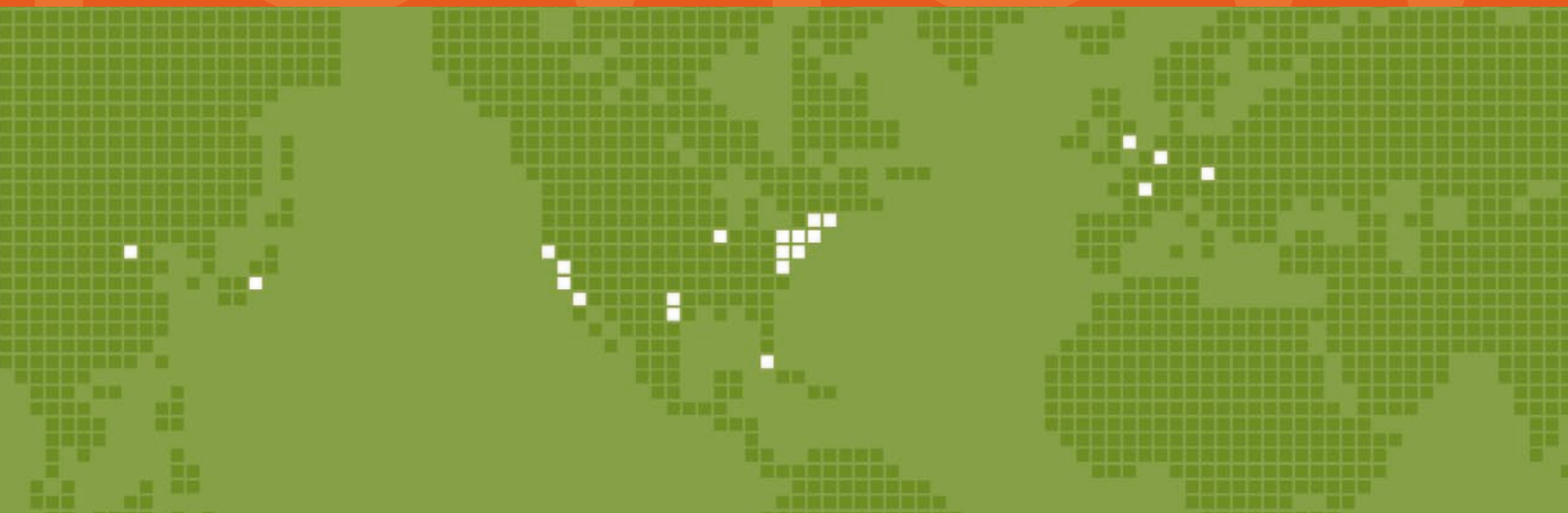


Morgan Lewis

review



2011 Year in Review:
Select SEC Enforcement Cases
and Developments Regarding
Investments Advisers and
Investment Companies

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This Outline highlights key U.S. Securities and Exchange Commission (the “SEC” or the “Commission”) enforcement developments and cases involving investment advisers and investment companies during 2011.*

Summary of Key Statistics and Enforcement Developments

The SEC brought a record number of enforcement actions in FY 2011.¹ In its first complete fiscal year since the Division of Enforcement’s extensive reorganization, the Commission filed 735 enforcement actions. Although senior Commission officials continue to caution that statistics alone do not tell the whole story, the measures traditionally used to assess the SEC’s enforcement activity demonstrate that, in FY 2011, the Division of Enforcement vigorously pursued securities law violators. Some of the key statistics from FY 2011 are described below:

- Last year, the Commission brought 735 enforcement actions, an 8% increase from the 681 cases initiated in FY 2010.
- At the end of FY 2011, National Priority or High Impact cases represented 5.11% of the Division of Enforcement’s active docket up from 3.26% in FY 2010.
- Of particular note is the big jump in cases against investment advisers and investment companies. In FY 2011, the Commission brought 146 enforcement actions in this area. This is a single-year record and represents a 30% increase over the prior year. SEC actions against broker-dealers also increased significantly to 112 cases in FY 2011 from 70 in the prior year. This represents a 60% increase year-over-year.

* This Outline was prepared by Jennifer L. Klass, partner, and Joshua R. Blackman, associate, in the Investment Management Practice Group of Morgan Lewis with substantial assistance from associates Michael K. Carlton, Kaitlyn L. Piper and Erica L. Zong Evenson. Significant sections of this Outline are also set forth in the 2011 Year in Review: SEC and SRO Selected Enforcement Cases and Developments Regarding Broker-Dealers, which is a companion piece that is being published simultaneously with this Outline. As noted below, certain sections of the Outline were drawn from Law Flashes published by the Firm. Morgan Lewis served as counsel in certain actions described herein. Copyright 2012, Morgan, Lewis & Bockius LLP.

¹ The SEC’s fiscal year begins on October 1. References to FY 2011 are to the year that commenced on October 1, 2010 and ended on September 30, 2011.

Moreover, cases against investment advisers, investment companies, and broker-dealers represented about 35% of the SEC's total enforcement docket.

- The Division opened 578 formal investigations last year. By comparison, in FY 2010, the SEC issued 531 formal orders of investigation.
- Last year, there were 134 criminal actions relating to Commission cases, down slightly from FY 2010's 139 cases.
- The Commission also works closely with other regulators. In FY 2011, 586 SEC investigations were referred to self-regulatory organizations or other state, federal and foreign authorities for enforcement, up from FY 2010 when 492 such referrals were made. In addition, the SEC increased the number of occasions (772) when it sought assistance from foreign regulatory authorities and it received an increasing number of requests (492) for assistance from such regulators.
- Last year, almost 18.5% of the investigations opened during FY 2011 came from referrals within the Commission or other internal analysis. This represents a slight decrease from FY 2010 (21.9%).
- The Commission sought emergency relief in federal courts in 39 cases; that technique was used 37 times in FY 2010. The Commission also sought 42 asset freezes to preserve money for the benefit of harmed investors in FY 2011 versus 57 such actions in the prior year.
- In FY 2011, the Commission filed 61% of its first enforcement actions within two years of starting an investigation or inquiry, well below its target rate of 70%.
- For FY 2011, the SEC reported that it had obtained orders requiring the payment of approximately \$928 million in penalties by securities law violators. This is slightly less than the \$1.03 billion the SEC reported for FY 2010. It is interesting to note that, like FY 2010, a relatively small number of cases seemingly account for a substantial portion of the fines imposed last year. Specifically, it appears that ten cases represent approximately 46% of the \$928 million in penalties imposed by the SEC in FY 2011.
- The Commission obtained orders requiring disgorgement of \$1.878 billion in illicit gains last year, a small increase from the \$1.82 billion in FY 2010.

Last year there were also a number of important enforcement developments at the Commission, including the SEC's first ever deferred prosecution agreement, the finalization of the Dodd-Frank whistleblower rules, and the continued focus on individual liability in enforcement actions. The SEC also started the process of seeking Congressional approval to enhance its penalty authority and reportedly

began leaning toward filing negligence charges rather than scienter-based fraud claims in connection with certain cases.

In 2011, the SEC's long-standing settlement practice, which includes defendants neither admitting nor denying the allegations against them, came under increasing judicial attack. In March 2011, Judge Jed Rakoff of the Southern District of New York took issue with this practice in connection with his review of a proposed settlement between the SEC and a corporation and two individual defendants. Judge Rakoff ultimately approved the agreement and reserved for another time the substantial questions the SEC's settlement practices raised. That time came in November 2011, when Judge Rakoff rejected another SEC settlement with a large financial institution, finding that the proposed agreement was neither fair, reasonable, adequate nor in the public interest. That case is now on appeal to the Second Circuit.

As the calendar turned to 2012, the Commission reportedly changed its "no admit or deny" policy in cases involving parallel criminal actions. In such cases, the SEC will no longer allow a settling defendant to neither admit nor deny the Commission's allegations while at the same time admitting to a criminal violation or entering into a deferred prosecution agreement with the Department of Justice. Congress will hold hearings on the SEC's settlement policy in early 2012.

Summary of Investment Adviser and Investment Company Enforcement Trends

Last year, the SEC focused its attention on investment advisers and investment companies in several of its traditional areas of interest, including conflicts of interest, inaccurate or inadequate disclosure, valuation, misappropriation of client assets and fraudulent trading schemes, misallocation of investment opportunities, false or misleading performance claims, market manipulation and insider trading. In connection with its efforts to investigate misconduct during the financial crisis, the Commission continued to be active in the collateral debt obligation and mortgage-backed securities areas. Late 2011 also brought a number of enforcement actions growing out of specific initiatives within the Division of Enforcement's Asset Management Unit. These include mutual fund fee arrangements, adequate compliance policies and procedures and hedge fund performance.

These developments and cases are described in more detail on pages 28 through 58 of this Outline.

Key Statistics and Enforcement Developments

Personnel Changes²

In 2011, there were a number of significant personnel changes in the SEC's Enforcement, Risk and Examination groups. These include the following:

- In January, SEC Chairman Mary L. Schapiro appointed Dr. Jonathan S. Sokobin as Acting Director of the SEC's Division of Risk, Strategy, and Financial Innovation ("RiskFin"). RiskFin was created in September 2009 and serves as the agency's "think tank" for policymaking, rulemaking, enforcement, and examinations. Dr. Sokobin has been with the SEC since 2000 and most recently served as Director of the former Office of Risk Assessment. Before holding that position, he served as the SEC's Deputy Chief Economist from 2004 to 2008. In May, the SEC appointed Craig M. Lewis as the Chief Economist and Director of RiskFin. Dr. Lewis was a professor of finance at Vanderbilt University and, at the time of his appointment, was a visiting scholar at the SEC. In August, the Commission announced that Kathleen Weiss Hanley was named as Deputy Director and Deputy Chief Economist of RiskFin. Dr. Hanley had previously served at the Board of Governors of the Federal Reserve System and the SEC.
- On January 18, 2011, the Commission announced that Eileen Rominger had been appointed Director of Investment Management. Ms. Rominger has almost 30 years of experience in the asset management industry, most recently serving as the Global Chief Investment Officer of Goldman Sachs Asset Management. Ms. Rominger replaced Andrew J. "Buddy" Donohue, who left the agency in November 2010.
- Also in January, the agency announced that Askari Foy had been promoted to Associate Regional Director for Examinations in the SEC's Atlanta Regional Office. Mr. Foy directs a staff of approximately 40 accountants, examiners, attorneys, and support staff responsible for the examination of broker-dealers and investment advisers in Alabama, Georgia, North Carolina, South Carolina and Tennessee.

² Unless otherwise noted, the information regarding these personnel changes was drawn from SEC press releases available on the Commission's website.

- On February 4, 2011, Mark D. Cahn was promoted to General Counsel in the SEC's Office of the General Counsel, replacing David M. Becker. Mr. Cahn joined the SEC in 2009 and previously served as the agency's Deputy General Counsel for Litigation and Adjudication. Also in the spring, Anne K. Small was named as Deputy General Counsel in the Office of General Counsel.
- Sean McKessy was appointed in February to oversee the new Whistleblower Office in the Division of Enforcement (an office created to administer the whistleblower provisions called for by the Dodd-Frank Wall Street Reform and Consumer Protection Act). The Office handles whistleblowers' tips and complaints and helps the SEC determine rewards made to individuals who provide the agency with information that leads to successful enforcement actions.
- In mid-April, Rose Romero left her position as Director of the SEC's Fort Worth Regional office after five years at the SEC. In August, David Woodcock was named as the Regional Director of the Fort Worth office. Mr. Woodcock had previously been a partner at Vinson & Elkins and practiced public accounting for several years at two major firms.
- Also in April, Sanjay Wadhwa was promoted to Associate Regional Director for Enforcement of the SEC's New York Regional Office. He joined the SEC in 2003 and was named as the Deputy Chief of the Enforcement Division's Market Abuse Unit in early 2010.
- Julius Leiman-Carbia joined the SEC in April as Associate Director of the SEC's National Broker-Dealer Examination Program (part of the agency's Office of Compliance Inspections and Examinations) ("OCIE"). In that capacity, he oversees 300 attorneys, examiners and accountants responsible for inspecting broker-dealers. Prior to joining the SEC in 1989, Mr. Leiman-Carbia worked in the private sector for several firms, including Citigroup Global Markets, JP Morgan and Goldman Sachs.
- On April 25, 2011, the SEC announced that Gene Gohlke, the long-time Associate Director for Examinations in OCIE, was retiring from the Commission. Dr. Gohlke had spent more than 35 years at the SEC, serving under 10 Commission Chairmen during his tenure.
- Also on April 25, 2011, the Commission announced that Cameron Elliot joined the agency as an Administrative Law Judge. These judges act as independent judicial officers who preside over public hearings involving allegations of securities law violations instituted by the Commission. Mr. Elliot had previously been an Administrative Law Judge for the Social Security Administration.
- SEC Commissioner Kathleen L. Casey left the Commission on August 5, 2011 after completing her five-year term earlier in the year. In the press

release announcing her departure, the Commission noted her active engagement on international matters, particularly her role as Chair of the International Organization of Securities Commission's Technical Committee and as the SEC's representative to the Financial Stability Board.

- The SEC announced on September 19, 2011 that James Brigagliano, Deputy Director of the Division of Trading and Markets, was leaving the agency at the end of September. Mr. Brigagliano served at the SEC for 25 years, the past 13 in the Division of Trading and Markets.
- On October 4, 2011, the Commission named Michael A. Conley as Deputy General Counsel in the Office of General Counsel. Mr. Conley's portfolio includes enforcement matters, appellate cases and adjudications.
- Also in October, the Commission appointed Andrew J. Bowden as an Associate Director heading OCIE's National Investment Adviser/Investment Company examination program. Mr. Bowden succeeds Gene Gohlke; he joined the SEC from Legg Mason.
- Daniel M. Gallagher was sworn into office as an SEC Commissioner on November 7, 2011. Mr. Gallagher took the place of former Commissioner Casey. Among other things, Mr. Gallagher had previously served at the SEC in a number of senior positions, including as Deputy Director of the Division of Trading and Markets.
- In late November, Kristin Snyder was promoted to head the examinations program in the San Francisco Regional Office.
- On December 8, 2011, Louis A. Aguilar began his second term as an SEC Commissioner.
- Finally, on December 19, 2011, Michael E. Garrity was appointed to head the examination program in the Commission's Boston Regional Office.

In addition to the foregoing individual personnel changes, it is important to note that the Division of Enforcement has hired various specialists to help it in its investigations. In particular, in February 2011, it was reported that Enforcement had recently hired 10 industry specialists to assist it with investigations, training and initiative planning. The specialists include a former portfolio manager, a former trading desk head and a former municipal bond trader.³

Enforcement Statistics

In its first complete fiscal year since the Division of Enforcement's extensive reorganization, the Commission filed a record 735 enforcement actions in FY

³ "Enforcement Adds Industry Specialists," Compliance Reporter (Feb. 14, 2011).

2011. The SEC has suggested that its record performance was brought about due to the Division's reorganization, the close collaboration among SEC offices and the increased use of technology to identify and stop illegal activity. For example, the SEC has stated that the Division of Enforcement has forged closer ties with OCIE, developed specialized skills and new approaches for investigating potential wrongdoing, and utilized new information technology resources to develop analytical tools and to process the large amount of data that it receives in connection with investigations.⁴

Although senior Commission officials continue to caution that statistics alone do not tell the whole story,⁵ several of the measures traditionally used to assess the SEC's enforcement activity demonstrate that, in FY 2011, the Division of Enforcement actively and aggressively pursued misconduct affecting the U.S. markets.⁶ The year's statistics are described below.

A Record Number of Enforcement Actions

Last year, the Commission **brought 735 enforcement actions**, an 8% increase from the 681 cases initiated in FY 2010. FY 2011's 735 cases is the highest number of actions ever brought by the SEC.

“National Priority” or “High Impact” Actions

The SEC is focusing on its “National Priority” or “High Impact” actions, which the Commission hopes will be widely covered by the media and affect the future conduct of market participants. At the end of FY 2011, National Priority or High Impact cases represented 5.11% of the Division of Enforcement's active docket, up from 3.26% in FY 2010. Eighty-five of the SEC's 735 enforcement actions were designated as National Priority cases last year.

⁴ SEC's 2011 Performance and Accountability Report available at: <http://sec.gov/about/secpar2011.shtml> at pages 12 and 13.

⁵ Testimony of Robert Khuzami, November 16, 2011 before the United States Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment “Khuzami Congressional testimony”, available at: <http://sec.gov/news/testimony/2011/ts111611rk.htm>.

⁶ As noted previously, the SEC's fiscal year begins on October 1st. References to FY 2011 refer to the year that began on October 1, 2010 and ended on September 30, 2011. The FY 2011 statistics in this section were taken from the Commission's Select SEC and Market Data – Fiscal 2011 report available on the SEC's website at: <http://www.sec.gov/about/secstats2011.pdf> and the SEC's 2011 Performance and Accountability Report.

Categories of Cases

The major categories of cases and the number of actions within each include:

Type of Case	Number of Actions	% of Total Actions
Investment Advisers/Investment Companies	146	19.9
Securities Offering Cases	123	16.7
Delinquent Filings	121	16.5
Broker-Dealer	113	15.4
Financial Fraud/Issuer Disclosure ⁷	89	12.1
Insider Trading	57	7.8
Market Manipulation	35	4.8
FCPA	20	2.7

Of particular note is the big jump in cases against **investment advisers and investment companies**. In FY 2011, the Commission brought 146 enforcement actions in this area. This is a single-year record and represents a 30% increase over the prior year. SEC actions against **broker-dealers** also **increased significantly to 113 cases** in FY 2011 from 70 in the prior year. This represents a 60% increase year-over-year. Cases against investment advisers, investment companies, and broker-dealers accounted for about 35% of the SEC's enforcement docket. Taken together, it is clear that the SEC devoted significant resources and placed regulated financial institutions under increased scrutiny in the last year.

Consistent with the SEC's aggressive stance on insider trading, the SEC brought **57 insider trading cases**, up from 53 in FY 2010 (an 8% increase). The SEC charged 124 individuals and entities in these actions versus 138 defendants charged in the prior year.

Formal Orders of Investigation

The Division opened **578 formal investigations** last year. By comparison, in FY 2010, the SEC issued 531 formal orders of investigation.

⁷ Prior to FY 2011, the SEC characterized this group of cases as "Issuer Reporting and Disclosure" and included Foreign Corrupt Practices Act ("FCPA") actions in this group. Last year, FCPA actions were tracked separately.

SEC Coordination with Criminal Authorities and Referrals to Other Agencies

In the last several years, a significant amount of attention has been paid to the increasing “criminalization” of the federal securities laws. In FY 2011, the evidence reflects that the SEC continued to work closely with criminal prosecutors. Last year, there were **134 criminal actions** relating to Commission cases, down slightly from FY 2010’s 139 cases.

The Commission also works closely with other regulators. In FY 2011, **586 SEC investigations were referred** to self-regulatory organizations or other state, federal and foreign authorities for enforcement, up from FY 2010 when 492 such referrals were made. In addition, the SEC increased the number of occasions (772) when it sought assistance from foreign regulatory authorities and it received an increasing number of requests (492) for assistance from such regulators. The amount of such requests to and from the SEC increased from the prior year.

Internally Generated Cases, Emergency Relief and First Time Actions

As part of its retooling efforts since 2009, the SEC has tried to enhance its ability to turn internally generated tips, audits or other prospects into investigations. Last year, **almost 18.5%** of investigations opened during FY 2011 **came from referrals within the Commission or other internal analysis**. This represents a slight decrease from FY 2010 (21.9%).

Over the last several years, the SEC leadership has indicated that a top priority is to move quickly to stop and punish misconduct affecting the securities markets. However, last year two statistics used to examine how quickly the SEC moved to stop ongoing misconduct reflected a mixed record in this area. The Commission sought **emergency relief in federal courts in 39 cases**; that technique was used 37 times in FY 2010. The Commission also sought **42 asset freezes** to preserve money for the benefit of harmed investors in FY 2011 versus 57 such actions in the prior year. Of course, these two measures may not necessarily indicate that the SEC moved more slowly than in the past, but rather can also be explained by the fact that there may have been about the same or fewer cases that required such emergency action.

On a related note, last year the Commission **filed 61% of its first enforcement actions within two years** of starting an investigation or inquiry, falling further behind its target rate of 70%. That 61% figure represents a 6% decrease year-over-year and compares even more unfavorably to the Commission’s statistics in prior years.

Successful Outcomes

Last year, the Commission continued its record of “successfully” resolving the vast majority of its cases. Specifically, in FY 2011 the SEC reported that it had obtained a **“favorable” outcome**, including through litigation, settlement or a

default judgment, in **93% of its cases**. (The Commission calculates this measure on a per-defendant basis.) This figure is 1% higher than the Commission achieved between FY 2007 and FY 2010.

Penalties, Disgorgement and Distributions to Injured Investors

For FY 2011, the SEC reported that it had obtained orders requiring the payment of approximately **\$928 million in penalties** by securities law violators. This is slightly less than the \$1.03 billion the SEC reported for FY 2010. It is interesting to note that, like FY 2010, a relatively small number of cases account for a substantial portion of the fines imposed last year. Specifically, it appears that ten cases represent approximately 46% of the \$928 million in penalties imposed by the SEC in FY 2011.

The Commission also obtained orders requiring **disgorgement of \$1.878 billion** in illicit gains last year, a small increase from the \$1.82 billion in FY 2010.

Below is a chart reflecting fines and disgorgements between FY 2004 and FY 2011.

Fiscal Year	Civil Money Penalties	Disgorgement
2004	\$1.2 billion	\$1.9 billion
2005	\$1.5 billion	\$1.6 billion
2006	\$975 million	\$2.3 billion
2007	\$507 million	\$1.093 billion
2008	\$256 million	\$774 million
2009	\$345 million	\$2.09 billion
2010	\$1.03 billion	\$1.82 billion
2011	\$928 million	\$1.878 billion

Focus on Individuals

Over the last year, it appears that the SEC has continued to focus on the potential liability of individuals in its investigations. For example, since 2009 and through December 16, 2011, in connection with financial crisis cases alone, the Commission reported that it had charged 87 entities and individuals. This included 45 CEOs, CFOs and other senior corporate officers. It also noted that 25 officer and director bars, industry bars, and Commission suspensions had

been imposed on individuals. Finally, the Commission ordered \$1.2 billion in penalties in these cases over a roughly three-year period.⁸

In addition to the statistics, this trend can also be seen in several cases summarized below.

Judicial Criticism of SEC Settlement Practices

In 2011, the SEC's long-standing settlement practices came under increasing judicial attack.

In March 2011, Judge Jed Rakoff of the Southern District of New York, took issue with the SEC's practice of accepting settlements in which the defendants neither admit nor deny the allegations against them. Writing in *SEC v. Vitesse Semiconductor Corp., et al.*, 10-Civ-9239 (S.D.N.Y. Mar. 21, 2011), Judge Rakoff questioned whether such agreements met the legal standards required for the Court to approve a settlement.

In recounting the procedural facts of the case, Judge Rakoff noted:

Simultaneous with filing the Complaint on December 10, 2010, the S.E.C. – confident that the courts in this judicial district were no more than rubber stamps – filed proposed Consent Judgments against [certain of the defendants] without so much as a word of explanation as to why the Court should approve these Consent Judgments or how the Consent Judgments met the legal standards the Court is required to apply before granting such approval.

Unhappy with this lack of information, Judge Rakoff ordered the SEC to submit a letter brief and convened a hearing.

In its opinion, after finding the financial and injunctive portions of the settlement to be fair and reasonable, the Court went on to express its concern about the SEC's long-standing practice of allowing a defendant to settle without admitting or denying the allegations, but also requiring that the defendant not publicly deny the charges.

The result is a stew of confusion and hypocrisy unworthy of such a proud agency as the S.E.C. The defendant is free to proclaim that he has never remotely admitted the terrible wrongs alleged by the S.E.C.; but, by gosh, he had better be careful not to deny them either (though, as one would expect his supporters feel no such compunction). Only one thing is left certain: the public will never know whether the S.E.C.'s

⁸ See "SEC Enforcement Actions Addressing Misconduct that Led to or Arose from the Financial Crisis," available at: www.sec.gov.

charges are true, at least not in a way that they can take as established by these proceedings.

* * *

The disservice to the public inherent in such a practice is palpable.

Judge Rakoff contrasted the SEC's settlement practice to the Department of Justice's policy of rarely allowing defendants to plead *nolo contendere*, clearly suggesting that this was the preferable protocol. The Court then added, "for now, however, the S.E.C.'s practice of permitting defendants to neither admit nor deny the charges against them remains pervasive, presumably for no better reason than it makes the settling of cases easier."

Judge Rakoff ultimately approved the Consent Judgments in this matter because the two individual defendants had pleaded guilty in parallel criminal cases and the company had, despite its financial difficulties, paid \$2.4 million to a class action settlement fund and would pay an additional \$3 million under the settlement. As Judge Rakoff stated: "No reasonable observer of these events could doubt that the company had effectively admitted the allegations of the complaint in the way that, for a company, is particularly appropriate: by letting its money do the talking."

Judge Rakoff reserved for another time the "substantial questions" of whether it was permissible to approve other settlements in which the defendant neither admits nor denies the allegations against it.

That time came only six months later. On October 29, 2011, the SEC announced that Citigroup had agreed to pay \$285 million in penalties, disgorgement and prejudgment interest to settle charges that it had negligently misled investors in connection with its 2007 structuring and sale of a CDO tied to the housing market. Like the SEC's well publicized case against Goldman Sachs in 2010, the SEC alleged that Citigroup failed to disclose that it had bet against the CDO's mortgage collateral. The proposed settlement included the usual provision that Citigroup neither admitted nor denied the allegations in the SEC's complaint, which was filed on the same day in the U.S. District Court for the Southern District of New York.⁹

Like the *Vitesse* case, the *Citigroup* action was assigned to Judge Rakoff.¹⁰ In the *Citigroup* case, Judge Rakoff responded to the proposed settlement by issuing an Order setting a hearing to determine whether the settlement was "fair,

⁹ *SEC v. Citigroup Global Markets Inc.*, Case No. 1:11-cv-07387-JSR.

¹⁰ Interestingly, in 2009, Judge Rakoff had raised significant objections to the fine in a proposed SEC settlement with Bank of America over disclosures relating to its purchase of Merrill Lynch. Ultimately, after the parties renegotiated the settlement, which called for an increased penalty, Judge Rakoff approved the agreement.

reasonable, adequate, and in the public interest.” Judge Rakoff also asked the SEC and Citigroup to answer at least nine questions at the hearing that addressed such topics as the “no admit or deny” language in the settlement, the manner in which the penalty amount was determined, how the SEC enforces injunctions and treats recidivist financial institutions, and why, given the facts cited in the Complaint, the SEC charged Citigroup with negligence instead of fraud.

The SEC responded to Judge Rakoff’s questions with a forceful submission, arguing, among other things, that the proposed settlement “reflects the scope of relief likely to be obtained by the Commission under the applicable law if successful at a trial on the merits, also taking into account the litigation risks likely to be presented, the benefits of avoiding those risks, the willingness of Citigroup to consent to a judgment and not deny liability, and the opportunity to detail publicly in this forum the facts that led the Commission to pursue this action.” The SEC also strongly defended its “no admit or deny” policy, noting that such settlements had long been endorsed by the U.S. Supreme Court and observing that Justice Department civil settlements, as well as settlements by other federal agencies such as the Federal Trade Commission, include similar provisions. Finally, the SEC argued that Judge Rakoff should base his analysis of the proposed settlement solely on the allegations in the Complaint, should not seek information about the SEC’s investigation or its settlement negotiations, and should give substantial deference to the Commission.

Despite the SEC’s arguments, as well as similar arguments raised by Citigroup, Judge Rakoff rejected the Citigroup settlement in a 15-page opinion issued on November 28, 2011. Although he noted that the SEC’s views about the appropriateness of the settlement are entitled to substantial deference, Judge Rakoff determined that he “must still exercise a modicum of independent judgment” in evaluating whether the settlement serves the public interest. According to Judge Rakoff, this was particularly true when the Court is asked to employ its injunctive and contempt powers in support of a settlement.

Applying that judgment to the proposed settlement, Judge Rakoff found it to be neither fair, reasonable, adequate, nor in the public interest because, among other things, it allowed Citigroup to neither admit nor deny the Complaint’s allegations. Referring to this policy as “hallowed by history, but not by reason,” Judge Rakoff complained that such settlements “deprive[] the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact.” He further opined that such settlements, and the comparatively modest penalties they impose, are viewed “as a cost of doing business” by the business community. In a not-so-subtly veiled criticism of the SEC, Judge Rakoff further wrote that the settlement offers little to the public, and nothing to the SEC besides “a quick headline.” He concluded his opinion by stating that the “application of judicial power that does not rest on facts is worse than mindless, it is inherently dangerous,” and that only admissions or trials can

establish such facts. Judge Rakoff ordered the parties to proceed to trial in the summer of 2012.

On December 15, 2011, Enforcement Director Robert Khuzami announced that the SEC would appeal Judge Rakoff's ruling to the U.S. Court of Appeals for the Second Circuit.¹¹ Calling the ruling "unprecedented" and harmful to investors, Mr. Khuzami stated that requiring defendants to admit facts or go to trial "is at odds with decades of court decisions that have upheld similar settlements by federal and state agencies across the country." He also warned that a broader application of Judge Rakoff's standard would mean "that other frauds might never be investigated or be investigated more slowly because limited agency resources are tied up in litigating a case that could have been resolved."

While the case makes its way through the appellate process, another federal court took note of Judge Rakoff's decision and has questioned the SEC's proposed settlement with Koss Corporation and its CEO and CFO.¹² On December 20, 2011, Judge Rudolph Randa of the U.S. District Court for the Eastern District of Wisconsin issued a letter to the SEC asking it to provide a "written factual predicate" for why it should approve the settlement. Judge Randa's letter cited to Judge Rakoff's November 28, 2011 opinion and questioned both the injunctive relief he was being asked to enter and the basis on which the SEC had determined the disgorgement amount. The SEC has until January 24, 2012, to submit a brief to Judge Randa addressing these issues.

In early January 2012, furthermore, Mr. Khuzami announced a significant change in the SEC's "no admit or deny" policy in cases involving parallel criminal actions. In such cases, the SEC will no longer allow a settling defendant to neither admit nor deny the SEC's allegations while at the same time admitting to a criminal violation or entering into a deferred prosecution agreement with the Justice Department. Rather, under the new policy, the SEC's action will cite the admissions made in the parallel criminal case. SEC critics had noted the inconsistency between the Commission's approach and that of the Department of Justice in such recent cases as the Wachovia Bank, N.A. municipal securities bid-rigging matter. In that case, Wachovia settled the SEC's action without admitting or denying the allegations leveled against it but, at the same time, settled with the Justice Department by admitting, acknowledging and accepting responsibility for the same conduct.¹³ However, the new SEC policy will not affect

¹¹ The level of discord between the SEC and Judge Rakoff even flowed over to the initial stages of the appeal. Just before the Christmas holiday, the SEC asked Judge Rakoff to stay the district court proceedings while the appeal is pending. Anticipating that Judge Rakoff might deny its motion, the SEC sought an emergency order from the Second Circuit staying the lower court action. The SEC apparently did not inform Judge Rakoff of its application for an emergency order, which resulted in him issuing an Order on December 27, 2011, denying the SEC's motion at virtually the same time that the Second Circuit issued an Order granting the SEC's motion for an emergency stay. Judge Rakoff shot back at the SEC on December 29 by issuing a Supplemental Order accusing the SEC of misleading both him and the Second Circuit.

¹² *SEC v. Koss Corp. et al.*, Case No. 11-C-991 (E.D. Wisc.)

¹³ "SEC Changes Policy on Firms' Admissions of Guilt," Edward Wyatt, *New York Times* (Jan. 7, 2012).

the majority of its cases – those in which it alone is resolving a case against a company.

Finally, Congress has indicated that it will hold a hearing to examine this issue in early 2012.¹⁴

Insider Trading and Parallel Proceedings

Although federal criminal prosecutors have made major headlines in the insider trading area over the last two years, the SEC also continues to be active and aggressive in pursuing such cases. To support this view, Mr. Khuzami stated, in late March 2011, that the SEC “continue[s] to vigorously enforce insider trading laws.”¹⁵ Indeed, a total of 57 actions were brought in FY 2011 alleging insider trading violations, an 8% increase from the prior year. Defendants included individuals from hedge funds, broker-dealers, corporate boards, and even a former Nasdaq managing director. High profile cases were brought against a former board member of Goldman Sachs and involving a new product – exchange traded funds.

Many insider trading cases involve both criminal and SEC charges. Speaking generally about the close collaboration between the DOJ and the SEC, Deputy Director of the Division of Enforcement Lorin Reisner commented in June 2011 that, of the Commission’s highest priority cases, approximately 55-65% have “some type” of parallel criminal investigation.¹⁶

The Rajaratnam Criminal Conviction and SEC Judgment

The most widely followed securities-related case of 2011 was the criminal trial of hedge fund manager Raj Rajaratnam. As we reported in 2009, the United States Attorney’s Office for the Southern District of New York charged Rajaratnam with perpetrating an insider trading scheme that involved extensive and recurring insider trading ahead of various corporate announcements. Prosecutors alleged that Rajaratnam orchestrated a scheme that resulted in over \$50 million in illicit profits. The case, along with a companion civil action filed by the SEC against Rajaratnam and dozens of other individuals, has reportedly led to additional inquiries involving employees at major Wall Street investment banks, expert networks, law firms and other professionals. In something of a departure from prior practice, the government made extensive use of write taps made during its investigation, the validity of which was sustained in the cases brought to trial.

Although most of the defendants in these civil and criminal actions settled, Rajaratnam elected to take his criminal case to trial. Following a two-month trial, Rajaratnam was convicted on May 11, 2011, on all 14 counts of conspiracy and

¹⁴ *Id.*

¹⁵ Remarks at SIFMA’s Compliance & Legal Society Annual Seminar, March 23, 2011.

¹⁶ “Interaction of SEC’s Bounty Program, Cooperation Initiative Remains to be Seen,” *BNA Securities Regulation and Law Report* (June 13, 2011).

securities fraud leveled against him. While his conviction is on appeal, Rajaratnam began serving an 11 year prison sentence in December 2011. Rajaratnam was also ordered to pay more than \$53.8 million to forfeit illegal gains and \$10 million in criminal fines.

As for the SEC, in November 2011, the Commission announced that it had obtained a record monetary penalty of \$92.8 million from Rajaratnam in its own civil action. In its press release, the SEC stated that the case “marks the largest penalty ever assessed against an individual in an SEC insider trading case.”¹⁷

SEC Efforts to Enhance its Penalty Authority

In late November 2011, SEC Chairman Schapiro delivered a letter to top members of the Securities Subcommittee of the Senate Finance Committee asking for statutory changes that would substantially increase the monetary penalties that the SEC can seek in enforcement actions.

First, the SEC asked that the top tier of its penalty scale increase to \$1 million per violation for individuals and \$10 million per violation for entities.

Second, the SEC’s proposal would increase the alternative maximum tier three penalty to three times the gross amount of pecuniary gain to the defendant, as opposed to the current one time, and make a calculation method based on the gross amount of pecuniary gain available in SEC administrative proceedings for all violations. This latter change would align the penalties available in federal district court actions with SEC administrative proceedings.

Third, the SEC asked the Senators to consider allowing a third alternative for tier three penalties that would be based on investor losses incurred as a result of a defendant’s violations. As noted in Chairman Schapiro’s letter, this methodology would require SEC actions to determine the amount of investor losses in particular cases through event studies or expert witnesses testimony. This methodology would also create a dichotomy in that the SEC is not required to prove loss causation to establish liability in its enforcement actions, yet would need to establish causation for purposes of calculating penalties.

To address recent criticism that the SEC is not aggressive enough on recidivists, the fourth proposed change in Chairman Schapiro’s letter would authorize the SEC to seek a three-times penalty if, within the preceding five years, a defendant has been sanctioned by the SEC or criminally convicted of securities fraud.

The fifth, and related, proposal would allow the SEC to seek a civil penalty for violations of a federal court injunction or an industry bar obtained by the SEC in a federal court action or administrative proceeding.

¹⁷ “SEC Obtains Record \$92.8 Million Penalty Against Raj Rajaratnam” (Nov. 8, 2011).

These changes would, in the Chairman's view, provide the SEC with greater flexibility regarding monetary penalties in cases where the misconduct is very serious, repeated or involves substantial losses, but current statutes do not allow for an appropriately significant penalty.

The Commission's Use of Negligence Rather Than Scier-Based Fraud Charges

A fall 2011 Wall Street Journal article reported that the Commission had changed its enforcement strategy to make it easier for the SEC to hold individuals accountable for misconduct that occurred during the financial crisis.¹⁸

Specifically, the SEC was reportedly leaning toward filing negligence charges rather than scier-based fraud claims in such cases.¹⁹ Of course, the standard for proving negligence is much lower than that needed to demonstrate that an individual acted with intent.

A review of several FY 2011 cases against both firms and individuals appears to support the notion that the Commission is looking to use this tactic. Specifically, several cases described in more detail below contain charges under Sections 17(a)(2) and (3) of the Securities Act of 1933 rather than under Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934.

This development bears watching in the coming year.

Cooperation Initiatives²⁰

In 2010, the Commission announced a series of new measures designed to encourage individuals and companies to cooperate in Enforcement Division investigations and enforcement actions. These initiatives include formal guidelines to evaluate and potentially reward cooperation by individuals, and incentives for individuals and companies to cooperate with the Division such as cooperation agreements, deferred prosecution agreements and nonprosecution agreements. These tools seek to provide the SEC with some of the same methods available to federal prosecutors in fighting white collar crime, and are consistent with the philosophy that Enforcement Director Robert Khuzami and Deputy Enforcement Director Loren Reisner, both former federal prosecutors, have brought to the Division. Below are the developments in these areas that occurred in 2011.

¹⁸ "At SEC, Strategy Changes Course," Gene Eaglesham, *Wall Street Journal* (Sept. 30, 2011).

¹⁹ See also "The SEC's Recent Interest in Negligence-Based Charges," Audrey Strauss, *New York Law Journal* (Nov. 3, 2011). This article provides an excellent analysis of this issue.

²⁰ Parts of this section of the Outline were drawn from "The Securities and Exchange Commission Announces New Cooperation Initiative," by Patrick D. Conner and E. Andrew Southerling, published January 2010, available at: <http://www.morganlewis.com/index.cfm/publicationID/66edba61-e068-4a7e-8f1a-694da513d7ae/fuseaction/publication.detail>.

Cooperation Agreements

The Enforcement Division has trumpeted its use of these cooperation tools in 2011. According to the most recently available statistics that we have seen, the SEC has entered into approximately 25 cooperation agreements with individuals since its program began, and officials expect that number to increase as the program becomes more established.²¹

Deferred Prosecution Agreements

In May 2011, the SEC announced its first ever deferred prosecution agreement (“DPA”) in connection with a Foreign Corrupt Practices Act (“FCPA”) investigation involving Tenaris S.A., a global steel pipe manufacturer and supplier. DPAs are formal written agreements in which the Commission agrees to forego an enforcement action against a cooperator. These agreements are executed only if the individual or company agrees, among other things, to cooperate fully and truthfully, including producing all potentially relevant nonprivileged documents and materials, and to comply with express prohibitions and undertakings during a period of deferred prosecution, which generally should not exceed five years.

In announcing the Tenaris DPA, Mr. Khuzami stated in the SEC’s press release that the Commission agreed to a deferred prosecution agreement because Tenaris’ “immediate self reporting, thorough internal investigation, full cooperation with SEC staff, enhanced anti-corruption procedures, and enhanced training made it an appropriate candidate for the Enforcement Division’s first deferred prosecution agreement.”

Pursuant to the terms of the agreement, the SEC agreed not to bring any enforcement action against Tenaris arising from the alleged FCPA violations in exchange for Tenaris’ agreement to, among other things, pay \$5.4 million in disgorgement and prejudgment interest and to perform certain express undertakings. The Tenaris deferred prosecution agreement contains notable provisions, many of which mimic the Department of Justice’s (“DOJ”) deferred prosecution program, including:

- *Acceptance of responsibility.* The Tenaris DPA includes an introductory paragraph that states that “[p]rior to a public enforcement action being brought by the Commission against it, without admitting or denying these allegations, [Tenaris] has offered to accept responsibility for its conduct....”
- *Term.* The Tenaris DPA, as is typical of DOJ DPAs, contains a term for the agreement – in this case, two years.

²¹ This figure comes from the remarks of Robert Khuzami at a late June 2011 SIFMA Compliance & Legal Society luncheon.

- *Statute of limitations.* The Tenaris DPA, like many DOJ DPAs, includes a provision that the statute of limitations is tolled during the term of the DPA.
- *Statement of Facts.* Similar to DOJ DPAs, the Tenaris DPA includes a detailed statement of facts. In contrast to typical DOJ DPAs, however, Tenaris does not admit these facts. Instead, the DPA includes a footnote stating that the recitation of facts arose out of settlement negotiations and are not binding against Tenaris in any other legal proceeding.
- *Prohibitions.* The Tenaris DPA includes a set of prohibitions that are reminiscent of standard DOJ DPAs, including that Tenaris agrees to refrain from: 1) violating the federal and state securities laws; 2) seeking a federal or state tax credit or deduction for any monies paid pursuant to the DPA; and 3) seeking or accepting reimbursement or indemnification from any source with respect to monies paid pursuant to the DPA.
- *Undertakings.* Standard DOJ DPAs usually include requirements to disclose any later investigations or misconduct to DOJ and to enhance existing compliance programs. Tenaris agreed to similar requirements here.

Nonprosecution Agreements

In December 2010, the SEC announced its first nonprosecution agreement involving a company called Carters Inc. About a year later, the Commission entered into highly publicized nonprosecution agreements with Fannie Mae and Freddie Mac, while at the same time charging several former executives of those entities with securities fraud.

Dodd-Frank Whistleblower Provisions²²

On May 25, 2011, the Commission voted to approve final rules to implement the SEC whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), enacted by Congress on July 21, 2010. The vote was split, with three Commissioners voting in favor of implementation and two voting against. According to the majority of the Commissioners, the final rules attempt to balance the tension between encouraging whistleblowers to come forward to the SEC while simultaneously discouraging them from bypassing internal company compliance programs. The dissenting Commissioners disagreed, taking the position that the failure to require mandatory internal reporting would have a detrimental effect on internal

²² This section of the Outline was drawn from “SEC’s Final Rules for Implementing Dodd-Frank Whistleblower Provisions: Important Implications for Covered Entities,” by Firm partners Sarah Bouchard and Thomas Linthorst, published May 25, 2011, available at: http://www.morganlewis.com/pubs/FRR_LEPG_LF_SECFinalRulesForDodd-FrankWhistleblowerProvisions_25may11.pdf.

compliance and spur whistleblowers to bypass those internal mechanisms in favor of directly reporting to the SEC.

The Commission's whistleblower program officially became effective on August 12, 2011.

Whistleblowers Protected from Retaliation

A key component of the final rules is the definition of "whistleblower," which reflects the SEC's view that the antiretaliation protections of the Dodd-Frank Act do not depend on a finding of an actual violation of securities laws. The final rules provide that "[y]ou are a whistleblower if, alone or jointly with others, you provide the Commission . . . and the information relates to a possible violation of the federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur." This definition tracks the statutory definition, but adds the "possible violation" language, a standard that does not require an actual violation for the antiretaliation protections to apply. In its proposed rules, the SEC had included the phrase "potential violation;" it replaced that phrase with "possible violation" in the final rules.

However, the final rules also require that, to be afforded protection from retaliation, the whistleblower must possess a "reasonable belief" that the employer is violating the securities laws. The SEC has defined "reasonable belief" in three ways: (1) specific, credible and timely information; (2) information related to a matter already under investigation by the SEC, but that makes a "significant contribution" to the investigation; or (3) information that was provided through the employer's internal compliance mechanisms, which is subsequently reported to the SEC by the employer, and which satisfies the first or second prong of the definition. This standard is a significant change from the proposed rules (which included no such requirement), and the final rules echo and cite to specific comments and proposals that Morgan Lewis submitted to the Commission on December 17, 2010.

Finally, the SEC makes clear that the antiretaliation provisions do not depend on whether the whistleblower ultimately qualifies for an award (see below). An otherwise-eligible whistleblower is protected from retaliation even if the award requirements are not met.

Rules Relating to Eligibility for an Award

To be considered for an award, the whistleblower must (1) voluntarily provide the SEC (2) with original information (3) that leads to the successful enforcement by the SEC of a federal court or administrative action (4) in which the SEC obtains monetary sanctions totaling more than \$1 million.

The final rules provide that an individual whistleblower may be eligible for an award of 10% to 30% of the recovery, depending on a number of factors. This range reflects the SEC's attempt to balance competing interests: receiving

high-quality information directly from whistleblowers and encouraging whistleblowers to utilize internal compliance procedures.

Reporting Through Internal Compliance Procedures

As an initial matter, a whistleblower need not report information through an employer's internal compliance procedures in order to be eligible for an award. This issue was left undecided under the proposed rules. In the final rules, however, the SEC has left the decision of whether to use internal compliance up to the individual whistleblower. This reflects the SEC's belief that whistleblowers will utilize robust internal compliance measures if they exist, despite having no requirement that they do so.

The SEC has set up financial incentives as a further effort to encourage the use of internal compliance measures. In determining the amount of an award, voluntary participation in corporate internal reporting programs can increase the reward, while interference with corporate internal reporting programs can decrease the reward. These incentives had not been included in the proposed rules.

Moreover, if any individual reports information to the company's internal compliance team or other similar department, the individual has 120 days from the original date of submission to report the information to the SEC. The individual will receive credit as if he or she had reported "original" information to the SEC on the date he or she disclosed it internally. This provision is also designed to promote internal compliance measures.

Similarly, the final rules provide that if a whistleblower reports information through the employer's internal compliance systems, and if the company subsequently self-reports to the SEC, the original whistleblower is credited with the report and any resulting award.

Original and Voluntary Information

Further, to obtain an award, the final rules require that the whistleblower come forward voluntarily. The SEC has defined "voluntarily" to exclude information provided pursuant to a subpoena, judicial order, demand from government authority or the Public Company Accounting Oversight Board, or preexisting legal obligation (such as those of certain corporate officers). The whistleblower must also provide "original information" to qualify for an award. "Original information" must be derived from the whistleblower's "independent knowledge or independent analysis."

The final rules exclude certain categories of information from the definition of "original information." For example, the SEC would not generally consider information obtained through an attorney-client privileged communication to be derived from independent knowledge or analysis. The carveout for attorneys reflects the SEC's concern that the monetary incentives of the SEC whistleblower

program may deter companies from consulting with attorneys about potential securities laws violations. The final rules also exclude any information gained through the performance of an engagement required under the securities laws by an independent public accountant if the information relates to a violation by the engagement client or its directors, officers or other employees. This exception reflects the SEC's recognition of the role of independent public accountants and their pre-existing duty under securities laws to detect illegal acts. The SEC also excludes from "original information" any information the whistleblower obtained as a person with legal, compliance, audit, supervisory or governance responsibilities for an entity, such as an officer, director or partner, if the information was communicated to the whistleblower through the company's internal compliance mechanisms. However, this exclusion is not absolute, and several exceptions allow such individuals to still be whistleblowers (e.g., if the person believes that disclosure is needed because the company is engaging in conduct likely to cause substantial injury to the financial interest or property of the entity or investors). Here, the SEC attempts to reconcile the tension between the potential bounty available to whistleblowers and its recognition that effective internal compliance programs can promote the goals of federal securities laws.

Misconduct and Aggregation

Finally, the final rules do not necessarily disqualify a whistleblower who has engaged in fraud or misconduct, even if it is the same fraud or misconduct the whistleblower is reporting. The degree and nature of the misconduct is simply a factor the SEC will consider in determining the award to a whistleblower. In determining whether the \$1 million in monetary sanctions threshold has been satisfied (a necessary precondition for award eligibility), the SEC will aggregate awards from separate proceedings if the proceedings were based on the same nucleus of operative facts.

Impact on FCPA Investigations

The whistleblower provisions of the Dodd-Frank Act will almost certainly result in a significant increase in the number of Foreign Corrupt Practices Act ("FCPA") investigations initiated by current and former employees through allegations related to bribery of foreign officials. In recent years, some of the highest SEC recoveries have been in FCPA books and records cases including actions involving sanctions of \$77 million, \$137 million and \$218 million. Whistleblowers, who stand to obtain awards of 10% to 30% of those staggering amounts, will be highly incentivized to report allegations of the books and records provision of the FCPA, which the SEC enforces through civil enforcement proceedings.

Impact on Covered Entities

According to the SEC, through these final rules it has attempted to "incentivize" whistleblowers to use company internal compliance programs while simultaneously offering whistleblowers the right to contact the SEC directly. Although this compromise may dissuade some from reporting internally, having

robust internal mechanisms is still of utmost importance. In light of these rules, companies should undertake a thorough review of their internal compliance programs and assess their effectiveness. The quality of these programs may significantly impact whether (1) a whistleblower approaches the SEC in the first instance, or (2) the employee complains internally and waits to see how effectively the company handles the internal complaint. Further, the availability and quality of these programs will have a significant effect on whether the SEC decides to initiate an investigation, or whether it believes that the company has cured any problematic conduct such that no investigation or enforcement action is necessary.

Whistleblower Statistics

In November 2011, the Office of the Whistleblower issued its first annual report to Congress.²³ Although the report only addresses the Office's activities during the seven weeks between August 12 (the effective date of the new rules) and September 30, 2011, it contains several statistics of interest to broker-dealers and other financial industry participants. Of the 334 whistleblower tips that the SEC received during this time period, 16.2% related to market manipulation, 7.5% related to insider trading, 5.1% related to trading and pricing, and 2.7% related to municipal securities and public pensions. Most U.S.-based tips originated from California (10%) and New York (7%). Surprisingly, 10% of all tips (32 in total) came from overseas, mostly from China and the UK. The report noted that the SEC has yet to pay out its first whistleblower award.

Developments in Administrative Proceedings

Penalties in Cease-and-Desist Proceedings

As part of the Dodd-Frank Act, Congress provided the SEC with the authority to seek penalties and other relief in cease-and-desist proceedings that were previously available only in federal court actions. Section 929P of the Dodd-Frank Act grants the SEC the authority to impose civil monetary penalties in administrative cease-and-desist proceedings, even against entities that are not registered with the SEC. The SEC brought the first such administrative cease-and-desist proceeding in an insider trading case against Rajat K. Gupta in March, 2011. The Gupta action arose from the SEC's ongoing investigation of insider trading involving Galleon Management LP. Gupta was a former member of the Board of Directors of The Goldman Sachs Group, Inc. The Commission's action against Gupta, his aggressive response to the filing of that administrative proceeding, and the SEC's decision to drop that proceeding while reserving the right to file an action in federal court are discussed in the case summaries below.

²³ Available at: <http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf>.

Collateral Bars

In April, an SEC administrative law judge held that certain of the collateral bar provisions in Dodd-Frank could not be applied retroactively to conduct that preceded the passage of the Act.²⁴ In an administrative proceeding involving John W. Lawton, who had pled guilty to mail and wire fraud, the SEC sought a collateral bar based on Lawton's conduct while associated with an unregistered investment adviser that occurred before Dodd-Frank was signed into law. Before Dodd-Frank, Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") only permitted the SEC to suspend or bar a person from association with an investment adviser. Dodd-Frank amended Section 203(f) to authorize the Commission to suspend or bar a person from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent or Nationally Recognized Statistical Rating Organization ("NRSRO").

In the Lawton case, Chief Administrative Law Judge Brenda P. Murray held that she could bar Lawton from association with a broker, dealer, municipal securities dealer and transfer agent for his pre-Dodd-Frank conduct, because such sanctions were effectively imposed by the statutory disqualification that flowed from his criminal conviction. However, Judge Murray found that amended Section 203(f) of the Advisers Act included two newly-created associational bars, municipal advisors and NRSROs, which could not be applied retroactively. Because those bars did not exist at the time of Lawton's conduct and would attach "new legal consequences" to his conduct, Judge Murray found them to be impermissibly retroactive.

Immunity Requests

In addition to the cooperation tools announced in 2010, the SEC amended its rules in June 2011 and delegated authority to the Enforcement Director to submit witness immunity requests to the U.S. Attorney General and, upon approval, grant immunity to witnesses in SEC investigations in order to compel those individuals to give testimony.²⁵ In its order amending the rules, the SEC stated that the delegation is intended to "enhance the Division's ability to detect violations of the federal securities laws, increase the effectiveness and efficiency of the Division's investigations, and improve the success of the Commission's enforcement actions." The amendment to the SEC's rules will last for 18 months, at which time the Commission will evaluate whether to extend the delegation to issue immunity orders.

Commissioner Paredes Sounds a Cautionary Note Regarding SEC Enforcement

Although the SEC continues to tout its new enforcement tools, at least one Commissioner has observed that the Enforcement staff must not forget that

²⁴ *In the Matter of John W. Lawton*, Initial Decision, Administrative Proceeding File No. 3-14162 (Apr. 29, 2011).

²⁵ Available at: <http://www.sec.gov/rules/final/2011/34-64649.pdf>.

“sometimes the best choice is not to bring a particular case or advance a particular charge.” In a May 2011 speech, Commissioner Troy A. Paredes cautioned that Enforcement cannot pursue each and every possible violation of the securities laws, and proposed several “guideposts” for the Enforcement staff to follow in deciding how to allocate its limited resources. These guideposts include:

- How and to what extent did the misconduct harm investors?
- Have certain enforcement-related objectives already been satisfied? The staff should consider, for example, whether a party has already undertaken appropriate remedial steps.
- Has the alleged wrongdoer been, or will the individual or entity be, meaningfully sanctioned through means other than an SEC enforcement action, thus reducing the marginal value of our bringing a case?
- What is the impact of bringing one more case of a particular type? Is there any appreciable general deterrence benefit of bringing another case of this type or have diminishing returns already set in?

Commissioner Paredes also observed that the SEC should give “meaningful credit” to those who cooperate with its investigations. In elaborating on what constitutes “meaningful” credit, Commissioner Paredes opined that the SEC “cannot be stingy” and that parties should receive “enough credit to make cooperating worth it.”²⁶

Criticism of Defense Counsel Tactics and Multiple Representations

In a June 1, 2011 speech to the Criminal Law Group of the UJA-Federation of New York, Mr. Khuzami addressed a number of defense counsel tactics that he deems to be of concern.²⁷ As he has in the past, Mr. Khuzami focused part of his speech on multiple representations and the potential conflicts they present. Although he made clear that multiple representations are permissible, Mr. Khuzami noted that he finds it troubling when multiple witnesses represented by the same counsel give highly consistent and not so obvious interpretations of the same events and documents. Although the SEC’s means of addressing these concerns may be limited, Mr. Khuzami stated that the staff intends to raise its concerns more frequently with counsel, and may question witnesses about their awareness of potential conflicts inherent in multiple representations. He also indicated that the staff may be less willing to grant extensions of time in cases where counsel represented multiple witnesses, only to have separate counsel engaged at the Wells stage.

²⁶ Available at: <http://www.sec.gov/news/speech/2011/spch050611tap.htm>.

²⁷ See “Remarks to Criminal Law Group of the UJA-Federation of New York” (June 1, 2011), available at: <http://www.sec.gov/news/speech/2011/spch060111rk.htm>.

In his speech, Mr. Khuzami highlighted other defense tactics he deems troubling. Among other things, he highlighted instances of witnesses answering “I don’t recall” dozens or hundreds of times in testimony, including in response to basic questions. Mr. Khuzami noted that one is “left to wonder” whether witnesses are “under instructions” from defense counsel to testify about only those events that they recall with near certainty. He further cited instances of counsel signaling to clients during testimony.

Mr. Khuzami also focused his speech on questionable tactics in document productions and internal investigations. He criticized the production of documents on the eve of testimony, withholding too many documents from production on the grounds that they may be privileged, without ever determining whether the documents are actually privileged, and delaying the production of a privilege log.

Finally, he noted what he deemed questionable tactics in internal investigations, including interviewing multiple witnesses at once, ignoring clear and identifiable red flags, casting blame on lower-level employees in order to protect senior management who have long-standing relationships with the counsel in question, and failing to acknowledge constraints placed on the scope of their inquiry.

The Enforcement Division’s focus on defense counsel behavior comes at the same time that the SEC has instituted proceedings against defense counsel for unprofessional conduct. In November 2010, the SEC issued an opinion barring Steven Altman, an attorney who represented a witness in an SEC proceeding, from appearing or practicing before the SEC.²⁸ According to the opinion, during the course of several telephone calls, Altman told counsel representing two respondents in an SEC administrative proceeding that Altman’s client would avoid service of an SEC subpoena in return for a monetary payment and other benefits from the respondents. Unknown to Altman, the respondents’ counsel recorded the telephone calls and provided the recordings to the SEC.

Cooperation with Foreign Regulators

As in the past, in 2011 the SEC enhanced its cooperation and collaboration with foreign regulators. Specifically, in July 2011, the SEC and the Capital Markets Board of Turkey announced the signing of an agreement aimed at promoting investor protection, fostering market integrity and making cross-border securities activities easier between the United States and Turkey. Among other things, the agreement calls for enhanced cooperation and the exchange of information in connection with cross-border securities enforcement cases.²⁹

²⁸ Available at: <http://www.sec.gov/litigation/opinions/2010/34-63306.pdf>.

²⁹ “SEC and Turkey Securities Regulator Announce Terms of Reference for Enhanced Cooperation and Collaboration,” available at: <http://www.sec.gov/news/press/2011/2011-153.htm>.

SEC Office of Inspector General Investigations and Reports

The Office of Inspector General (“OIG”) is an independent office within the SEC that performs audits of Commission activities and investigations into allegations of misconduct by staff or contractors.

While not all of its inquiries have been made public to date, in FY 2011, OIG issued several reports of some its investigations and audits and provided Congressional testimony on several issues affecting the SEC’s Enforcement mission.³⁰ The inquiries and reports included scrutiny of actions relating to an alleged conflict of interest arising from the SEC’s former General Counsel’s participation in Madoff-related matters, alleged misconduct in an insider trading case, allegations of improper preferential treatment and access affecting the settlement of an investigation, improper destruction of records relating to matters under inquiry, the leasing of office space, implementation of the SEC’s employee recognition program and recruitment, relocation and retention incentives, and the SEC staff’s handling of various investigations and examinations that failed timely to detect the Ponzi schemes conducted by Bernard Madoff and R. Allen Stanford and the fraud and misappropriations committed by principals of Westridge Capital Management.³¹

The OIG also frequently is asked to testify before Congress on the results of its investigations, audits and various Congressional inquiries it may receive.

While playing an important role, OIG’s investigations can be grueling and time intensive for current and former employees, as well as third parties whose testimony and records may be sought in a manner similar to Enforcement’s own investigative practices. The constant scrutiny and potential for criticism or reprisal may also impact how the staff conducts its own investigations.

SEC Enforcement Priorities Regarding Investment Advisers and Investment Companies

Based upon our review of currently available information, we believe the following list reflects some of the SEC’s top priorities for investment adviser and investment company enforcement:

- Compliance programs and supervisory structure, including the adoption and implementation of written compliance policies and procedures and the conduct of annual reviews

³⁰ Further information about OIG and copies of its publicly issued reports and Congressional testimony are available on the SEC’s website at: <http://www.sec-oig.gov/index.html>.

³¹ Further information about the outcome of the OIG’s investigations and other efforts can be found in its semi-annual reports to Congress for the six months ended March 31, 2011 and September 30, 2011, available at: http://www.sec-oig.gov/Reports/Semiannual/2011/SAR_fall_2011_FINAL.pdf (Mar. 31, 2011); http://www.sec-oig.gov/Reports/Semiannual/2011/SAR_fall_2011_FINAL.pdf (Sep. 30, 2011).

- Conflicts of interest and inaccurate or inadequate disclosure
- Mutual fund fee cases, including board oversight and the contract renewal process
- Turn key mutual fund solutions and inexperienced investment advisers
- False or misleading performance claims, including aberrational performance and portability of performance
- Representations to clients and investors relating to education, experience, past performance and the level of due diligence on investment decisions
- Private equity funds and related conflicts, including use of placement agents and other gatekeepers, preferential terms in side letters, co-investing, relationships with portfolio companies and investing at different levels of the capital structure
- Valuation of illiquid and hard-to-value assets, including compliance with pricing policies
- Insider trading, including the use of expert networks, information barriers for material non-public information and front running
- Misallocation of investment opportunities
- Market manipulation, including through false rumors, “marking the close” in an attempt to inflate performance and short sales
- Misappropriation of client assets and fraudulent trading schemes

Enforcement Actions³²

Marketing and Sales of Collateralized Debt Obligations

The SEC has been investigating the marketing and sales of a number of complex derivatives products since the start of the economic crisis in late 2008. The following cases represent actions brought against collateral managers focusing on conflicts of interest associated with the asset selection process.

- A. *In the Matter of GSCP (NJ), L.P.*, Admin. Proc. File No. 3-14514 (Aug. 25, 2011).
 1. The SEC initiated an administrative proceeding against GSCP (N.J.), L.P. (“GSC”), an investment adviser and

³² Unless otherwise apparent from the context of the descriptions of the actions, the cases described herein are settlements in which respondents neither admitted nor denied the allegations against them. Certain cases fall outside of the SEC’s FY 2011, but are included here for completeness.

collateral manager, alleging that GSC failed to disclose certain conflicts of interest associated with the structuring and marketing of a synthetic CDO, Squared CDO 2007-1 (“Squared”).

2. The SEC alleged that the marketing materials for Squared represented that its investment portfolio was selected by GSC based on its experience analyzing credit risk in CDOs. However, not disclosed in the marketing material and unknown to investors was that the Magnetar Capital LLC (“Magnetar”) hedge fund, which was poised to benefit if the CDOs defaulted, played a significant role in selecting which CDOs were included in the portfolio.
3. The SEC also alleged that while participating in the selection of the investment portfolio, Magnetar shorted a substantial portion of the assets it helped to select by entering into credit default swaps to buy protection on them. The CDO securities that Magnetar shorted had a notional value of approximately \$600 million, representing over half of Squared’s investment portfolio.
4. J.P. Morgan Securities Inc. (“J.P. Morgan Securities”) sold approximately \$150 million of “mezzanine” tranches of Squared’s liabilities to a group of approximately 15 institutional investors. The mezzanine investors lost virtually their entire principal.
5. GSC also allegedly failed to retain books and records regarding the process by which it purported to select the investment portfolio, including e-mail communications between GSC, J.P. Morgan Securities and/or Magnetar concerning the collateral selection process for Squared.
6. The SEC ordered GSC to cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and (3) of the Securities Act and Sections 204 and 206(2) of the Advisers Act and Rule 204-2 thereunder.
7. In considering the settlement, the SEC took into account cooperation by GSC.
8. In a related matter, J.P. Morgan paid \$153.6 million to settle charges based on its role in the offering. In a separate complaint, the SEC brought charges against Edward S. Steffelin, the GSC employee who was in charge of the team responsible for selecting the portfolio for Squared. The case against Steffelin is ongoing, and the SEC seeks injunctive

relief, disgorgement of profits, prejudgment interest and civil penalties.

- B. *In the Matter of Credit Suisse Alternative Capital, LLC (f/k/a Credit Suisse Alternative Capital, Inc.), Credit Suisse Asset Management, LLC and Samir H. Bhatt*, Admin. Proc. File No. 3-14594 (Oct. 19, 2011).
1. The SEC initiated an administrative proceeding against Credit Suisse Alternative Capital, LLC (f/k/a Credit Suisse Alternative Capital, Inc.) (“CSAC”), Credit Suisse Asset Management, LLC (“CSM”), and Samir H. Bhatt (“Bhatt”) alleging that they failed to disclose certain conflicts of interest associated with the structuring and marketing of a hybrid CDO, CSAC’s deviation from its stated asset selection process and that the CDO sold protection on the assets in the portfolio at a price below its fair market value.
 2. The SEC alleged that CSAC and Bhatt (as Director of CSAC’s Leveraged Investment Group) allowed Citigroup Global Markets Inc. (“Citigroup”) to improperly influence the selection of assets for a CDO investment portfolio. CSAC took a \$500 million short position representing half of the securities included in the CDO portfolio and therefore was representing economic interests potentially adverse to those of the CDO and its investors.
 3. The SEC also alleged that the marketing materials for the CDO were misleading because they represented that the investment portfolio was selected by CSAC based on its experience and expertise in analyzing credit risk and based on an extensive asset selection process. The marketing materials failed to describe the significant role played by Citigroup in the selection of assets and the fact that CSAC purchased several assets without following its process for selecting assets for the portfolio.
 4. CSAC also allegedly failed to obtain a fair and reasonable price when sold protection on assets in the CDO investment portfolio to Citigroup. Bhatt allegedly sold the protection without verifying the price, resulting in a purchase price that was far below fair market value. The SEC also alleged that CSAC purchased bonds underwritten by Citigroup for the CDO portfolio without performing a credit analysis as required by CSAC’s internal policies.
 5. The SEC ordered CSAC and CSAM to cease and desist from committing or causing any violations of Section 17(a)(2)

of the Securities Act and Section 206(2) of the Advisers Act, pay disgorgement of \$1,000,000 with prejudgment interest of \$250,000 and pay a civil penalty of \$1,250,000. Bhatt was sanctioned with a cease and desist order, a suspension from association with any investment adviser for a period of 6 months and a civil penalty of \$50,000.

6. In a related action involving similar allegations for a different CDO, Citigroup agreed to a total sanction of \$285 million for failing to disclose in its marketing materials that it was involved in the selection process for the underlying securities and had taken a short position in those securities. This sanction was rejected by the district court and the SEC has appealed the court's rejection of the settlement. In a separate complaint, the SEC brought fraud charges against Brian Stoker, the Citigroup employee who was allegedly in charge of structuring the CDO and responsible for the accuracy of statements in the offering circular and pitch book. The case against Stoker is ongoing and the SEC is seeking injunctive relief, disgorgement of profits, prejudgment interest and civil penalties.

Improper Mutual Fund Fee Arrangements

One of the stated priorities of the SEC's Asset Management Unit is the investment advisory contract renewal process and fee arrangements involving mutual funds. In announcing the first case representing this new initiative, Robert Khuzami, Director of the SEC's Division of Enforcement, said, "We want to take the advisory fee setting process out of the shadows by scrutinizing the role of the investment advisers and fund board members in vetting fee arrangements with registered funds."³³

- A. In the Matter of Morgan Stanley Investment Management Inc., Admin. Proc. File No. 3-14628 (Nov. 16, 2011)
 1. The SEC initiated an administrative proceeding against Morgan Stanley Investment Management Inc. ("MSIM") alleging that as investment adviser to The Malaysia Fund, Inc., MSIM failed to provide proper oversight and due diligence with respect to the services provided by the fund's sub-adviser, misrepresented to the fund's board and its investors that AMMB Consultant Sendirian Berhad ("AMMB") provided advisory and research services to the fund and failed to provide the board with adequate information during its 15(c) review of the sub-advisory agreement with AMMB.

³³ "SEC Charges Morgan Stanley Investment Management for Improper Fee Arrangement," available at: <http://www.sec.gov/news/press/2011/2011-244.htm>.

2. The SEC alleged that MSIM violated Section 206(2) of the Advisers Act by representing to the fund's board that AMMB was providing advisory services to MSIM for the benefit of the fund. The SEC alleged that AMMB provided MSIM with 15(c) reports representing that AMMB advised MSIM on the economic and political conditions in Malaysia, recommended stocks and provided research on Malaysian companies, when, in fact, AMMB provided MSIM with two monthly 2-page reports that were based on readily available public information (e.g., market capitalization of Malaysian companies). MSIM neither requested nor used the AMMB reports in its management of the fund. In addition, the SEC alleged that, contrary to the sub-advisory agreement, MSIM did not engage in regular communications or develop any research with AMMB. As a result, the fund allegedly paid AMMB over \$1.8 million for sub-advisory services that it did not receive.
3. The SEC alleged that MSIM violated its duty under Section 15(c) of the Investment Company Act of 1940 ("Investment Company Act") by failing to provide the Fund's board with information reasonably necessary to evaluate the nature, quality and cost of AMMB's services under its sub-advisory agreement during each 15(c) renewal process over a twelve-year period.
4. The SEC alleged that MSIM violated Section 206(4) of the Advisers Act and Advisers Act Rule 206(4)-7 by failing to adopt and implement written policies and procedures governing its oversight of AMMB's services and its representations and provision of information tied to the 15(c) renewal process.
5. The SEC alleged that MSIM violated Section 34(b) of the Investment Company Act by preparing and distributing false and misleading annual and semi-annual reports to shareholders stating that AMMB provided the Fund with advisory and research services.
6. The SEC sanctioned MSIM with a cease and desist order, censured MSIM and ordered MSIM to pay a civil penalty of \$1,500,000 and pay the fund \$1,845,000 (less \$543,000 already repaid) to reimburse the fund for the unearned sub-advisory fees. In addition, the SEC ordered MSIM to implement and maintain new policies governing its handling of the 15(c) renewal process and its oversight of service providers, including sub-advisers.

7. In considering the settlement, the SEC took into account MSIM's commitment to implement these new policies and its initial reimbursement payments to the fund.

Failure to Perform Adequate Due Diligence

Below are two cases that involve the failure to perform adequate due diligence on potential investments before recommending or investing client assets. This is an area of particular concern for investment advisers that invest client assets in hedge funds.

- A. *In the Matter of Jack W. Luna*, Admin. Proc. File No. 3-14221 (Feb. 2, 2011)
 1. The SEC initiated an administrative proceeding against Jack W. Luna ("Luna"), alleging that Luna failed to conduct due diligence prior to investing his clients' assets in a Ponzi scheme and continued to recommend the investment to other clients despite red flags regarding the investment.
 2. The SEC alleged that Luna, an advisory representative of Titan Wealth Management, LLC ("Titan"), failed to conduct any independent due diligence prior to recommending that his clients invest in certain securities offered by Thomas Lester Irby II ("Irby"), Titan's owner, who was misappropriating millions of dollars of client assets to make Ponzi scheme payments and diverting money to a company controlled by Irby.
 3. The SEC alleged that Luna failed to verify how the invested funds were being used and continued to recommend the investment to additional clients, including by representing it to be low risk and comparing it to a certificate of deposit. In addition, with the knowledge that his other clients had not received promised returns on their investments from Irby, Luna continued to recommend such securities and misrepresented to other clients that delayed returns were "en route" in violation of Advisers Act Rule 206(2).
 4. The SEC imposed a cease and desist order against Luna.
 5. In considering the settlement, the SEC took into account Luna's cooperation with SEC staff and remedial acts promptly undertaken by Luna.
 6. In a separate complaint, the SEC brought fraud charges against Titan, Irby, Point West Partners, LLC and several

other defendants, resulting in a preliminary injunction that froze the defendants' assets and halted Irby's scheme.

- B. *SEC v. Chetan Kapur, Lilaboc, LLC (d/b/a ThinkStrategy Capital Management, LLC)*, 11-cv-8094 (S.D.N.Y. Nov. 10, 2011); *In the Matter of Chetan Kapur*, Admin. Proc. File No. 3-14650 (Nov. 30, 2011)
1. The SEC filed a settled action against Chetan Kapur ("Kapur") and Lilaboc, LLC (d/b/a ThinkStrategy Capital Management, LLC) ("ThinkStrategy") and initiated an administrative proceeding against Kapur alleging that over a seven-year period they misrepresented their due diligence process for their hedge fund of funds product and engaged in deceptive conduct by making misrepresentations about the fund of funds.
 2. The SEC alleged that ThinkStrategy and Kapur, its founder and the sole managing director of its hedge funds, violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, Section 206(4) of the Advisers Act, and Advisers Act Rule 206(4)-8 by misrepresenting to investors the funds' investment performance, longevity, assets and the credentials and experience of ThinkStrategy's management team.
 3. In addition, the SEC alleged that Kapur and ThinkStrategy misstated the scope and quality of their "rigorous" due diligence process, which resulted in the selection of certain hedge fund investments that were later revealed to be Ponzi schemes or other serious frauds. The SEC alleged that ThinkStrategy would have avoided these fraudulent investments had it adhered to its stated due diligence policies and confirmed that the funds had reputable service providers and audited financial statements.
 4. As a result of the civil action, Kapur and ThinkStrategy consented to a permanent injunction against further violations and agreed to pay disgorgement and prejudgment interest and a civil penalty in amounts to be determined by the court upon motion by the SEC.
 5. The SEC also barred Kapur from associating with any firm in the securities industry with a right to apply for re-entry.

Compliance Policies and Procedures

The SEC brought the following three cases on the same day in order to send a message as to the importance of developing and maintaining a robust compliance program.³⁴ These actions specifically focus on violations of Advisers Act Rule 206(4)-7, which requires registered investment advisers to adopt and implement written policies and procedures and to test those procedures on an annual basis. Two of the cases involve situations where investment advisers allegedly failed to correct compliance deficiencies that the SEC staff had brought to their attention in earlier examinations.

A. *In the Matter of Asset Advisors, LLC*, Admin. Proc. File No. 3-14644 (Nov. 28, 2011)

1. The SEC initiated an administrative proceeding against Asset Advisors, LLC (“Asset Advisors”) alleging that Asset Advisors failed to implement and enforce its compliance program and code of ethics.
2. The SEC alleged that Asset Advisors violated Section 206(4) of the Advisers Act and Advisers Act Rule 206(4)-7 by failing to implement its compliance policies and procedures and failing to review those policies at least annually. During a 2007 compliance examination, the SEC staff noted that Asset Advisors had failed to adopt compliance policies and procedures and did not have a written code of ethics.
3. The SEC staff alleged that, subsequent to the 2007 examination, Asset Advisors took no steps to implement its compliance policies and procedures in any meaningful way. In particular, Asset Advisors did not provide any compliance training regarding its new compliance manual to its personnel, its chief compliance officer (“CCO”) was inexperienced, it did not conduct an annual review in 2008 and it did not amend its compliance manual in response to earlier SEC staff comments until prompted by a 2009 SEC examination. The SEC also alleged that Asset Advisors’ compliance manual was not customized to Asset Advisors’ business and its 2009 annual review was inadequate.
4. The SEC alleged that Asset Advisors violated Section 204A of the Advisers Act and Advisers Act Rule 204A-1 by not collecting acknowledgements of receipt of the code of ethics from its staff and quarterly transaction reports from its access persons. In addition, Asset Advisors apparently failed

³⁴ “SEC Penalizes Investment Advisers for Compliance Failures,” available at: <http://www.sec.gov/news/press/2011/2011-248.htm>.

to pre-clear access person's transactions in IPOs and other limited offerings until March 2011.

5. The SEC sanctioned Asset Advisors with a cease and desist order, censured Asset Advisors and ordered Asset Advisors to pay a civil penalty of \$20,000.
6. In considering the settlement, the SEC took into account that Asset Advisors agreed to close operations and dissolve, withdraw its registration as an investment adviser, transfer its existing advisory accounts to an investment adviser with a developed compliance program and notify its advisory clients of the SEC's findings and provide them with a copy of the SEC's order.

B. *In the Matter of Feltl & Company, Inc.*, Admin Proc. File No. 3-14645 (Nov. 28, 2011)

1. The SEC initiated an administrative proceeding against Feltl & Company, Inc. ("Feltl"), a dually-registered investment adviser and broker-dealer, alleging that it failed to adopt a compliance program and a code of ethics for its advisory business, engaged in principal transactions for its advisory clients without making the proper disclosures or obtaining consent and charged undisclosed fees to clients enrolled in its wrap fee program.
2. The SEC alleged that Feltl violated Section 206(4) of the Advisers Act and Advisers Act Rule 206(4)-7 by failing to adopt and implement compliance policies and procedures specific to its advisory business and failing to review such policies annually. The SEC attributed Feltl's compliance breakdown to Feltl's growing brokerage business, which allegedly consumed 95% of the CCO's time and was the focus of Feltl's compliance manual.
3. The SEC alleged that Feltl violated Section 206(3) of the Advisers Act by selling securities to or purchasing securities from its advisory clients without disclosing in writing the capacity in which Feltl was acting and obtaining client consent to such transactions. The principal trades involved securities in which Feltl made a market or was involved in the underwriting of an IPO.
4. The SEC alleged that Feltl violated Section 206(2) of the Advisers Act by failing to maintain sufficient compliance procedures to detect billing errors that resulted in Feltl charging commissions to wrap clients.

5. The SEC alleged that Feltl violated Section 204A of the Advisers Act and Advisers Act Rule 204A-1 by not adopting a code of ethics specific to its advisory business and not collecting annual holding reports from its advisory representatives until prompted to do so by an SEC exam in 2011.
6. The SEC sanctioned Feltl with a cease and desist order, censured Feltl and ordered Feltl to pay disgorgement of \$142,527, a civil penalty of \$50,000 and prejudgment interest of \$10,645. The SEC also ordered Feltl to retain an independent consultant to review its compliance program and to notify its clients of the SEC order by sending it to existing clients, distributing it with its Form ADV and posting a copy on its website.
7. In considering the settlement, the SEC took into account Feltl's cooperation with SEC staff and remedial acts promptly undertaken by Feltl. Specifically, Feltl made changes to its trade execution procedures in April 2010, undertook an annual compliance review in November 2010 and adopted a new compliance manual for its advisory business in April 2011. Feltl also alerted the SEC staff to the duplicative billing issue during the course of its investigation.

C. *In the Matter of OMNI Investment Advisors Inc. and Gary R. Beynon*, Admin. Proc. File No. 3-14643 (Nov. 28, 2011)

1. The SEC initiated an administrative proceeding against OMNI Investment Advisors Inc. ("OMNI") and Gary R. Beynon ("Beynon") alleging that OMNI, a registered adviser, failed to adopt and implement a compliance program, establish and enforce a written code of ethics and maintain and preserve certain books and records.
2. The SEC alleged that OMNI and Beynon, as its CEO, violated Section 206(4) of the Advisers Act and Advisers Act Rule 206(4)-7 because it had no compliance program or CCO in place for over two years between September 2008 and November 2010 and it never conducted a review of its non-existent compliance policies during this time. The SEC further alleged that Beynon's violations extended to his eventual tenure as OMNI's CCO, during which time Beynon lived in Brazil where he was on a religious mission and did not perform the CCO's responsibilities.

3. The SEC alleged that OMNI and Beynon violated Section 204A of the Advisers Act and Advisers Act Rule 204A-1 by failing to maintain and enforce a written code of ethics.
4. The SEC alleged that OMNI and Beynon violated Section 204(a) of the Advisers Act and Advisers Act Rule 204-2(a)(10) by failing to maintain and preserve records of all written agreements entered into by the adviser. In particular, the SEC alleged that, in response to a SEC subpoena, Beynon backdated his signature to certain OMNI advisory agreements that required the CCO's signature.
5. The SEC sanctioned OMNI and Beynon with a cease and desist order, censured OMNI and Beynon and ordered Beynon to pay a civil penalty of \$50,000. The SEC also barred Beynon from associating with any firm in the securities industry, with a right to apply for re-entry.
6. In considering the settlement, the SEC took into account that OMNI and Beynon agreed to notify clients of OMNI during the relevant period of the SEC's findings and provide them with a copy of the SEC's Order. OMNI withdrew its registration as an investment adviser on August 19, 2011 and its clients were transferred to a new investment advisory firm.

Failure to Disclose Errors

The following case relates to an investment adviser's failure to disclose a material coding error in the quantitative investment model used to create and manage client portfolios. The facts and remedial undertakings in this case highlight the need for investment advisers to ensure that errors are appropriately escalated and addressed in a timely manner and that compliance controls extend to the portfolio management function within an organization.

- A. *In the Matter of AXA Rosenberg Group LLC, AXA Rosenberg Investment Management LLC and Barr Rosenberg Research Center LLC*, Admin. Proc. File No. 3-14224 (Feb. 3, 2011).
 1. The SEC initiated an administrative proceeding against a holding company, AXA Rosenberg Group LLC ("ARG") and its two wholly owned registered investment advisers, AXA Rosenberg Investment Management LLC ("ARIM") and Barr Rosenberg Research Center LLC ("BRRC"), alleging that they concealed a material error in the quantitative model used to create and manage client portfolios.

2. The SEC alleged that BRRRC was responsible for developing the computer code for a quantitative investment model used by ARIM to invest its clients' funds.
3. According to the SEC, in June 2009, an employee of BRRRC reported that an error in the computer code effectively eliminated one of the main components used to control risk in the client portfolios, performance correlation between securities, to Barr Rosenberg ("Rosenberg"), a senior officer of BRRRC and ARIM. Rosenberg allegedly told the employee not to disclose the error and directed that the error not be fixed until the new version of the risk model was released, which eventually occurred during September and October 2009. When the new version was released, BRRRC and ARIM failed to disclose that an error in the previous version was corrected.
4. When clients complained about their portfolios' poor performance and over concentration in certain industries, ARG, ARIM, and BRRRC failed to disclose the error and misrepresented the model's ability to control risk by attributing losses to market volatility. The error ultimately caused approximately \$217 million in losses to over 600 client portfolios.
5. The employee eventually informed the CEO of ARG in November 2009 and after an internal investigation, ARG reported the issue to SEC examination staff when they began their exam of ARG in March 2010.
6. The SEC charged that these actions violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, Sections 206(2) and 206(4) of the Advisers Act and Advisers Act Rule 206(4)-7.
7. ARG, ARIM, and BRRRC agreed to reimburse \$216,806,864 to its clients whose funds were lost because of the error and were sanctioned with a cease and desist order and a civil penalty of \$25 million. ARG and BRRRC agreed that BRRRC's internal controls would be subject to ARG's policies and procedures and that BRRRC's director would report to ARG's CCO. ARG, ARIM, and BRRRC agreed to hire an independent consultant to review its policies and procedures and maintain a global compliance and ethics oversight structure until at least 2015. ARG, ARIM, and BRRRC also agreed to pay, jointly and severally, a \$25 million civil fine.

8. In considering the settlement, the SEC took into account that ARG, ARIM and BRRC promptly hired a consultant to determine the losses to client portfolios caused by the coding error and cooperated with the SEC.
9. In a separate action, the SEC sanctioned Rosenberg with a \$2.5 million civil penalty, a cease and desist order and a bar from associating with any firm in the securities industry.

Mutual Fund Valuation

This case highlights the SEC's continuing focus on accurate valuation of client assets and is another example of the Commission's focus on mortgage-backed securities.

- A. *In the Matter of Morgan Asset Management, Inc., Morgan Keegan & Company, Inc, James C. Kelsoe, Jr. and Joseph Thompson Weller, CPA*, Admin. Proc. File No. 3-13847 (June 22, 2011)
 1. The SEC, Financial Industry Regulatory Authority ("FINRA"), and state regulators in Alabama, Kentucky, Mississippi, South Carolina and Tennessee settled actions against Morgan Keegan, an affiliated entity and two individuals concerning deficiencies in fund pricing, sales and marketing in connection with seven affiliated funds.
 2. During the period November 2004 through July 29, 2008, Morgan Keegan was the principal underwriter and distributor of certain mutual funds that were managed by Morgan Asset through Kelsoe, a portfolio manager. The funds' prospectuses stated that Morgan Asset would price the securities in the funds, but the boards of directors of each of the funds delegated this responsibility to Morgan Keegan. Morgan Keegan priced the securities and calculated the funds' NAV through its Fund Accounting Department, which was overseen by a Valuation Committee, of which Weller, Morgan Keegan's Controller and an officer and treasurer of the funds, was part.
 3. The SEC alleged that Morgan Keegan and Weller failed to price securities held by the funds in accordance with the funds' policies and procedures. For example, Fund Accounting often sought broker-dealer price confirmations for certain securities. Kelsoe reviewed the price confirmations and convinced one broker-dealer to change the price confirmations obtained by Fund Accounting and the independent auditor, who were unaware of this practice. Kelsoe also allegedly did not inform Fund Accounting or the

funds' boards of directors when he received price-changing information regarding the funds' securities.

4. The SEC also alleged that: (i) low-level employees with little experience were responsible for pricing decisions; (ii) Fund Accounting accepted price adjustments from Kelsoe without any supporting documents or reasonable bases; (iii) Kelsoe was allowed to determine the broker-dealer price confirmations to use, which was beyond the scope permitted by the valuation procedures; and (iv) Fund Accounting and the Valuation Committee allowed securities to be assigned stale prices by not making sure that such prices were re evaluated.
5. As a result of such practices, the SEC alleged that Morgan Keegan published daily NAVs that it did not know were accurate and sold and redeemed shares of the funds based on those NAVs. Moreover, documents filed with the Commission included untrue statements of material fact regarding the funds' performance.
6. FINRA's action alleged that during the period January 1, 2006 through September 30, 2007, sales materials for the Regions Morgan Keegan Select Intermediate Fund were not fair and balanced, contained exaggerated claims and did not appropriately disclose the impact market conditions in the summer of 2007 had on the value of the fund. Although the fund was marketed as a fairly safe, fixed income mutual fund, FINRA alleged that, in fact, the fund carried with it the potential for higher risk, especially with respect to its investments in asset-backed and mortgage-backed securities.
7. Morgan Keegan agreed to pay restitution of \$200 million to settle all of the foregoing actions. Specifically, \$20.5 million in disgorgement, \$4.5 million in prejudgment interest, and \$75 million in civil penalties will be paid to the SEC, to be distributed to harmed customers through a Fair Fund. The firm will pay \$100 million into a state fund for customers. Additionally, as part of the settlement with the SEC, Morgan Keegan and Morgan Asset are barred from being involved in the pricing of securities for investment companies for three years. Kelsoe consented to pay a civil penalty of \$250,000 and to an industry bar and a bar from participating in any penny stock offering. Weller agreed to a penalty of \$50,000 and a 12-month suspension from acting in a supervisory capacity and participating in the offering of a penny stock.

He was also prohibited from appearing or practicing before the Commission as an accountant.

8. As part of the settlement in the state proceedings, Morgan Keegan agreed to retain an Independent Consultant to review certain policies and protocols and to provide training to its registered representatives. These items were incorporated into the firm's settlement with FINRA.

Misallocation of IPOs and Investment Opportunities

As evidenced by the following cases, the manner in which investment advisers allocate investment opportunities among client accounts continues to be an area of focus for the SEC.

- A. *In the Matter of Alpine Woods Capital Investors, LLC and Samuel A. Lieber*, Admin. Proc. File No. 3-14233 (Feb. 7, 2011)
 1. The SEC initiated an administrative proceeding against Alpine Woods Capital Investors, LLC ("Alpine"), an investment adviser, and Samuel A. Lieber ("Lieber"), Alpine's CEO, majority owner and a portfolio manager to several of its funds, alleging that Lieber misallocated IPOs among the adviser's funds and that Alpine misled investors by failing to disclose the impact of IPO trading on fund performance.
 2. The SEC alleged that Alpine violated Section 17(a)(3) of the Securities Act, Sections 206(2) and 206(4) of the Advisers Act, Advisers Act Rule 206(4)-8 and its own compliance policies by misallocating shares that Alpine obtained from IPOs disproportionately to the advantage of Alpine's two smallest mutual funds.
 3. The SEC alleged that Alpine and Lieber violated Section 206(4) of the Advisers Act and Advisers Act Rule 206(4)-7 by failing to implement and test the policies and procedures set forth in its compliance manual and Form ADV relating to the allocation of IPOs and disclosure of the IPOs' contribution to performance. The SEC further noted that, during the relevant period, the firm's compliance program did not have adequate resources.
 4. The SEC alleged that Alpine failed to provide the Board of Trustees of the Alpine Series Trust ("Trust") relevant funds with appropriate information about the IPO trading and violated Section 34(b) of the Investment Company Act by failing to disclose the risks associated with short-term IPO trading and its impact on fund performance in the relevant

funds' shareholder reports, prospectuses and Statements of Additional Information.

5. Alpine allegedly caused the Trust to violate Investment Company Act Rule 31a-1(b)(5) by failing to maintain proper records of brokerage orders and Alpine violated Section 204 of the Advisers Act and Advisers Act Rule 204-2(a)(3) by failing to document and retain records of the initial indications of interest for each IPO.
6. The SEC imposed a cease and desist order against Alpine and Lieber, censured Alpine, ordered Alpine to pay a fine of \$650,000, ordered Lieber to pay a fine of \$65,000 and ordered Alpine to comply with the findings of an independent compliance consultant responsible for conducting a review of Alpine's policies and procedures relating to IPO allocations.
7. In considering the settlement, the SEC took into account Alpine and Lieber's cooperation with SEC staff and that prior to the SEC's investigation, Alpine voluntarily replaced its inexperienced CCO and voluntarily retained an independent compliance consultant.

B. *In the Matter of Melhado, Flynn & Associates, Inc., George M. Motz and Jeanne McCarthy*, Admin. Proc. File No. 3-12574 (May 11, 2011)

1. On May 11, 2011, the SEC settled an administrative proceeding that it had initiated in 2007 against Melhado, Flynn & Associates, Inc. ("MFA"), a registered broker-dealer and investment adviser, George M. Motz ("Motz"), MFA's President and CEO, and Jeanne McCarthy, MFA's Comptroller and FINOP, for engaging in fraudulent trade allocations.
2. The SEC alleged that from 2001 through September 2003, Motz (MFA's only trader) engaged in a cherry-picking scheme that generated risk-free profits for the firm's trading account at the expense of the firm's advisory clients. From 2003 through 2005, Motz expanded the scheme to boost the returns of the Third Millennium Fund, LP, an advisory client hedge fund affiliated with MFA.
3. As alleged, Motz effected the scheme by placing orders with his trading desk early in the day, and then deciding later in the day (often just before the closing bell) whether to sell the position – if profitable – and book the gains in MFA's proprietary account or, instead, to allocate the securities – if

trading at a loss by the end of the trading day – to MFA’s advisory client account. As a result of this scheme, day-trades allocated to MFA’s proprietary account were profitable 98% of the time and yielded a net gain of close to \$1.4 million over 18 months for MFA and day-trading in the Third Millennium account was 100% profitable from 2003 through 2005.

4. Motz also admitted to altering certain order tickets in a failed attempt to hide his activities from regulators.
5. The settled order against MFA, among other things, revoked MFA’s registrations as a broker-dealer and an investment adviser. Based on its inability to pay and the five-year probation sentence levied in a related criminal proceeding, the SEC did not impose any penalties against MFA or require it to pay disgorgement.
6. In October 2009, MFA pled guilty to one count of securities fraud relating to the cherry-picking alleged in these proceedings. For his involvement in the scheme, Motz agreed to a bar from associating with any firm in the securities industry with a right to apply for re-entry. The United States District Court for the Eastern District of New York ordered Motz to pay disgorgement and prejudgment interest totaling \$864,806, which the SEC deemed sufficient to satisfy Motz’s restitution obligation, and sentenced Motz to an eight-year prison sentence. Motz’s appeal is pending before the Second Circuit. For her involvement in the scheme, McCarthy agreed to a bar from associating with any firm in the securities industry with a right to apply for re-entry. Based on her inability to pay, the SEC did not impose any civil penalties against McCarthy or require her to pay disgorgement.

Failure to Disclose Conflicts of Interest

The cases below highlight the SEC focus on ensuring that investment advisers make full and fair disclosure of material facts that may affect the nature of the investment advisory relationship. This is particularly so where the investment adviser has a financial or other conflict of interest that could affect the trading or investment decisions made on behalf of its clients.

- A. *In the Matter of Scott E. Desano, Thomas H. Bruderman, Timothy J. Burnieika, Robert L. Burns, David K. Donovan, Edward S. Driscoll, Jeffrey D. Harris, Christopher J. Horan, Steven P. Pascucci and Kirk C. Smith*, Admin. Proc. File No. 3-12978 (Apr. 4, 2011)

1. The SEC initiated an administrative proceeding against Thomas H. Bruderman (“Bruderman”), a Fidelity trader, alleging that he accepted travel and gifts from brokerage firms that executed trades for Fidelity’s advisory clients, including its mutual funds.
2. As an equity trader, Bruderman was responsible for, among other things, selecting brokerage firms to execute brokerage transactions on behalf Fidelity’s clients. The SEC alleged that Bruderman, an equity trader, violated Section 17(e)(1) of the Investment Company Act by accepting additional compensation in the form of travel and gifts, including private airfare, bachelor party entertainment and drugs, from brokerage firms with which he conducted business.
3. The SEC also alleged that Bruderman violated his fiduciary duty under Section 206(2) of the Advisers Act by failing to disclose to his clients the material conflict of interest created by his conduct.
4. The SEC imposed a cease and desist order, censured Bruderman and ordered Bruderman to pay disgorgement of \$205,000 plus prejudgment interest of \$74,218 and a civil penalty of \$70,000.
5. This case is one of a number of cases stemming from a March 5, 2008 settlement in which Fidelity agreed to a number of undertakings and to pay a civil penalty of \$8 million based on allegations that it failed to supervise employees who accepted inappropriate gifts from brokerage firms seeking to execute trades for Fidelity’s funds. The SEC also commenced proceedings against the other traders who allegedly accepted gifts and their supervisors.

B. *In the Matter of Western Pacific Capital Management, LLC and Kevin James O’Rourke*, Admin. Proc. File No. 3-14619 (Nov. 10, 2011)

1. The SEC initiated an administrative proceeding against Western Pacific Capital Management, LLC (“Western Pacific”) and James O’Rourke (“O’Rourke”) alleging that they failed to disclose a financial interest in various investments that they recommended to their clients, misused fund assets for the benefit of the adviser and repeatedly misrepresented the fund’s liquidity to investors.
2. The SEC alleged that Western Pacific, a registered investment adviser, and O’Rourke, the adviser’s sole owner

and principal, violated Section 17(a) of the Securities Act, Sections 206(1), 206(2), and 206(4) of the Advisers Act, Advisers Act Rule 206(4)-8, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5 when Western Pacific served as a placing agent for an unregistered offering of Ameranth stock. The SEC alleged that O'Rourke urged Western Pacific clients to purchase shares of the Ameranth stock and invest in his hedge fund, which, unbeknownst to investors, would later invest in the Ameranth stock, without disclosing that Western Pacific was earning a 10% success fee on all sales of Ameranth stock. Western Pacific earned \$482,745 in success fees as Ameranth's placement agent.

3. The SEC alleged that Western Pacific and O'Rourke violated Section 206(4) of the Advisers Act and Advisers Act Rule 206(4)-8 when O'Rourke misused fund assets to resolve a dispute with an advisory client who wanted to return \$800,000 of Ameranth stock before the offering closed. O'Rourke used fund assets to purchase a portion of the client's stock and allowed the client to use the remainder of his Ameranth stock to finance the client's investment in the fund. Western Pacific received \$80,000 in success fees associated with this action.
4. The SEC further alleged that O'Rourke repeatedly represented to clients that the fund was liquid or had less than 25% of its holdings in illiquid securities, when in fact approximately 90% of the fund's assets were illiquid. In addition, the SEC alleged that Western Pacific and O'Rourke violated Section 206(3) of the Advisers Act because they allegedly purchased securities without appropriate disclosure of the principal capacity in which they were acting and the client's prior consent.
5. Finally, the SEC alleged that Western Pacific and O'Rourke violated Section 15(a)(1) of the Exchange Act because neither Western Pacific nor O'Rourke were registered as or associated with a broker-dealer when they used interstate commerce to effect transactions related to the Ameranth offering.
6. The SEC proceeding against Western Pacific and O'Rourke is still pending.

C. *In the Matter of JSK Associates, Inc., Jerome S. Keenan and Paul Dos Santos*, Admin. Proc. File No. 3-14296 (Mar. 14, 2011)

1. The SEC initiated an administrative proceeding against JSK Associates, Inc. (“JSK”), Jerome S. Keenan (“Keenan”) and Paul Dos Santos (“Dos Santos”) alleging that they failed to disclose that an affiliated broker-dealer received financial benefits from the cash holdings in advisory accounts and engaged in principal transactions without disclosure and client consent.
2. The SEC alleged that JSK failed to adequately disclose to clients that its affiliated broker-dealer received compensation from its clearing firm based on the amount of uninvested cash balances and money market fund balances in its clients’ advisory accounts. In addition, JSK allegedly did not have appropriate policies and procedures relating to its investment advisory activities and code of ethics and did not conduct annual compliance reviews in accordance with Advisers Act Rule 206(4)-7.
3. The SEC further alleged that JSK, Keenan and Dos Santos violated Advisers Act Section 206(3) by engaging in hundreds of fixed income transactions through the affiliated broker-dealer on a riskless principal basis without providing prior written disclosure or obtaining client consent. The SEC alleged that Keenan and Dos Santos aided and abetted and caused JSK’s violations of Section 206(3).
4. The SEC imposed a cease and desist order against and censured JSK, Keenan and Dos Santos, ordered JSK to pay disgorgement of \$60,350, a fine of \$60,000 and prejudgment interest of \$3,805 and ordered Keenan and Dos Santos to each pay a civil penalty of \$10,000.
5. In considering the settlement, the SEC took into account cooperation with SEC staff and remedial acts promptly undertaken by JSK, Keenan and Dos Santos.

Marking the Close

Following is a discussion of two recent cases that involve the practice of “marking the close” in order to inflate performance numbers prior to a month or quarter-end period.

A. *In the Matter of Donald L. Koch and Koch Asset Management LLC*, Admin. Proc. File No. 3-14355 (Apr. 25, 2011)

1. The SEC initiated an administrative proceeding against Donald L. Koch (“Koch”) and Koch Asset Management LLC (“KAM”) alleging that they engaged in a scheme to artificially

inflate the reported closing prices of certain securities held in client accounts.

2. The SEC alleged that KAM, an investment adviser, and Koch, the President, CCO, and founder of KAM, violated Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5 and Sections 206(1) and 206(2) of the Advisers Act by engaging in practice known as “marking the close” by placing buy orders for certain thinly traded securities at inflated prices at or near the close of the market in order to artificially increase the reported closing price, which, in turn, improved the portfolio performance reported to KAM’s investors. The SEC also alleged that by engaging in this practice KAM and Koch breached their fiduciary duty to seek best execution.
3. KAM and Koch also allegedly violated Section 206(4) of the Advisers Act and Advisers Act Rule 206(4)-7 by failing to implement KAM’s written policies and procedures that prohibit “transactions intended to raise, lower, or maintain the price of any security.”
4. Additionally, the SEC alleged that KAM and Koch violated Section 204 of the Advisers Act and Advisers Act Rule 204-2(a)(7) by failing to maintain required books and records by deleting certain electronic communications related to the placing and execution of orders for one of the securities at issue in this case.
5. The SEC proceeding against KAM and Koch is still pending.

B. *In the Matter of Eric David Wanger and Wanger Investment Management, Inc.*, Admin. Proc. File No. 3-14676 (Dec. 23, 2011)

1. The SEC initiated an administrative proceeding against Eric David Wanger (“Wanger”) and Wanger Investment Management, Inc. (“WIM”) alleging that they engaged in a scheme to artificially inflate the reported closing prices of stock held in a WIM-advised hedge fund that was managed by Wanger.
2. The SEC alleged that WIM, a registered investment adviser, and Wanger, the President, CCO, and owner of WIM, violated Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5 and Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act by engaging in a scheme to mark-the-close of thinly traded securities by placing buy orders for such securities at inflated prices at or near the

close of market trading (for the month or quarter) in order to artificially increase the securities' reported closing prices, which, in turn, improved fund performance.

3. The SEC alleged that WIM violated, and Wanger aided and abetted WIM's violations of, Sections 206(1), 206(2), and 206(4) of the Advisers Act and Advisers Act Rule 206(4)-8 by engaging in fraudulent conduct as an investment adviser. As a result of these violations, the SEC alleged that WIM received more management fees, failed to obtain best price execution for the fund and made material misrepresentations and omissions to existing and potential investors.
4. The SEC alleged that Wanger, acting through WIM, violated Section 206(3) of the Advisers Act by engaging in unauthorized sale and purchase transactions between the advisory account and his personal account on multiple occasions without providing written disclosure of the capacity in which he was acting to the board or obtaining its consent to do so.
5. The SEC also alleged that WIM and Wanger violated Section 16(a) of the Exchange Act and Exchange Act Rule 16a-3 by failing to timely file Form 4 with the SEC for each of their transactions in AltiGen Communications, Inc. ("AltiGen"). The SEC alleged that Wanger, a director on the board of AltiGen, needed to file Form 4 with respect to eight personal transactions in AltiGen and WIM needed to file Form 4 with respect to at least forty transactions in AltiGen because the Fund owned more than 10% of AltiGen's stock.
6. The SEC proceeding against WIM and Wanger is still pending.

Misappropriation of Client Assets and Investment Opportunities

The SEC continues to be vigilant in bringing enforcement actions where investment advisers misappropriate client assets and engage in fraudulent trading schemes that result in using client assets for their own person benefit.

- A. *SEC v. Lawrence R. Goldfarb*, CV-11-0938-DMR (N.D. Cal. Mar. 1, 2011); *In the Matter of Lawrence R. Goldfarb*, Admin. Proc. File No. 3-14362 (May 2, 2011)
 1. The SEC filed a settled action and initiated an administrative proceeding against Lawrence R. Goldfarb ("Goldfarb"), charging him with misappropriating customer assets and

concealing his activities by claiming that he “side pocketed” assets that he owed investors in his hedge fund.

2. The SEC alleged that Goldfarb, the managing member of Baystar Capital Management, an unregistered investment adviser to a hedge fund, violated Advisers Act Sections 206(1), 206(2) and 206(4) and Advisers Act Rule 206(4)-8 by misappropriating more than \$12 million in client assets, comingling client funds with his personal assets and concealing the misappropriation by issuing false account statements.
3. Specifically, the SEC alleged that Goldfarb invested hedge fund assets into a real estate venture and directed the real estate venture to pay all returns from the investment to a bank account belonging to a defunct company owned by Goldfarb.
4. When the investors from the hedge fund redeemed their shares, Goldfarb produced account statements stating that the real estate investment had been placed in a side pocket and therefore could not be redeemed at that time.
5. As a result of the civil action, Goldfarb consented to a permanent injunction against violations of Sections 206(1), (2) and (4) of the Advisers Act and agreed to pay disgorgement of \$12,112,416, a fine of \$130,000 and prejudgment interest of \$1,967,371.
6. The SEC also barred Goldfarb from associating with any firm in the securities industry with a right to apply for re-entry in five years.

B. *In the Matter of Matthew Crisp*, Admin. Proc. File No. 3-14520 (Aug. 29, 2011).

1. The SEC initiated an administrative proceeding against Matthew Crisp (“Crisp”) alleging that he misappropriated investment opportunities in two private companies for his personal benefit.
2. The SEC alleged that while working as a partner of Adams Street Partners, LLC (“Adams Street”), an investment adviser that manages private equity funds, Crisp formed a private investment vehicle called AV Partners LP with a friend without disclosing the investment vehicle to Adams Street.

3. Crisp was responsible for reviewing the investment opportunity and recommending that Adams Street invest \$15 million in the TicketsNow offering. Adams Street instructed Crisp to syndicate or find other investors to take up to \$1.5 million of Adams Street's commitment. The SEC alleged that Crisp informed TicketsNow that other investors were purchasing \$2 million of Adams Street's investment. Of the \$2 million of the investment that was syndicated, AV Partners LP obtained \$1.5 million of the investment. Crisp did not obtain authorization for raising the amount taken by other investors by \$500,000.
4. Crisp allegedly violated Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5 and Advisers Act Sections 206(1), 206(2) and 206(4) and Advisers Act Rule 206(4)-8 by concealing the reduction in shares allocated to the Adams Street funds and his association with AV Partners LP.
5. TicketsNow was eventually purchased by another company resulting in investors receiving almost four times their original investment. Based on his ownership in AV Partners LP, Crisp realized a profit of approximately \$2.8 million. In addition, as a board member of TicketsNow, Crisp received a transaction bonus of \$150,000.
6. Similar to TicketsNow, Adams Street also agreed to invest \$14 million in an offering for Sherman's Travel and authorized Crisp to find investors to take \$1 million of their commitment. Crisp allocated the \$1 million to AV Partners without disclosing his financial interest.
7. When Adams Street discovered Crisp's actions, it self-reported the matter to the SEC. Crisp voluntarily returned approximately \$2.4 million of his profits from the TicketsNow transaction and was terminated by Adams Street.
8. The SEC proceeding against Crisp is still pending.

C. *SEC v. David Kugel*, 11-CIV-8434 (S.D.N.Y. Nov. 21, 2011)

1. The SEC filed a complaint against David Kugel ("Kugel"), a longtime employee of Bernie Madoff, charging him with fraud for his role in creating fake trades for investment advisory accounts that were used to facilitate the Madoff Ponzi scheme.

2. The SEC alleged that Kugel provided the firm's investment advisory operations with backdated arbitrage trade information that was used to formulate fictitious trading on investors' account statements. The SEC also alleged that Kugel's own account was among those in which backdated trades were entered and Kugel withdrew almost \$10 million in purported "profits" from his account even though he knew that they were not proceeds from actual trading.
3. The SEC alleged that Kugel, through his falsification of investors' account statements, violated or aided and abetted violations of Sections 10(b), 15(c) and 17(a) of the Exchange Act, Exchange Act Rules 10b-3, 10b-5 and 17a-3, Sections 204, 206(1) and 206(2) of the Advisers Act, and Advisers Act Rule 204-2.
4. The SEC proceeding against Kugel is still pending, but Kugel has pled guilty to parallel criminal charges in the Southern District of New York and has agreed to settle the SEC's civil charges. Subject to court approval, Kugel will be permanently enjoined from further violations and ordered to pay disgorgement.
5. The SEC previously charged two other Madoff employees, Annette Bongiorno and JoAnn Crupi, for their role in falsifying investors' account statements. The SEC also filed a complaint on December 19, 2011 against Enrica Contellessa-Pitz for violating Section 204 of the Advisers Act by falsifying internal accounting journals and ledgers as well as financial statements filed with regulators. The SEC additionally filed a complaint against Eric Lipkin for aiding and abetting violations of Sections 204, 206(1) and 206(2) of the Advisers Act by assisting in creating the perception of trading in the advisory accounts by researching securities prices, falsifying portfolio statements, preparing false books and records, making false statements to regulators regarding the legitimacy of Madoff's trading strategy and sending communications to clients with misrepresentations.

D. *S.E.C. v. Market Street Advisors, Shawn R. Merriman, LLC-1, LLC-2, Marque LLC-3 and LLC-4*, Civil Action No. 09-cv-00786-PAB (D. Colo. Dec. 29, 2011)

1. The SEC filed a civil action against Shawn R. Merriman ("Merriman") in April 2009 that settled in December 2011 alleging that he conducted a Ponzi scheme, raising approximately \$20 million dollars.

2. The SEC alleges that Merriman raised funds by selling interests in at least 4 limited liability companies to 38 or more investors. The Ponzi scheme allegedly began in 1995, when Merriman concealed a \$400,000 trading loss in his first investment fund from his investors by using additional funds raised by new investors to pay for any withdrawals.
3. Merriman allegedly represented to investors that their investments would generate annual returns of 7 to 20% and offered incentives such as a bonus or rebate on funds invested to encourage additional investments.
4. Although Merriman allegedly represented to investors that he was using their funds for securities trading and produced account statements showing the purported value of the limited liability companies and the investor's interest in the company, Merriman allegedly stopped trading completely in 1996 and used the funds he raised exclusively to pay for fund withdrawals, his personal expenses and to purchase artwork for his company, Impressions Everlasting.
5. For the alleged misrepresentations and misappropriation of customer assets, the SEC charged Merriman with violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and 10b-5 thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8.
6. Merriman was ordered to disgorge \$20,124,183.13 which was satisfied by order of restitution in a related criminal case. No civil penalty was imposed due to the fact that Merriman is currently serving a prison sentence of 151 months after pleading guilty to one count of mail fraud in violation of 18 U.S.C. §1341.

E. *SEC v. Otto Sam Folin, Benchmark Asset Managers LLC and Harvest Managers LLC*, Civil Action No. 11-CV-4447 (E.D. Pa. July 12, 2011)

1. The SEC filed a settled action against Benchmark Asset Managers LLC ("Benchmark"), its founder, Otto Sam Folin ("Folin") and its parent company charging them with misappropriating almost \$9 million from advisory clients, friends and family by making material misrepresentations and omissions as part of a Ponzi scheme.
2. Specifically, the SEC alleged that Benchmark and Folin issued various "notes" and recommended that its clients invest in various portfolios of Save Haven Portfolio LLC

(“Safe Haven”), a fund managed by Benchmark and Folin. In connection with these investments, Benchmark and Folin promised investors that their funds would be invested in “socially responsible” public and private companies, their investments were guaranteed to earn above-market interest rates and that the type of investment was considered to be conservative and safe. In actuality, Benchmark and Folin were using investor funds to pay previous investors and to sustain various expenses, including Folin’s salary. They also allegedly failed to amortize expenses and costs in accordance with general accounting principles, which caused the expenses to be overstated on client statements.

3. Benchmark and Folin allegedly borrowed almost \$4 million from Safe Haven in violation of Safe Haven’s investment criteria and did not disclose the loans to investors. Folin also transferred the debt from his investment adviser to the books of Harvest Managers LLC, a company owned and controlled by Folin. In addition, these loans were not valued properly in accordance with general accounting principles, but instead were reported on financial statements at face value.
4. As a result of the civil action, Folin and Benchmark consented to the entry of a final judgment enjoining them for future violations. In addition, the Respondents have agreed to accept joint and several liability for disgorgement of \$8,706,620 and prejudgment interest of \$1,454,177, Folin has consented to pay a civil penalty of \$150,000 and Harvest and Benchmark have agreed to each pay a civil penalty of \$750,000.
5. Folin also consented to an SEC order instituting administrative proceedings which barred him from associating with any firm in the securities industry. Benchmark consented to an SEC order instituting administrative proceedings which revokes its SEC investment adviser registration.

Failure to Register as an Investment Adviser

Below is a case involving the failure to register as an investment adviser and broker-dealer.

- A. *In the Matter of Banco Espirito Santo S.A.*, Admin. Proc. File No. 3-14599 (Oct. 24, 2011)
 1. The SEC filed a settled administrative proceeding against Banco Espirito Santo S.A. (“BES”), a commercial bank

headquartered in Portugal with over 700 branches throughout the world, alleging that BES violated broker dealer and investment advisor registration provisions – as well as the securities transaction registration provisions – of the federal securities laws.

2. The SEC alleged that BES acted as a broker-dealer and investment adviser, even though it was not a registered broker-dealer or investment advisor and did not utilize a registered broker-dealer as an intermediary, and thus willfully violated Sections 5(a) and 5(c) of the Securities Act, Section 15(a) of the Exchange Act, and Section 203 (a) of the Advisers Act.
3. Specifically, the SEC alleged that BES maintained relationships with approximately 3,800 U.S. residents, who were largely Portuguese immigrants, that held securities in their brokerage and advisory accounts with BES between 2004 and 2009.
4. The SEC further alleged that, from 2005 until 2009, BES dedicated a relationship manager to the U.S. market and that relationship manager provided services to approximately 225 U.S. clients.
5. The SEC also alleged that BES retained a third party to operate a customer service call center, that had two Portugal-based employees dedicated to servicing BES's U.S. customers, and those two employees offered various financial products, including securities, to those customers over the phone.
6. In addition, the SEC alleged that BES charged its U.S. based customers and clients commissions and fees on their accounts and for securities transactions.
7. BES consented to a cease-and-desist order, disgorgement of \$1.65 million plus prejudgment interest and a civil penalty of \$4.5 million.
8. In considering the settlement, the SEC took into account BES's cooperation with SEC staff, remedial acts promptly undertaken by BES and its agreement to pay U.S. clients interest on securities they purchased and to compensate each U.S. client for any realized or unrealized losses on securities purchased through BES.

Misrepresentations and False Statements

The following two cases are examples of cases where investment advisers allegedly engaged in fraudulent marketing practices in order to attract and retain clients.

- A. *SEC v. Locke Capital Management, Inc. and Leila C. Jenkins*, 794 F. Supp. 2d 355 (D.R.I. 2011)
1. The SEC was granted summary judgment against an investment adviser, Locke Capital Management, Inc. (“Locke”) and Leila C. Jenkins (“Jenkins”), its founder and sole owner, charging them with engaging in a scheme to gain credibility and attract potential investors by fabricating the existence of a billion-dollar client.
 2. Specifically, the SEC alleged that Locke and Jenkins violated Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder and Sections 204, 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 204-2 and 206(4)-1(a)(5) thereunder, by repeatedly claiming that the firm managed more than \$1 billion in “confidential” client assets. Jenkins frequently mentioned this fictitious client to genuine clients in various ways, including in brochures, meetings, submissions to online databases that prospective clients used to select money managers and in SEC filings. Jenkins also allegedly lied to the SEC staff about the existence of the invented client and furnished the SEC staff with false documents, including fake custodial statements that she created on her laptop.
 3. The Court permanently enjoined Locke and Jenkins from future violations, ordered that they be jointly and severally liable for disgorgement in the amount of \$1,781,520 and prejudgment interest in the amount of \$110,956 and ordered each defendant to pay a civil penalty of \$1,781,520.
- B. *In the Matter of Roman Lyniuk*, Admin. Proc. File No. 3-14304 (July 13, 2011)
1. The SEC initiated an administrative proceeding against Roman Lyniuk (“Lyniuk”), the founder and manager of Atlantis Capital Management, L.P. (“Atlantis”) and Pacific Capital Markets Cayman LDL (“Pacific”), two small hedge funds, alleging that he solicited investors by making false and misleading statements about the funds and their investments and historical performance, failed to disclose

certain conflicts of interest associated with investment decisions for the funds and misappropriated funds.

2. The SEC alleged that Lyniuk violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 206(1) and 206(2) of the Advisers Act in offering and selling shares of Atlantis between 2004 and 2006 and Pacific between 2006 and 2010. In doing so, Lyniuk provided false statements and other documents for the funds to a marketing firm and to third-party hedge fund information providers, who in turn published the misleading information for use by potential investors. This information included misleading and inaccurate statements about historical performance, assets under management, whether the funds were audited, the presence of a fund administrator and the number and investment experience of fund employees.
3. According to the SEC, Lyniuk lied to investors regarding the nature of the fund's investments, emphasizing the fund's extensive risk prevention system, high liquidity and consistent performance, when in fact no such system existed and the performance of the fund was plummeting.
4. Lyniuk did not disclose significant conflicts of interest regarding his trading decisions for the fund. Specifically, Lyniuk allegedly made a large investment in return for a \$40,000 payment to him with the hope that his firm would be hired to provide asset management services to the company. He also received rebates on brokerage commissions and other undisclosed volume-based compensation from numerous broker-dealers in exchange for trading fund assets.
5. Lyniuk used fund assets as collateral for his personal trading which led the funds' brokers to transfer balances from fund accounts to cover negative balances in his personal trading accounts. When investors attempted to redeem their shares after large losses by the funds, Lyniuk failed to disclose why he did not have the assets to redeem their shares and eventually only paid redeeming customers 10% of their statement balance. For those customers that did not redeem their shares, Lyniuk provided false account statements to cover the losses.
6. Lyniuk also allegedly misappropriated assets by transferring \$74,000 in fund assets to himself and \$22,500 to his business partner.

7. In October 2010, Lyniuk received an SEC subpoena and appeared for testimony before the SEC staff. Lyniuk, at first, failed to provide the materials requested in the subpoena, but he eventually submitted to the staff materials that differed from those received by those provided by fund investors. During later searches conducted by the FBI, versions of the materials sent to investors were found, along with evidence that Lyniuk had submitted altered versions to the SEC.
8. The SEC sanctioned Lyniuk with a cease and desist order, a bar from associating with any firm in the securities industry with a right to apply for re-entry, disgorgement in the amount of \$4,072,500 and payment of prejudgment interest in the amount of \$1,181,606. However, the order for disgorgement and prejudgment interest was waived in light of Lyniuk's sworn representation of an inability to pay such penalty.

Short Sales – Violations of Rule 105 under Regulation M

The SEC continues to focus on violations of Rule 105 under Regulation M of the Exchange Act ("Rule 105"), which prohibits an adviser from buying an equity security in a public offering after having sold short the same security during a restricted period. Although the facts in these cases are relatively straight-forward, Rule 105 represents a risk to investment advisers that have not adopted appropriate controls around short selling. The following are representative examples of enforcement actions relating to Rule 105.³⁵

- A. *In the Matter of Brookside Capital, LLC*, Admin. Proc. File No. 3-14444 (June 28, 2011)
 1. The SEC initiated an administrative proceeding against a registered investment adviser, Brookside Capital, LLC ("Brookside"), alleging that Brookside used shares it obtained in a public secondary offering to cover short sales.
 2. The SEC alleged that Brookside, acting as the investment adviser to Brookside Capital Trading Fund, L.P., a hedge fund, violated Rule 105 by executing a short sale of 600,000 shares of Lincoln National Corporation Co. ("LNC") at prices between \$17.70 and \$17.75 per share 3 days before purchasing 1,000,000 shares of LNC at \$15 per share in a public secondary offering. The SEC alleged that Brookside

³⁵ See also *In the Matter of Horseman Capital Management, L.P.*, Admin. Proc. File No. 3-14202 (Jan. 24, 2011); *In the Matter of Aristeia Capital, LLC*, Admin. Proc. File No. 3-14360 (May 2, 2011); *In the Matter of Fontana Capital, LLC and Forrest Fontana*, Admin. Proc. File No. 3-14176 (July 8, 2011); *In the Matter of Touradji Capital Management, L.P.*, Admin. Proc. File No. 3-14658 (Dec. 9, 2011).

made a profit of \$1,658,660 as a result of participating in the offering.

3. During the time period involved in the transaction, Brookside did not have policies, procedures or controls in place to detect or prevent violations of Rule 105.
4. The SEC imposed a cease and desist order, censured Brookside and ordered it to pay disgorgement in the amount of \$1,658,660 plus prejudgment interest of \$90,419 and a civil penalty of \$375,000.
5. In determining appropriate sanctions, the SEC took into consideration certain remedial acts promptly undertaken by Brookside after it discovered the alleged Rule 105 violation, including the development and implementation of policies, procedures and training programs relating to Rule 105 compliance.

B. *In the Matter of Level Global Investors, L.P.*, Admin. Proc. File No. 3-14443 (June 28, 2011)

1. The SEC initiated an administrative proceeding against an unregistered investment adviser, Level Global Investors, L.P., (“Level Global”), alleging that on two separate occasions Level Global executed short sales in a security within 5 days of purchasing shares of the security in a public offering in violation of Rule 105.
2. Level Global executed a short sale of 50,000 shares of Goldman Sachs Group, Inc. (“Goldman”) at \$128.7081 per share before purchasing 400,000 shares of Goldman stock in a public offering at \$123 on the next day. Although Level Global did not use the shares it obtained in the public offering to cover its short sales, it was still prohibited from participating in the public offering because it executed a short sale within 5 days of the offering. Level Global also sold some of the Goldman shares it obtained from the offering on the date of the offering.
3. Over the 5 day period before the public offering of Regions Financial Corporation (“RF”), Level Global executed short sales of 1.5 million shares of RF at prices from \$5.0506 to \$5.4878 per share. Level Global then purchased 2 million shares of RF stock as part of the public offering at \$4.00 per share. Although Level Global did not use the shares it obtained in the public offering to cover its short sales, it was still prohibited from participating in the public offering

because it executed a short sale within 5 days of the offering. In addition, Level Global profited on the discount it received in the price of RF shares.

4. The SEC also alleged that during the time period involved in the transactions, Level Global did not have policies, procedures or controls in place to detect or prevent violations of Rule 105.
5. As a result of these violations, Level Global obtained a total profit of \$2,679,515.
6. The SEC imposed a cease and desist order, censured Level Global and ordered Level Global to pay disgorgement in the amount of \$2,679,515 plus prejudgment interest of \$186,656 and a civil penalty of \$375,000.
7. In determining appropriate sanctions, the SEC took into consideration certain remedial acts promptly undertaken by Level Global after it discovered the alleged Rule 105 violation, including the prompt distribution of an educational memorandum to trading and investment staff, the institution of policies to prevent future Rule 105 violations, an update and reissuance of its compliance manual, mandatory formal training sessions for staff and adoption of the practice of distributing periodic e-mail reminders regarding Rule 105 to relevant employees.

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