Nasdaq Execution Services LLC, Proc. No. 3-15339

On May 29, 2013, the SEC announced the largest fine in its history against a stock exchange when two subsidiaries of Nasdaq OMX Group Inc. agreed to pay a $10 million fine to settle the SEC's suit for violations stemming from initiation of trading following Facebook, Inc.'s initial public offering.[26] The SEC accused Nasdaq of failing to address problems with the firm's system for matching buy and sell orders. Senior leaders at the exchange believed that they had fixed the problem and allowed the commencement of secondary market trading in Facebook shares. When the problem persisted, more than 30,000 Facebook shares became stuck in Nasdaq's system instead of being executed or cancelled. In entering into the settlement, Nasdaq did not admit or deny the SEC's allegations.

In the Matter of Chicago Board Options Exchange Inc. and C2 Options Exchange Inc., Proc. No. 3-15353

On June 11, 2013, the SEC levied a $6 million fine against the Chicago Board Options Exchange ("CBOE") for allegedly failing to enforce rules designed to prevent illegal short-

[26] Press Release, U.S. Securities and Exchange Commission, SEC Charges NASDAQ for Failures During Facebook IPO, Release No. 2013-95 (May 29, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171575032.

selling.[27] This marks the first ever fine against a stock exchange for oversight issues rather than for misconduct in an exchange's business operations and only the third time the SEC has fined an exchange. The SEC claimed that in April 2012, optionsXpress Inc., a CBOE member brokerage firm, violated Regulation SHO through alleged short-selling. Regulation SHO requires that firms deliver securities to a clearing agency within three days after a trade date. If the securities are not delivered on time, the firm must borrow or purchase the securities to close out the position no later than four days after the trade date. The administrative action claimed that CBOE failed to enforce Regulation SHO, because its staff lacked a "fundamental understanding" of the rule and its investigators never received formal training on the regulation. Compounding the problem, the SEC alleged that CBOE failed to provide the SEC with information and even assisted optionsXpress to contest the claims. In entering into the settlement, CBOE did not admit or deny the SEC's allegations.

V. Commodities and Futures Litigation and Enforcement

CFTC Sues Jon Corzine and Assistant Treasurer for MF Global Collapse

On June 27, 2013, the CFTC brought suit in the U.S. District Court for the Southern District of New York against MF Global's former Chief Executive Officer Jon Corzine and Assistant Treasurer Edith O'Brien.[28] While MF Global was also named in the complaint, the CFTC announced a settlement with the company[29] that will provide full restitution to its customers.[30]

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[27] Press Release, U.S. Securities and Exchange Commission, SEC Charges CBOE for Regulatory Failures, Release No. 2013-17 (June 11, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171575348.

[28] *Comm. Fut. Trading Comm'n v. MF Global Inc.,* No. 13-CV-04463 (S.D.N.Y. June 27, 2013) (complaint).

[29] Because MF Global is currently the subject of Securities Investor Protection Act liquidation proceeding, the consent order was entered by the SIPA Trustee on behalf of MF Global.

[30] Final Consent Order of Restitution, Civil Monetary Penalty and Ancillary Relief Against MF Global Inc., *Comm. Fut. Trading Comm'n v. MF Global Inc.,* No. 13-CV-04463, (S.D.N.Y. June 27, 2013).

The complaint against Corzine and O'Brien related to MF Global's alleged misuse of approximately $1 billion of customer funds. The CFTC alleged that MF Global was a futures commission merchant ("FCM") "with deficient systems and controls" who "on the brink of failure and in desperate need of cash to survive, invaded its customer funds" on a "scale never previously seen in the U.S. futures markets."[31] An FCM must at all times segregate customer funds intended for trading on U.S. exchanges and may never use these customer funds for the FCM's own purposes. When an FCM knows or should know that accounts holding customer segregated funds do not hold sufficient funds to meet the FCM's financial obligations to all customers, the FCM, through its responsible personnel, must immediately notify the CFTC and the applicable designated self-regulatory organization. In order to provide additional protections to customer property, CFTC regulations limit an FCM's ability to invest customer funds to certain authorized investments.

When Corzine joined MF Global, it is alleged that he planned to transition the firm from a business that generated the majority of its revenue from its role as a commodities brokerage, earning revenue primarily from interest income for serving customers' deposits and from commissions on customer transactions, to a major Wall Street investment bank, entering a sphere that generated its revenue from proprietary trading and other business lines. As part of this plan, Corzine allegedly caused MF Global to make significant investments in various instruments, such as the sovereign debt of certain European countries, and that these investments both eventually became a material portion of the firm's business and increasingly risky, placing a significant strains on MF Global's capital and liquidity. The CFTC alleged that, by late October 2011, MF Global's sources of cash were "drying up," and that it was in "desperate need of funding to survive." During the last week of October 2011, MF Global allegedly used nearly one billion dollars of customer segregated funds to support its own proprietary operations and the operations of its affiliates.

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[31] *Comm. Fut. Trading Comm'n v. MF Global Inc.,* No. 13-CV-04463 (S.D.N.Y. June 27, 2013) (complaint).

Although Corzine himself is not accused of using customer money improperly, the CFTC argued that he was aware of his firm's fragile state in the days surrounding its bankruptcy nearly two years ago but still failed to keep his employees from unlawfully taking customer funds. The CFTC also alleged that O'Brien, as assistant treasurer and head of liquidity management, "directed, approved, and/or caused numerous illegal transfers of customer segregated funds" to MF Global's proprietary accounts.

The CFTC brought claims for failure to segregate and misuse of customer funds against all the defendants and for failure to supervise diligently against Corzine. The settlement with MF Global orders that MF Global shall make restitution to its customers in the amount of $1.212 billion. Additionally, the settlement also calls for MF Global to pay a $100 million penalty if there are funds left over after the customers are paid in full.

CFTC Rule Requiring Mutual Fund Registration Survives Appellate Challenge

On June 25, 2013, in *Investment Company Institute v. U.S. Commodity Futures Trading Commission, the* U.S. Court of Appeals for the District of Columbia upheld a CFTC rule requiring mutual funds to register with the agency as part of an effort to quantify fund participation in commodity markets to study the need for new rules on fund activities to properly enforce commodity trading laws.

The CFTC rule at issue, which amended Section 4.5 of its regulations, requires that mutual funds and exchange-traded funds with commodities investments must register with the CFTC as "Commodity Pool Operators" and adhere to regulatory requirements regarding disclosures, recordkeeping and reporting.[32]

The Investment Company Institute, a fund-industry group, and the U.S. Chamber of Commerce brought suit challenging the rule. In December 2012, the District Court held that the CFTC

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[32] 17 C.F.R. § 4.5.

fulfilled its responsibilities under both the Commodity Exchange Act and Administrative Procedures Act.[33]

The Investment Company Institute appealed this decision and argued that the rule violated the Administrative Procedures Act because it was "arbitrary and capricious" because the CFTC failed to "adequately consider the costs and benefits of the rule" as required by the Commodity Exchange Act. In particular, the Investment Company Institute argued that regulation by the CFTC is unnecessary and duplicative because mutual funds are already regulated by the SEC and that the CFTC "ignored existing SEC regulations that could provide the necessary information about mutual funds' activities in derivatives markets."

The D.C. Circuit affirmed the District Court's decision and noted that the CFTC, in promulgating the rule, explicitly discussed the SEC's oversight, noting that although the SEC addressed these issues on a case-by-case basis, it had not developed a "comprehensive and systematic approach to derivative issues." The D.C. Circuit reasoned that the CFTC "surveyed the existing regulatory landscape and concluded that it 'is in the best position to oversee entities engaged in more than a limited amount of non-hedging derivatives trading'" and explained how the rule would allow the CFTC to collect information from entities that would not otherwise be collected by the SEC. The D.C. Circuit also pointed out that the CFTC issued a harmonization proposal to ensure that its rule does not duplicate or contradict SEC regulations.

VI. Recent SEC Policy and Regulatory Developments

Identity Theft Red Flags Rules

To combat identity theft, the SEC and CFTC recently issued final rules that require certain regulated financial institutions or creditors that maintain covered accounts to implement identity theft programs to ensure the confidentiality of customer personal information by identifying and responding to red

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[33] *Investment Company Institute v. U.S. Commodity Futures Trading Commission*, No. 12-CV-612 (D.D.C. Dec. 12, 2012).

flags.[34] "Red flags" are defined as "a pattern, practice, or specific activity that indicates the possible risk of identity theft,"[35] such as:

- Alerts, notifications or other received from consumer reporting agencies or service providers, such as fraud detections services;
- Presentation of suspicious documents, such as documents that appear to have been altered or forged;
- Presentation of suspicious personal identifying information, such as a suspicious address change;
- Unusual use of, or other suspicious activity related to, a covered account; and
- Notice from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution or creditor.[36]

Pursuant to the final rules, financial institutions and creditors must periodically determine whether they maintain covered accounts. If a financial institution or creditor does maintain covered accounts, it must institute and maintain an identity theft prevention program that encompasses four elements. First, the program must identify red flags that are specific to its particular business and customers. Second, the program must identify red flags that are common to its particular industry. Third, the program must incorporate policies and procedures to respond appropriately to red flags as they arise. And finally, the program must be routinely reviewed and updated. Given the interest regulators have shown recently in cybersecurity, financial institutions and creditors that maintain covered accounts should carefully assess their customers, business and industry to prepare and implement an appropriate program.

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[34] Press Release, U.S. Securities and Exchange Commission, Identify Red Flags Rule Release No. 34-69359 (Apr. 10, 2013), http://www.sec.gov/rules/final/2013/34-69359.pdf.

[35] 12 CFR Part 41 at 63723 (2007).

[36] Press Release, U.S. Securities and Exchange Commission, Identify Red Flags Rule Release No. 34-69359 at 36 (April 10, 2013), http://www.sec.gov/rules/final/2013/34-69359.pdf.

Trading and Markets Speech: Broker-Dealer Registration for Private Investment Funds

On April 5, 2013, Chief Counsel for the SEC Division of Trading and Markets David Blass emphasized to the Trading and Markets Subcommittee of the American Bar Association that hedge funds should analyze their business practices to determine whether registration as a broker dealer could be required under the Exchange Act.[37] For example, certain activities (*e.g.*, marketing securities, soliciting or negotiating securities transaction, or handling of customer funds and securities) could require that fund personnel register as brokers under the Section 15(a) of the Exchange Act, particularly if compensation is tied to these activities.

To help with identifying whether broker-dealer registration is appropriate and necessary, Chief Counsel Blass outlined the following relevant factors:

- The methods by which an adviser solicits and retains investors—with a particular focus on responsibilities regardless of compensation;
- Whether an employee's primary function is to solicit business for an adviser;
- Whether personnel who solicit investment receive transaction-based compensation; and
- Whether the adviser charges fees per securities transactions.

Chief Counsel Blass noted the SEC's recent enforcement action against Ranieri Partners as an example of the "serious consequences for acting as an unregistered broker, even where there are no allegations of fraud." (*Ranieri Partners LLC*[38] involved a settled order alleging violations of Section

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[37] Speech, A Few Observation in the Private Fund Space, Delivered by David W. Blass, Chief Counsel of the SEC Division of Trading and Markets, before the American Bar Association, Trading and Markets Subcommittee (Apr. 5, 2013), https://www.sec.gov/News/Speech/Detail/Speech/1365171515178.

[38] *In the Matter of Ranieri Partners LLC and Donald W. Phillips*, Exchange Act Rel. No. 69091 Order Instituting Administrative And Cease-And-Desist Proceedings Pursuant To Section 21C Of The Securities Exchange Act Of 1934 And Section 203(f) Of The Investment Advisers Act Of 1940, Making

15(a) of the Exchange Act on the purported basis that Ranieri Partners paid transaction-based fees to a consultant, who was not registered as a broker, for the purpose of actively soliciting investors for private fund investments.) However, he also noted an interest in considering "whether a broker-dealer registration exemption written specifically for private fund advisers is needed or would be helpful."

SEC Approval of JOBS Act Rule to Lift Ban on General Solicitation of Private Placements

On July 10, 2013, the SEC approved a proposed rule to lift the ban on general solicitation in offerings conducted under Rule 506 of Regulation D. The amendments to the rule were required by Section 201(a) of the Jumpstart Our Business Startups Act. With the approval of the rule, many private issuers (including certain hedge funds, private equity funds and start-up companies) will soon be able to use the Internet and other media to solicit investors in a manner that was previously prohibited (absent public offering registration or very narrow exemptions).

Actual sales by issuers that generally solicit will be permitted only to "accredited investors" which are generally defined as: individuals with net worth in excess of $1 million (excluding home equity) or annual income in excess of $200,000 ($300,000 if combined with spousal income) and entities with assets of $5 million or more. Issuers using general solicitation must file a Form D with the SEC at least 15 days prior to the offering and an amended Form D within 30 days after the offering ceases. Failure to file a Form D can result in the issuer being prohibited from further issuance of securities. Issuers that choose not to use general solicitation may continue to use Rule 506(b). Issuers that generally solicit investors under new Rule 506(c) will be required to take "reasonable steps" to verify the "accredited" status of investors. This is a more onerous requirement than current requirements under Rule 506 and will require increased documentation, issuer verification efforts and recordkeeping.

The effective date of this final rule is 60 days from the date of publication, which is slated for September 8, 2013.

Findings, And Imposing Remedial Sanctions And A Cease-And-Desist Order (Mar. 8, 2013), http://www.sec.gov/litigation/admin/2013/34-69091.pdf.

VII. SEC Cooperation Program

Over the past half-year, the SEC continued to develop and implement its Cooperation Program by rewarding two companies, an individual and a municipality with cooperation credit. As discussed further below, these cases offer significant insight on the framework in which the SEC analyzes and rewards cooperation. Moreover, the posting of some of these case materials on the SEC's newly-created "Enforcement Cooperation Program" webpage[39] is a major development. (The webpage links to SEC materials that discuss the cooperation of the two companies and the individual, but does not yet link to any of the materials that discuss the cooperation of the municipality.) Indeed, the webpage itself provides a central repository for the most significant SEC cooperation materials – something that did not exist until recently.

First, the webpage outlines the purpose of the Cooperation Program—namely, that it is "a series of measures designed to encourage greater cooperation by individuals and companies in SEC investigations and enforcement actions" by "provid[ing] incentives to individuals and companies who come forward and provide valuable information to SEC investigators." (Perhaps the webpage's focus on "individuals and companies" explains why the materials discussing the municipality's cooperation have not been included.)

Second, the webpage provides an overview of the SEC's cooperation framework by linking to its Enforcement Manual, which lists the factors and circumstances used to analyze cooperation by companies and individuals (including the Seaboard Report[40]) and the cooperation tools available to the SEC (including proffer agreements, cooperation agreements, deferred prosecution agreements, non-prosecution agreements and immunity requests).

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[39] *See* U.S. Securities and Exchange Commission, *Enforcement Cooperation Program*, http://www.sec.gov/spotlight/enfcoopinitiative.shtml.

[40] *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Exchange Act Rel. No. 44969 (Oct. 23, 2001) (hereinafter "Seaboard Report").

Third, the webpage links to the Tips, Complaints and Referrals Portal to assist cooperators with reporting potential violations of the securities laws.

Fourth and most importantly, the webpage posts enforcement cases involving cooperation (including releases, complaints, deferred prosecution agreements and non-prosecution agreements). In light of the factual intensive framework in which the SEC analyzes cooperation, these materials provide valuable guidance on how the SEC weighs facts and circumstances in determining whether, and to what extent, a cooperator should receive credit.

As mentioned above, the following cases are the most recent examples of how companies, individuals and even municipalities can benefit from the SEC's Cooperation Program.

Volt Information Sciences, Inc. Cooperation Agreement[41]

In January 2013, the SEC announced the filing of a settled civil action against Volt Information Sciences, Inc. in connection with an alleged scheme by its former CFO to materially overstate its revenue by $7.55 million for the fourth quarter and fiscal year ended October 28, 2007. According to the complaint, the former CFO allegedly knew that the revenue was impossible and did not follow GAAP because the revenue was based on a fabricated sales contract that was inconsistent with a leasing arrangement with the same customer.

In reaching the settlement (in which Volt neither admitted nor denied the allegations), the SEC noted that Volt cooperated during the investigation and undertook "significant remedial measures." Although the SEC did not provide in its release any additional details on Volt's cooperation or remediation, the complaint filed against the former CFO noted that Volt terminated him as an officer and employee in February 2012.[42] Such a remedial measure is consistent with the Seaboard

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[41] Litigation Release, U.S. Securities and Exchange Commission, SEC Charges Volt Information Sciences, Inc. and Two Former Officers with Securities Fraud, Rel. No. 22589 (Jan. 11, 2013), http://www.sec.gov/litigation/litreleases/2013/lr22589.htm.

[42] *SEC v. Egan*, No. 13-CIV-236, at ¶ 16 (S.D.N.Y. Jan. 10, 2013) (complaint).

factors, which (as previously discussed) still guide the SEC in evaluating cooperation by companies.[43]

Based on its cooperation, Volt apparently avoided a civil penalty, which the SEC sought against Volt's two non-cooperating co-defendants. Instead, the settlement sought only to enjoin Volt from violating Section 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, and 13a-11 thereunder.

William G. Reeves Cooperation Agreement[44]

In February 2013, the SEC announced the filing of a settled civil action against William G. Reeves, the in-house counsel for We The People Inc., in connection with an alleged scheme to defraud elderly investors by misrepresenting the purported value and security of We The People's investments. According to the complaint, We The People allegedly obtained $75 million from more than 400 investors in more than 30 states from June 2008 to April 2012 by selling investments for a purported charitable organization. Instead of acting as a charity, We The People allegedly used these proceeds to pay substantial commissions to key executives, third-party promoters and consultants. Among other things, these marketing and promotional materials allegedly contained material omissions regarding these commissions as well as the previous indictments and regulatory sanctions against key executives for their sale of similar investment products. Reeves allegedly knew about these material misstatements and omissions when he reviewed and approved We The People's marketing and promotional materials and administered its investment program.[45]

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[43] Seaboard Report ("What steps did the company take upon learning of the misconduct? Did the company immediately stop the misconduct? Are persons responsible for any misconduct still with the company? If so, are they still in the same positions?"), http://www.sec.gov/litigation/investreport/34-44969.htm.

[44] Press Release, U.S. Securities and Exchange Commission, SEC Charges Husband and Wife in Florida with Defrauding Seniors Investing in Purported Charity, Immediate Rel. No. 2013-19 (Feb. 4, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171512714.

[45] *SEC v. Reeves*, No. 13-CIV-14048, at ¶ ¶ 3, 13, 29, 30, 32 (S. D. Fla. Feb. 4, 2013) (complaint).

The SEC noted that the terms of the settlement (in which Reeves neither admitted nor denied the allegations) "reflect [Reeves's] assistance in the SEC's investigation and anticipated cooperation against" his co-defendants. Like the Volt release (discussed previously), the SEC did not provide much detail on Reeves's cooperation, but did note what benefits Reeves could receive as a result of his cooperation. In particular, the SEC sought to suspend Reeves from appearing or practicing before the SEC for at least five years and to enjoin him from violating Sections 5(a), 5(c), 17(a)(2), and 17(a)(3) of the Securities Act, but left it to the court to determine at a later date whether a civil penalty should be imposed. The SEC also did not seek disgorgement (as it was seeking against Reeves's co-defendants), even though Reeves's $100,000 annual salary arguably could have been characterized as ill-gotten gains.[46]

Given Reeves's significant involvement in the alleged misconduct over the course of four years, this settlement is extraordinary and shows that the SEC's interest in holding an individual accountable is only one of many factors weighed to determine cooperation credit. Because the SEC was silent as to the other factors (*e.g.*, assistance provided by the individual, importance of the underlying matter, interest in holding the individual accountable and profile of the individual),[47] it is unclear how they were analyzed together.

Ralph Lauren Corporation Non-Prosecution Agreement[48]

In April 2013, the SEC announced the filing of a non-prosecution agreement ("NPA") with Ralph Lauren Corporation in connection with alleged FCPA violations by its Argentinian subsidiary from 2005 through 2009. Pursuant to the NPA, Ralph Lauren agreed to pay approximately $734,000 in disgorgement and prejudgment interest and the SEC agreed not to charge Ralph Lauren with FCPA violations. In a parallel

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[46] *SEC v. Reeves*, No. 13-CIV-14048, at ¶ 8 (S. D. Fla. Feb. 4, 2013) (complaint).

[47] U.S. Securities and Exchange Commission, SEC Enforcement Manual § 6.1.1 (Nov. 1, 2012), http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

[48] Press Release, U.S. Securities and Exchange Commission, SEC Announces Non-Prosecution Agreement With Ralph Lauren Corporation Involving FCPA Misconduct, Immediate Rel. No. 2013-65 (Apr. 22, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514780.

NPA with the DOJ, Ralph Lauren agreed to pay an $882,000 penalty.[49]

According to the NPA (in which Ralph Lauren neither admitted nor denied liability or the factual allegations therein), the Argentinian subsidiary allegedly avoided customs requirements by paying approximately $568,000 to a customs broker who funneled money to Argentinian customs officials. The illegal nature of these payments was allegedly disguised in invoices submitted for reimbursement as "Loading and Delivery Expenses" and "Stamp Tax/Label Tax." During the same time period, the Argentinian subsidiary also allegedly provided gifts (including perfume, dresses and handbags) totaling $25,000 to Argentinian government officials to improperly secure importation of Ralph Lauren products.

Ralph Lauren discovered these improper payments and gifts as a result of an internal investigation, which was triggered by concerns raised by employees of the Argentinian subsidiary who had reviewed a new FCPA policy that Ralph Lauren had implemented in 2010. Within two weeks of this discovery, Ralph Lauren self-reported its preliminary findings to both the SEC and DOJ.

In announcing the NPA, the SEC stated that it determined not to charge Ralph Lauren "due to the company's prompt reporting of the violations on its own initiative, the completeness of the information it provided, and its extensive, thorough, and real-time cooperation with the SEC's investigation."

The SEC's FCPA Unit Chief, Kara Brockmeyer, stated that: "This NPA shows the benefit of implementing an effective compliance program. Ralph Lauren Corporation discovered this problem after it put in place an enhanced compliance program and began training its employees. That level of self-policing along with its self-reporting and cooperation led to this resolution."

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[49] Press Release, U.S. Department of Justice, Ralph Lauren Corporation Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay $882,000 Monetary Penalty, DOJ Immediate Rel. No. 13-456 (Apr. 22, 2013), http://www.justice.gov/opa/pr/2013/April/13-crm-456.html.

The NPA further outline the significant remedial measures and cooperation efforts undertaken by Ralph Lauren, including:

- Reporting preliminary findings of its internal investigation within two weeks of discovering the improper payments and gifts;
- Voluntarily and expeditiously producing documents and information (including English language translations);
- Summarizing interviews of overseas witnesses and making those witnesses available for the SEC to interview in the US;
- Conducting a risk assessment of its major operations worldwide to identify any other compliance issues – the review identified no other issues;
- Revamping its compliance training;
- Strengthening its internal controls and procedures for third-party due diligence;
- Terminating employment and business arrangements with all individuals involved in the wrongdoing; and
- Ceasing business operations in Argentina.

In fact, the NPA noted that "the revised compliance policies appear to be working, as the world-wide review identified one instance of a bribe solicitation being rejected by the company's employees after adoption of the company's revised FCPA policy in 2010."

The success of Ralph Lauren's remedial measures was emphasized by Acting Director of the SEC's Division of Enforcement, George S. Canellos, who stated that the NPA "makes clear that [the SEC] will confer substantial and tangible benefits on companies that respond appropriately to violations and cooperate fully with the SEC." In this sense, the Ralph Lauren NPA is the latest example of how companies may receive significant cooperation credit (even avoiding an enforcement action altogether because, unlike a deferred prosecution agreement, an NPA is not filed in court) through, among other things, taking appropriate remedial measures to address a violation and protect against its recurrence.

Harrisburg, PA Administrative Order[50]

In May 2013, the SEC announced the filing of a settled administrative order against the City of Harrisburg, Pennsylvania alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder for material misstatements and omissions in the City's public statements and financial information from January 2009 through March 2011. The SEC alleged that these misstatements and omissions occurred because the City did not have any policies and procedures with respect to its disclosure obligations. Without admitting or denying the allegations, the City consented to cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

In accepting the City's settlement offer, the SEC considered the City's cooperation and the following remedial measures:

- With the assistance of counsel, enhancing its disclosure process by instituting formal written policies and procedures with respect to public statements regarding its financial information and compliance with disclosure obligations;

- Designating the City Business Administrator as the individual responsible for filing annual financial information and notices, including requiring that the City Business Administrator provide the Mayor, City officials and the City Council with written confirmation of those filings;

- Implementing annual training conducted by the City Business Administrator for City employees involved in the disclosure process, including requiring that those employees provide written certification that they have completed the training and will comply with the City's disclosure policies and procedures;

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[50] *In the Matter of City of Harrisburg, Pennsylvania*, Exchange Act Rel. No. 69515, Order Instituting Cease-And-Desist Proceedings Pursuant To Section 21C Of The Securities Exchange Act Of 1934, Making Findings, And Imposing A Cease-And-Desist Order (May 6, 2013), http://www.sec.gov/litigation/admin/2013/34-69515.pdf.

- Submitting its disclosure policies and procedures to the Electronic Municipal Market Access ("EMMA") system and placing it on the City's website;

- Including a certification by the City Business Administrator in all City securities offerings that the offering document does not contain any material misstatements or omit any material facts; and

- Disclosing the terms of the order on EMMA and in any City offering documents for the next five years.

Although the City was unable to avoid an enforcement action (like Ralph Lauren was able to do), the City's cooperation and remediation resulted in significant credit. Notably, the SEC pursued an administrative action instead of a civil action, and the administrative order did not impose a monitor or a civil penalty. In this sense, the *Harrisburg* administrative order is an example of how municipalities may receive significant cooperation credit by implementing appropriate remedial measures to address a violation and protect against its recurrence. Having said that, the fact that Harrisburg is "a near-bankrupt city under state receivership due to $260 million in debt"[51] also likely played a significant role in helping the City avoid those onerous sanctions.

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[51] Press Release, Securities and Exchange Commission, SEC Charges City of Harrisburg for Fraudulent Public Statements, Rel. No. 2013-82 (May 6, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514194.

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