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Analysis & Perspective

Enforcement

Top 10 SEC Enforcement Developments of 2006

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ENFORCEMENT

This article highlights significant developments during 2006 in the enforcement program of the U.S. Securities and Exchange Commission. Developments were selected because they may signal future trends or establish new legal standards.

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During 2006, the Number One SEC enforcement development was the expansive and widespread investigations of stock options backdating. By the end of 2006, the SEC and the Department of Justice had only begun filing what will likely be a substantial number of civil and criminal actions in this area.

Also during 2006, the SEC provided for the first time explicit guidance as to what factors it would consider in determining whether to assess civil penalties on a corporation. The SEC's guidance on corporate civil penalties is the Number Two SEC enforcement development of 2006.

The remaining Top Ten developments illustrate other significant issues and trends in the SEC enforcement program:

- Number Three is a district court opinion suggesting limits on cooperation between the SEC and criminal authorities.

- Number Four is a case alleging improper investment adviser fee arrangements.

- Number Five is a decision by the D.C. Circuit upholding SEC sanctions imposed on a lawyer for negligence.

- Number Six is the continuing focus on market timing cases.

- Number Seven is a pair of decisions by the SEC potentially opening the door to asserting the Fifth Amendment privilege in NASD proceedings.

- Number Eight is an enforcement action against outside directors.

- Number Nine is the case brought against the City of San Diego.

- Number Ten is the first case brought under the USA Patriot Act.

1. Stock Options Backdating

In March 2006, *The Wall Street Journal* published an article which ultimately resulted in a massive investigation of more than 100 companies by the SEC and the Department of Justice.[1]

The Journal had asked Erik Lie, a finance professor at the University of Iowa, to provide a list of companies that made stock option grants which were followed by "large gains in the stock market." The *Journal* then studied a number of those companies, finding that for several executive grants, the option grant patterns were unlikely without the benefit of backdating, with chance occurrence of some grant patterns being in the neighborhood of one in 300 billion.[2] The response to this article generated one of the broadest securities investigations in recent history.

Only a few backdating cases were actually filed in 2006 by the SEC or the Department of Justice.[3] Two notable cases are the SEC's actions against former executives of Brocade Communication Systems, Inc. and Comverse Technology, Inc.

A. Brocade Communication Systems, Inc.[4]

The SEC alleged that Brocade officers backdated options and thereby materially overstated the company's income and understated the company's compensation expense. According to the SEC, Brocade's former chief executive officer, Gregory Reyes, granted in-the-money options "to employees by falsifying in the options documentation the date on which the grants were made and thereby granting the options with below-market strike prices." The SEC further alleged that Reyes, with the help of former vice president of human resources Stephanie Jensen, looked back to dates in the past and determined what days the company's stock price was the lowest in the period. Then, using "hindsight," they created documents which falsely showed that a meeting of the compensation committee had occurred on the date, and that options were granted, when in fact, no meeting occurred. The SEC claimed that Reyes backdated options for his own benefit, receiving more than 1.1 million options in two grants and receiving additional grants on at least two other occasions. The SEC also alleged that Reyes falsified the dates upon which employment offers were given to key executives and signed compensation committee meeting minutes reflecting false hiring dates, and that Jensen took similar action, instructing employees to create backdated offer letters.

The SEC additionally alleged that Brocade's former chief financial officer, Antonio Canova, was made aware of the options backdating and took steps to ensure consistency in the false documentation. The SEC alleged that Canova instructed finance department employees to ensure that hire dates of employees matched the hire dates listed in the compensation committee meeting minutes, which "concealed date discrepancies from Brocade's external auditors." Canova further perpetuated this scheme by certifying financial documents that contained misstatements.

The SEC charged Reyes, Jensen and Canova with fraud under the 1933 Securities Act and the 1934 Securities Exchange Act, violations of the books and records provisions of the Exchange Act, and aiding and abetting various violations of the securities laws. The SEC also charged Reyes and Canova with falsely certifying statements made in the Company's 10-Ks and 10-Qs and taking actions to mislead or fraudulently influence outside auditors.

The U.S. Attorney's Office for the Northern District of California charged Reyes and Jensen, but not Canova, with securities fraud and aiding and abetting securities fraud.[5]

B. Comverse Technology, Inc.[6]

The SEC alleged that Jacob "Kobi" Alexander, Comverse's former chairman and CEO, and David Kreinberg, Comverse's former senior general counsel, director and corporate secretary, instituted a backdating scheme with the assistance of William Sorin, Comverse's former CFO. According to the complaint, beginning in 1998, Alexander worked with Kreinberg to pick a grant date that corresponded with a time when Comverse's stock was trading at a low. Sorin or Alexander's assistant would draft unanimous consents containing an "as of" date which corresponded to the selected grant date. In general, compensation committee members were unaware of an impending grant prior to receiving a telephone call or approval packet from Sorin, which took place after the "as of" date had passed.[7]

The SEC alleged that Alexander and/or Kreinberg expanded the backdating scheme by later creating a slush fund of backdated options that were used to recruit and retain key employees. Options were added to the slush fund in various ways. For example, the SEC alleged that Alexander's assistant opened fictitious accounts which were included in the company's master grant list that was sent to the compensation committee for approval.[8] After the grants to the fictitious employees were approved, they were transferred into the slush fund.

The SEC charged Alexander, Kreinberg and Sorin with violations of "antifraud, books and records, internal accounting controls, misrepresentations to auditors and ownership reporting provisions of the federal securities laws. Alexander and Kreinberg were separately charged with violating Sarbanes-Oxley [Act] officer certification provisions."[9] The Commission additionally charged all three defendants with aiding and abetting Comverse's violations of periodic reporting, books and records, and internal controls provisions of the federal securities laws.[10] The SEC's requested relief included injunctive relief, disgorgement, civil penalties, as well as prohibiting the defendants from acting as officers or directors. The SEC has since settled its civil fraud charges against Kreinberg, who agreed to pay $2,394,917.68 in disgorgement and prejudgment interest and to cooperate in the SEC's ongoing litigation.[11]

The criminal complaint, which was filed in the Eastern District of New York, recites a backdating fact pattern substantially similar to that recounted by the SEC. The criminal complaint, however, additionally discusses admissions allegedly made by the defendants both to a Comverse attorney and to the special committee.[12] The three defendants have been charged with violating provisions of the federal securities laws, as well as engaging in wire fraud and mail fraud. Kreinberg has since pled guilty to one criminal count of conspiracy to commit securities fraud, mail fraud, and wire fraud, and one criminal count of securities fraud, while Sorin pled guilty to one count of conspiracy to commit mail fraud, securities fraud and wire fraud.[13] Alexander is currently fighting extradition from Namibia, and a three-day hearing on the extradition request is scheduled to begin on April 25, 2007.[14]

2. Guidance on Corporate Civil Penalties

In January 2006, the SEC issued a statement reaffirming its commitment to the use of civil penalties against corporations and, for the first time, formally articulated the factors that it considers when deciding whether to impose civil penalties against corporate issuers.[15]

While the SEC has had the authority to issue civil monetary penalties against corporate issuers since 1990, it was a rare occurrence throughout the 1990s.[16] This changed with the financial scandals of recent years, with the number and magnitude of corporate civil penalties dramatically escalating.

In its January 2006 statement, the SEC stated that whether it will impose a corporate penalty rests principally on two considerations: First, the "presence or absence of a direct benefit to the corporation as a result of the violation." The SEC explained that the "strongest case" for imposing corporate penalty is one in which the shareholders have received an improper benefit as a result of the violation and the "weakest case" is one in which the shareholders are the principal victims of the violation. Second, the "degree to which the penalty will recompense or further harm the injured shareholders." The SEC acknowledged that the imposition of a penalty on a corporation risks innocent shareholders bearing the burden of the penalty, and stated that the likelihood that a corporate penalty will unfairly injure investors weighs against its use as a sanction. In some cases, however, the penalty may be used to compensate the victims and the presence of an opportunity to use the penalty as a meaningful source of compensation to injured shareholders is a factor in support of its use as a sanction, according to the SEC.

In addition to the two principal factors, the SEC listed seven other factors to be considered in determining whether a corporate civil penalty is appropriate, including the need for deterrence, extent of injury to innocent parties, whether complicity is widespread throughout the corporation, level of intent, difficulty of detection, presence or lack of remedial steps, and extent of cooperation by the corporation.

The statement is a step toward the goal of providing "a high degree of transparency to the workings of the Securities and Exchange Commission"[17] and improving company counsel's ability to advise whether the SEC might seek a penalty. However, substantial uncertainty remains. For instance, it is not clear how the SEC will determine whether a penalty will harm innocent investors. Further, beyond the classification of two "principal" considerations and seven "additional" factors, there is no guidance as to the relative weight of each. Importantly, there is also no guidance as to the appropriate size of corporate penalties.

The SEC explained its application of its framework to two cases that it settled at the same time as the release of the January statement. The SEC's settlement with McAfee included a $50 million penalty.[18] In contrast, the settlement with Applix had no monetary penalty.[19] A key consideration for the SEC was that McAfee's shareholders benefited from the fraud, while Applix's did not.[20] The SEC also looked to the effect on the current shareholders, concluding that McAfee was a large, strong company that could bear a financial penalty, while a financial penalty to Applix could cause disproportionate harm to its shareholders. The McAfee penalty monies could be fairly distributed to harmed shareholders, while that would be more difficult with Applix. Lastly, the SEC asserted that, in McAfee, the illegal conduct was pervasive and spanned two years, while in Applix it was limited to a few bad actors and to only two instances.

In subsequent cases during 2006 that included penalties imposed on corporate issuers, the SEC did not expressly set out its analysis of the considerations listed in the January 2006 statement.[21] It is notable that in most, if not all, of the releases announcing settlements involving civil penalties against corporations, the SEC did not expressly address either of the "principal" considerations described in the January 2006 statement, but did mention that the company's cooperation was taken into consideration, suggesting that even though the extent of cooperation was listed as merely one of the seven factors, it is still given significant or even disproportionate weight.

3. Court Opinion Suggests Limits on Cooperation Between the SEC and Criminal Authorities

On January 9, 2006, the district court in *U.S. v. Stringer* dismissed a criminal indictment that charged three former executives of FLIR Systems, Inc. with conspiracy and securities fraud.[22] The court found that the cooperation between the SEC and the Department of Justice in pursuing parallel civil and criminal investigations prior to the filing of the indictment deprived the defendants of fundamental rights.

According to the district court, shortly after the SEC began investigating the defendants in mid-2000, the U.S. Attorney's Office requested access to SEC investigative files pursuant to ongoing investigations by the U.S. Attorney's Office, the Federal Bureau of Investigation and the Department of Justice. The U.S. Attorney's Office identified the defendants as potential targets and determined that prosecution was likely, but asked the SEC to continue to lead the investigation, fearing that disclosure of a criminal investigation would jeopardize the opportunity to obtain information.

Throughout the SEC's investigation, the U.S. Attorney's Office remained actively involved: meeting with the SEC, obtaining documents, making requests and giving advice such as how best to conduct interviews to gather evidence. The involvement of the U.S. Attorney's Office, however, was concealed from the defendants, with, for example, the SEC instructing court reporters not to mention the U.S. Attorney in front of defense counsel.

Before giving testimony before the SEC, defendants were provided copies of SEC Form 1662, which lists among the "routine uses" of information provided to the SEC the sharing of information with criminal authorities. When defense counsel specifically inquired as to SEC cooperation with criminal enforcement agencies in this case, the SEC stated that it was their policy to not answer such questions but rather to refer them to the agency in question.

The district court held that the SEC failed to adequately warn the defendants of the extent of the SEC's cooperation with the Department of Justice, depriving them of due process and Fifth Amendment rights. The court further found that the prosecution abused the investigative process by effectively using the SEC to carry out its criminal investigation rather than conducting a parallel investigation and by exploiting conflicts of interest between defendants and their attorney. The court concluded that the government had engaged in "deceit and trickery."

An appeal is now pending before the Ninth Circuit. In an amicus brief filed with the Ninth Circuit, the SEC maintains that its cooperation with criminal authorities in the *Stringer* case was "fully in accord" with SEC policies concerning "parallel proceedings."[23]

4. Improper Investment Adviser Fee Arrangements

In 2006, the SEC stepped up its scrutiny of mutual fund fee arrangements and, in September 2006, the SEC filed a settled administrative proceeding against BISYS Fund Services, Inc., the third-party service provider that performs recordkeeping and other back-office services for mutual fund advisers.[24]

The SEC found that BISYS aided and abetted 27 mutual fund advisers in defrauding fund investors. According to the SEC, BISYS and the fund advisers entered into undisclosed side agreements through which advisers improperly used investors' mutual fund assets to pay for marketing expenses rather than paying for those expenses out of their own assets. Under the side agreements, BISYS rebated a portion of its fund administration fee to (or on behalf of) the investment advisers to the funds so that the advisers would continue to recommend that BISYS be retained as the fund administrator. Pursuant to these side agreements, BISYS provided over $230 million from its administration fees for the benefit of the funds' advisers or third parties. These side arrangements were not disclosed to the mutual funds' boards of trustees or shareholders.

Without admitting or denying the SEC's findings, BISYS agreed to the issuance of an order obligating it to pay a total of $21.4 million, consisting of disgorgement of $9.7 million in ill-gotten gains, prejudgment interest of $1.7 million, and a $10 million civil penalty. These monies were to be placed in a distribution fund for the benefit of the harmed mutual funds.

Also as part of the settlement, BISYS agreed to cease and desist from committing or causing any violations and any future violations of Sections 206(1) and 206(2) of the 1940 Investment Advisers Act, and Sections 12(b) and 34(b) of the 1940 Investment Company Act and Rule 12b-1(d) thereunder. BISYS also agreed to retain an independent consultant to review its policies and procedures governing the receipt of revenue and payment of expenses associated with its administrative, fund accounting, and distribution services, as well as to review the accuracy of its disclosures to mutual fund boards.

5. D.C. Circuit Upholds Sanctions on Counsel for Negligence

On November 28, 2006, the D.C. Circuit upheld SEC sanctions against bond counsel who rendered a "tax-exempt" opinion on the issuance of municipal bonds without conducting an adequate investigation.[25]

The tax-exempt status of municipal bonds creates arbitrage opportunities. For example, as the D.C. Circuit explained, an issuer could theoretically issue tax-exempt bonds at four percent interest and invest the proceeds in Treasury bonds earning five percent interest, yielding "an instant, risk-free profit."[26] Federal tax law, however, limits arbitrage by requiring municipal bonds to pass certain tests or forfeit their tax-exempt status, a bond is eligible for tax exempt status only if the issuer reasonably expects on the date of issue to incur an obligation to expend certain amounts on capital projects within specified time frames, and to pursue those projects with due diligence to completion.

In this case, the issuer was a school board which was considering a number of capital projects. An investment banker approached the school board and told the board that by issuing municipal bonds, it could borrow money for the projects years in advance and keep the investment profits. According to the SEC, bond counsel, Ira Weiss, who was present during this meeting, assured the board that the plan was legal. Weiss also did not explain the federal tax regulations with specificity to the board.

Weiss ultimately issued an unqualified opinion on the bonds' tax-exempt status, despite only having received a "wish list" of 33 projects that the board was contemplating. Weiss also obtained a nonarbitrage certificate signed by the school board, which Weiss had drafted, but the court held that the representations were vague and insufficient to justify Weiss' reliance.

While Weiss prevailed before the administrative law judge, the SEC reversed, finding that the lawyer was "at least negligent" in rendering his tax-exempt opinion without looking for "minimal objective indicia" of the board's intent.[27] The SEC concluded that Weiss had issued a materially misleading tax opinion without adequate investigation of the grounds for that opinion, and had failed adequately to apprise the school board of the requirements for tax exemption. Accordingly, the SEC ordered that Weiss cease and desist from violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, and ordered Weiss to disgorge $9,509.63 (the fee he received for his services as bond counsel) together with prejudgment interest.

The court denied Weiss's appeal from the SEC's order, concluding:

> The bond transaction in this case was promoter-induced. [The promoter] proposed the transaction after learning that the Board was considering capital projects. [The promoter] used the prospect of arbitrage to sell the transaction. Weiss was at the

> presentation. Weiss knew that the Board had not contracted for any projects or even sought bids. He could not have been unaware of the substantial likelihood that the Board would fail to satisfy the three tests. Yet Weiss never asked the Board to confirm that it was committed to specific projects or was ready to proceed with them. Substantial evidence thus supports the SEC's conclusion that "Weiss was responsible for misrepresentations and omissions in the Official Statement and in his legal opinions," which failed to provide investors with "full information concerning the substantial risk that the IRS would find the Notes to be taxable."

6. Market Timing Cases Continue

The SEC's market timing cases in 2006 reached both sides of the trading desk, involving individuals directly engaged in market timing trades as well as those who facilitated or approved them and, in some cases, involving significant monetary penalties.

A. *In the Matter of Prudential Equity Group, LLC.*[28]

On August 28, 2006, the SEC charged four former registered representatives of Prudential Securities, Inc., now known as Prudential Equity Group, LLC ("PEG"), with illegal market timing in more than 25 mutual funds between 2001 and September 2003. The complaint alleges that respondents used fraudulent and deceptive trading practices, including utilizing multiple representative and customer account numbers, to evade mutual fund efforts to block market timing. The SEC seeks injunctive relief, disgorgement, interest, and penalties.

PEG simultaneously settled an SEC administrative action based on the fraudulent market timing of former registered representatives.[29] Without admitting or denying the SEC's allegations, PEG agreed to pay $270 million in disgorgement and civil penalties.

B. *In the Matter of Bear, Stearns & Co., Inc., and Bear, Stearns Securities Corp*.[30]

On March 16, 2006, the SEC charged Bear, Stearns & Co., Inc. ("BS&Co") and its clearing firm Bear, Stearns Securities Corp. ("BSSC") with late trading and market timing.

According to the SEC, BSSC knowingly processed thousands of late trades and provided prime customers with deceptive trading devices, such as multiple identifying numbers, to avoid detection by mutual fund companies that prohibited market timing. The SEC further found that the "timing desk" maintained by BSSC purportedly to monitor and block market timing trades actually served to help market timing clients negotiate and evade restrictions on such activity. According to the SEC, BS&Co facilitated the illegal market timing by knowingly processing large numbers of late trades and by assigning multiple identifying numbers to BS&Co registered representatives, branches and customers accounts.

Respondents consented, without admitting or denying the SEC's allegations, to cease and desist from future violations, to pay $250 million in disgorgement and civil penalties and to adopt and implement policies and procedures and enhance compliance and oversight structure to prevent future violations.

C. *SEC v. Daniel Calugar and Security Brokerage, Inc*.[31]

On January 10, 2006, Calugar and Security Brokerage, Inc. ("SBI") settled a civil injunction action alleging improper market timing and late trading.[32] The complaint alleged that SBI and Calugar, a lawyer and the former president and owner of SBI, engaged in late trading and market timing between 2001 and 2003. According to the SEC, SBI created false internal records to conceal late trades and Calugar negotiated a *quid pro quo*, "sticky asset" agreement with a mutual fund family to invest in its hedge funds in exchange for market timing capabilities.

Without admitting or denying the SEC's allegations, Calugar consented to pay $153 million in disgorgement and penalties. Calugar also agreed to the entry of an order barring him from association with any broker-dealer, with a right to reapply after one year, and to a permanent injunction against future violations. SBI ceased to be a registered broker-dealer in 2003.

D. *SEC v. Stephan J. Treadway and Kenneth W. Corba.*[33]

On October 26, 2006, Stephan J. Treadway, a former PIMCO equity mutual funds executive, agreed to settle SEC charges after a federal court jury found him liable for securities fraud, breach of fiduciary duty and other securities violations in June 2006.[34]

The SEC's complaint alleged that Treadway engaged in fraud by approving, but failing to disclose, an arrangement that allowed a PIMCO client to market time certain of PIMCO's funds. According to the SEC, Corba negotiated and approved a *quid pro quo*, "sticky asset" agreement allowing the client to market time in exchange for long-term mutual fund and hedge fund investments.

Without admitting or denying the SEC's findings, Treadway agreed to pay disgorgement and penalties of $572,000. Treadway also consented to a permanent injunction against future violations and an order barring him from association with any broker-dealer, with a right to reapply after one year, and from serving as an officer or director of an investment company for a period of one year. Corba, the former CEO of PIMCO's adviser PEA Capital LLC, settled SEC charges in June 2006.[35]

7. Door Opens for Potential Fifth Amendment Privilege in NASD Proceedings

On two occasions during 2006, the SEC set aside disciplinary actions taken by the NASD after former associated persons of member firms asserted the privilege against self-incrimination in response to the NASD's requests for information under Rule 8210. In both cases, the SEC cautioned that circumstances in which the NASD would be considered a state actor for Fifth Amendment purposes would be rare. In neither case did the SEC reach a conclusion as to whether the NASD's actions in fact constituted state action.

A. *In the Matter of the Application of Frank P. Quattrone.*[36]

On March 24, 2006, the SEC set aside the finding of violation and sanctions the NASD had imposed in response to Frank P. Quattrone's assertion of the privilege against self-incrimination and refusal to provide requested information.

Quattrone asserted the Fifth Amendment privilege in response to the NASD's Rule 8210 request in connection with a joint investigation by the NASD, SEC and New York Stock Exchange into initial public offering "spinning" and research analysts' conflicts of interest. Quattrone asserted that the NASD's Rule 8210 Request was state action because of the joint nature of the investigation. He offered to provide information without giving testimony, or to testify after the conclusion of pending criminal investigations, but the NASD considered both offers to be unacceptable responses. The NASD dismissed Quattrone's allegation of state action and granted summary disposition of liability.

The SEC set aside the NASD's finding, holding that Quattrone had presented enough evidence to show a genuine issue of material fact regarding whether the NASD's investigation constituted state action. The SEC also stated that, according to the NASD's rules, Quattrone should have been granted an evidentiary hearing as to whether the NASD's request constituted state action. Although the SEC set aside the disciplinary action, the SEC did not reach the merits of the state action issue.

B. *In the Matter of the Application of Justin F. Ficken.*[37]

Justin F. Ficken was a former general securities representative of Prudential Securities, Inc. and its successor Wachovia Securities, LLC. The NASD took disciplinary action against Ficken after he refused to provide testimony at on-the-record interviews concerning a NASD investigation into market timing and late trading. Ficken, like Quattrone, argued that the NASD qualified as a state actor, because he believed that a grand jury convened in Boston was receiving information from the SEC, which was in turn (he believed) receiving information from the NASD. Ficken had also been informed by the Department of Justice that he was the target of a federal criminal investigation into matters on which the NASD sought his testimony.

After Ficken invoked his privilege, the NASD sought summary disposition against Ficken. Ficken unsuccessfully attempted to obtain discovery from the NASD to bolster his "state action" claim. The NASD hearing panel ultimately entered summary disposition against Ficken and barred him from association with any NASD member firm. The NASD's National Adjudicatory Council, upon reviewing that action, stated that Ficken's assertions that the NASD staff forwarded documents from its investigation to the SEC and DOJ were "unsubstantiated" and "generalized," "demonstrat[ing] no government coercion or significant encouragement and [do] not support a finding that the NASD's investigation of [Ficken] was state action."[38]

On November 3, 2006, the SEC set aside the disciplinary action and remanded the proceeding to the NASD for further consideration. The SEC noted that when the NASD took its disciplinary action, the SEC had not yet issued its *Quattrone* opinion. The NASD, therefore, had not yet had the opportunity to evaluate the *Quattrone* opinion and had not addressed the question of joint action in considering whether it was a state actor. In addition, the Commission held that, to the extent Ficken could meet the burden for obtaining discovery, stating the "precise manner" in which the facts support his claims, and explaining with some precision why he would need additional discovery, the NASD should give his request for discovery "due consideration." The SEC did not reach the merits of the state action claim, and specifically noted it did not intend to suggest any view on the outcome of the remand.

8. Enforcement Action Against Outside Directors

On November 2, 2006, the SEC filed settled enforcement actions against eight former officers and directors of Spiegel, Inc. in connection with financial reporting issues. The sanctioned individuals included three *outside* directors.[39] The SEC found that these three directors participated in Spiegel's decision to delay filing required financial reports in order to avoid issuance by its outside auditor of a "going concern" opinion.

In the SEC's press release announcing the filing of the actions, Linda Chatman Thomsen, Director of the Division of Enforcement, stated that: "Directors who keep important financial information from the investing public by purposely failing to file required financial reports will be sanctioned. Shareholders and investors deserve to know the unadulterated truth."[40]

Without admitting or denying the Commission's findings, two of the directors consented to the court's issuance of an order of permanent injunction enjoining them from future violations of the federal securities laws, as well as a civil penalty of $100,000. Without admitting or denying the Commission's findings, the third outside director consented to the entry of an administrative order to cease and desist from committing or causing future violations of the reporting provisions of the federal securities laws.

9. City of San Diego Sanctioned

On November 14, 2006, the SEC instituted an administrative proceeding charging the City of San Diego (the "City") with failing to disclose in five municipal bond offerings in 2002 and 2003 key information about certain pension and retiree health care obligations.[41]

The SEC alleged that the City failed to disclose in its offering materials that its unfunded liability to its pension plan was projected to increase dramatically--from $284 million in 2002 to an estimated $2 billion by 2009--and that its liability for retiree health care was estimated at another $1.1 billion. The SEC also alleged that the City did not disclose that it was deliberately under-funding its pension obligations in order to increase pension benefits while deferring the costs. According to the SEC, the misleading statements were made not only in the offering materials for the five municipal bond offerings in 2002 and 2003 (which raised more than $260 million from investors), but were also directed to the agencies giving the City its credit rating for its municipal bonds. After the pension and retiree health care issues were disclosed in fiscal year 2004, the credit rating agencies lowered the City's credit rating.

The SEC alleged that the City had knowledge or was reckless in not knowing that these disclosures were materially misleading, and that the City violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Without admitting or denying the SEC's findings, the City agreed to cease and desist from future securities fraud violations and to retain an independent consultant for three years to help "foster compliance" with its disclosure obligations, among other remedial measures. No money penalty was assessed.

10. First SEC Case Under the USA PATRIOT Act.[42]

On May 22, 2006, the SEC brought its first-ever enforcement action under the USA PATRIOT Act--*In the Matter of Crowell, Weedon & Co.*[43] The SEC sanctioned Los Angeles-based broker-dealer Crowell, Weedon & Co. ("Crowell") for failing properly to document its customer identification program ("CIP").

The CIP rule requires a broker-dealer to establish, document, and maintain its procedures for identifying customers and verifying their identities.[44] These procedures must be incorporated into the broker-dealer's overall anti-money-laundering program.

The SEC found that, from October 2003 to at least late April 2004, Crowell opened approximately 2,900 new accounts for customers, but failed to follow its customer identity verification procedures in its written CIP. The written CIP specified that Crowell would verify the identity of each new customer using certain non-documentary and documentary procedures (such as public database searching and reviewing government-issued identification). The SEC found that, instead of following these procedures, Crowell simply relied on its registered representatives' attestations that they had personal knowledge of the customers opening the new accounts. The SEC concluded that Crowell violated the record-keeping and record retention requirements under the CIP rule.

Without admitting or denying any of the findings, Crowell consented to the issuance of an order to cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-8 thereunder.

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[1] Charles Forelle, *How the Journal Analyzed Stock-Option Grants*, Wall St. J. Online, Mar. 18, 2006 (available at http://online.wsj.com/PA2VJBNA4R/article_print/SB114265125895502125.html).

[2] *Id.*

[3] A number of cases, however, have been filed in the first months of 2007, including an action against former executives of Engineered Support Systems, Inc. (*see* Complaint, *SEC v. Steven J. Landmann*, C.A. No. 4:07-CV-270 (E.D. Mo. Feb. 6, 2007) and Complaint, *SEC v. Gary C. Gerhardt*, C.A. No. 4:07-CV-271 (E.D. Mo. Feb. 6, 2007)); an action against the former CEO of Take-Two Interactive Software, Inc. (*see* Complaint, *SEC v. Ryan Ashley Brant*, C.A. No. 1:07-CV-1075 (DLC) (S.D.N.Y. Feb. 14, 2007)); and an action against the former general counsel of Monster Worldwide, Inc. (*see* Complaint, *SEC v. Myron F. Olesnyckyj*, C.A. No. 07-CV-1176 (S.D.N.Y. Feb. 15. 2007)).

[4] *See* Complaint, *SEC v. Gregory L. Reyes, Antonio Canova and Stephanie Jensen*, C. 06-4435 (N.D. Cal. July 20, 2006); *see also* Complaint, *United States v. Gregory L. Reyes and Stephanie Jensen*, No. 3-06-70450 (N.D. Cal. July 20, 2006); Affidavit in Support of Complaint by FBI Special Agent Joseph Schadler, *United States v. Gregory L. Reyes and Stephanie Jensen*, No. 3-06-70450 (N.D. Cal. July 20, 2006).

[5] Complaint, *United States v. Gregory L. Reyes and Stephanie Jensen*, No. 3-06-70450 (N.D. Cal. July 20, 2006).

[6] *See* Complaint, *SEC v. Jacob "Kobi" Alexander, David Kreinberg and William F. Sorin*, No. 06-CV-3844 (E.D.N.Y. Aug. 8, 2006); *see also* Affidavit In Support of Arrest Warrants, *United States v. Jacob Alexander, also known as "Kobi Alexander," David Kreinberg and William F. Sorin*, No. M-06-817 (E.D.N.Y. July 31, 2006).

[7] For at least one of the grants discussed in the complaint, the price per share for the backdated options was above the fair market price on the "as of" date, meaning the options were in the money as of the grant date.

[8] For a period of time, the grantee list was treated as a work in progress, whereby the names of the grantees or the number of options to be awarded was changed after the list was approved by the compensation committee.

[9] Press Release, Securities and Exchange Commission, *SEC Charges Former Comverse Technology, Inc., CEO, CFO and General Counsel in Stock Options Backdating Scheme* (Aug. 9, 2006) (available at http://www.sec.gov/news/press/2006/2006-137).

[10] The SEC also charged Kreinberg with similar misconduct in connection with another company, Ulticom.

[11] Press Release, Securities and Exchange Commission, *David Kreinberg Former CFO of Comverse Technology, Inc. Agrees to Settle SEC Ch*

arges in Options Backdating Case (Oct. 24, 2006) (available at http://www.sec.gov/news/press/2006/2006-180.htm).

[12] *See generally* Affidavit In Support of Arrest Warrants, *United States v. Jacob Alexander, also known as "Kobi Alexander," David Kreinberg and William F. Sorin*, No. M-06-817 (E.D.N.Y. July 31, 2006) at ¶¶ 78, 81-82, 90-99.

[13] *Text of Statement on Plea Deal of Ex-Comverse Finance Chief,* Wall St. J. Online, Oct. 24, 2006 (available at http://online.wsj.com/article/SB116171288903202289-search.html?KEYWORDS=kreinberg&COLLECTION=wsjie/6month); Paul Davies, *A Second Comverse Ex-Executive Pleads Guilty,* Wall St. J. Online, Nov. 3, 2006 (available at http://online.wsj.com/article/ SB116248739040311521-search.html?KEYWORDS=

sorin&COLLECTION=wsjie/6month).

[14] Steve Stecklow, *Stock Options Scandal Fugitive Puts Down Roots in Namibia,* Wall St. J. Online, Nov. 17, 2006 (available at http://online.wsj.com/article/SB116373005784725

882-search.html?KEYWORDS=kobi&COLLECTION=wsjie/6month.)

[15] Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006) (available at http://sec.gov/news/press/2006-4.htm).

[16] Annette L. Nazareth, Remarks Before the SEC Speaks Conference (Mar. 3, 2006) (available at http://www.sec.gov/news/speech/spch030306aln.htm).

[17] Christopher Cox, Speech by SEC Chairman: Statement of Chairman Cox Concerning Objective Standards for Corporate Penalties (Jan. 4, 2006) (available at http://www.sec.gov/news/speech/spch010406cc.htm).

[18] *SEC v. McAfee*, Litigation Release No. 19520 (Jan. 4, 2006) (available at http://www.sec.gov/litigation/litreleases/lr19520.htm).

[19] *In the Matter of Applix, Inc*., Securities Act Release No. 8651, Exchange Act Release No. 53049, Accounting and Auditing Enforcement No. 2349 (Jan. 4, 2006) (available at http://www.sec.gov/litigation/admin/33-8651.pdf).

[20] Linda Chatman Thomsen, Speech by SEC Staff: Statement regarding McAfee, Inc. and Applix, Inc. (Jan. 4, 2006) (available at http://www.sec.gov/news/speech/spch010406l

ct.htm).

[21] *See e.g., SEC v. American International Group, Inc*., Litigation Release No. 19560 (Feb. 9, 2006) (available at http://www.sec.gov/litigation/litreleases/lr19560.htm) ($800 million); *In the Matter of Prudential Equity Group*, Exchange Act Release No. 54371 (Aug. 28, 2006) ($270 million); *SEC v. Federal Nat'l Mortgage Ass'n,* Litigation Release No. 19710 (May 23, 2006) (available at http://www.sec.gov/litigation/litreleases/2006/lr19710.htm ($400 million to SEC and Office of Federal Housing Enterprise Oversight); *SEC v. Tyco Int'l Ltd*., Litigation Release No. 19657 (Apr. 17, 2006) (available at http://www.sec.gov/litigation/litreleases/2006/lr19657.htm) ($50 million).

[22] *United States v. Stringer*, 408 F. Supp. 2d 1083 (D. Or. 2006).

[23] Brief of the Securities and Exchange Commission, *amicus curiae*, in support of Appellant's Brief Seeking Reversal and Remand, *United States v. Stringer*, 9th Cir., No. 06-30100, 9/13/06.

[24] *In the Matter of BISYS Fund Services, Inc.*, Investment Act Release No. 2554 (Sept. 26, 2006).

[25] *Weiss v. SEC*, 468 F.3d 849 (D.C. Cir. 2006).

[26] *Id*. at 850.

[27] *In the Matter of Ira Weiss*, Securities Act Release No. 8641 (Dec. 2, 2005).

[28] Exchange Act Release No. 54371 (Aug. 28, 2006).

[29] Litigation Release No. 19813 (Aug. 28, 2006).

[30] Exchange Act Release No. 53490 (Mar. 16, 2006).

[31] Complaint, *SEC. v. Daniel Calugar*, C.A. No. CV-S-03-1600-RCJ-RJJ (D. Nev. Dec. 22, 2003).

[32] Litigation Release No. 19526 (Jan. 10, 2006).

[33] Complaint, *SEC v. Stephan J. Treadway*, C.A. No. 04 Civ. 3464 (VM) (S.D.N.Y. Nov. 4, 2004).

[34] Litigation Release No. 19888 (Oct. 26, 2006).

[35] Litigation Release No. 19724 (June 13, 2006).

[36] Exchange Act Release No. 53547 (Mar. 24, 2006).

[37] Exchange Act Release No. 54699 (Nov. 3, 2006).

[38] *Dept. of Enforcement v. Justin F. Ficken*, Complaint No. C11040006, 2005 NASD Discip. LEXIS 7, at *9 (NAC Dec. 7, 2005).

[39] Complaint, *SEC v. Michael Crusemann and Michael Otto*, No. 06-CV-5969 (N.D. Ill., Nov. 2, 2006); *In the Matter of Horst Hansen*, Exchange Act Release No. 54689 (Nov. 2, 2006).

[40] Available at http://www.sec.gov/news/press/2006/2006-184.htm.

[41] *In the Matter of City of San Diego, California*, Securities Act Release No. 8751 (Nov. 14, 2006).

[42] Pub. L. No. 107-56, 115 Stat. 272 (2001). Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-8 thereunder requires broker-dealers to comply with certain record-keeping requirements under the Bank Secrecy Act, as amended by the USA PATRIOT Act. Bank Secrecy Act, 12 U.S.C. §1829b, 12 U.S.C. §§1951-1959, and 31 U.S.C. §§5311-5330.

[43] Exchange Act Release No. 53847 (May 22, 2006).

[44] The customer identification program ("CIP") rule is located at 31 CFR §103.122.

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