



**"REAL TIME" ENFORCEMENT:
RECENT TRENDS IN SEC ENFORCEMENT ACTIONS**

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**Jonathan C. Dickey
John H. Sturc
John D. van Loben Sels
GIBSON DUNN & CRUTCHER LLP
Palo Alto, California**

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I. INTRODUCTION

Ask Not For Whom the Bell Tolls...

The past year has witnessed a series of spectacular financial failures of high profile public companies, and in too many instances the failures were accompanied by civil and criminal proceedings alleging that management "cooked the books" or otherwise engaged in egregious acts of corporate malfeasance. The level of SEC enforcement activity is now at record levels, spurred by the multi-billion dollar restatements and resulting bankruptcies of companies such as Enron, WorldCom, Adelphia, and others. Stating the obvious, the passage of the Sarbanes-Oxley Act of 2002 ("SOX") was in direct response to these disastrous breakdowns of corporate governance – and now SOX provides a multitude of new SEC enforcement tools designed to deter wrongdoing and to punish those who continue to abuse the corporate trust.

How did such unprecedented levels of fraud occur? What empirical evidence exists that offers an explanation? While boards and corporate executives will debate the issue endlessly, a few recent speeches and several recent studies offer some context.

Steven M. Cutler, Director of the Division of Enforcement for the SEC, has expressed the view that the source of many of the corporate governance failures in the recent past is an emphasis at the top of corporate management on achieving short-term gains. *See* Steven M. Cutler, remarks at the University of Michigan Law School, November 1, 2002. Another key problem Mr. Cutler recognized is that auditors became tools for achieving the appearance of better financial results, rather than as gatekeepers for accurate financial disclosure because auditing firms were focused on securing compensation for skills other than auditing. *Id.* Mr. Cutler was likewise critical of the legal profession, especially the practice where some firms take equity in their clients as part of their compensation.

Most observers agree that a major means of achieving the appearance of financial success has been to stretch the boundaries of GAAP accounting. Invariably, such creative accounting efforts ripen into restatements of financial results and earnings "surprises" when companies are forced to disclose that prior period financials were falsified. This problem is not an isolated one – indeed, in October 2002, following in the wake of so many notorious financial collapses, the General Accounting Office published a study that provides a devastating commentary on how financial fraud has affected public companies in the last five years:

- According to the GAO, 10% of all listed companies restated their financial results in the period 1997–2002;
- There were 225 restatements in 2001 alone;
- The average market cap of companies that restated their financials in 2002 was \$2 billion;
- The total market-adjusted loss in market cap of companies that restated their financial results in the period 1997–2002 was \$95 billion;

- Emphasizing that the problem is not confined to tech companies in Silicon Valley, the report notes that NYSE-listed companies are increasingly involved; and
- Finally, the main culprit in all the restatements was revenue recognition – involved in 38% of the restatements covered by the study.

SEC Enforcement – "Real Time" Enforcement, and the New Mantra of Cooperation.

Increasingly, SEC enforcement actions are focusing on individual wrongdoers, accompanied by a dramatic increase seen in SEC efforts to secure fines, penalties, and officer and director bars. Moreover, SEC enforcement efforts are focusing increasingly on lower level corporate officers and employees. Further, the Department of Justice and United States Attorneys are working closely with the SEC through parallel criminal investigations of a number of high profile alleged financial frauds, as witnessed by the Department of Justice Enron Task Force and the recent joint operation involving Federal regulators and law enforcement personnel investigating corruption at HealthSouth.

Statistics from the last fiscal year bear out these themes. For the year ending September 30, 2002, the SEC Enforcement Division set records in many categories:

- 598 enforcement actions in total – a 24% increase over 2001;
- 163 enforcement actions involving financial fraud or accounting improprieties – a 46% increase over 2001;
- 126 actions seeking D&O bars – a 147% increase over 2001;
- 48 actions seeking TRO's – a 55% increase over 2001; and
- 259 criminal actions in which the SEC also was involved.

Steven M. Cutler reiterated the emphasis the Commission is placing on affirmative cooperation from issuers faced with securities law violations. Mr. Cutler reviewed the criteria detailed in the Commission's Section 21(a) report issued in the Fall of 2001, and stressed their importance to Corporate America:

1. *Self-policing.* There should be an appropriate means for managers to report misconduct or misgivings in connection with an audit without fear of a reprisal. Moreover, Mr. Cutler emphasized that firms should have procedures in place so that difficult decisions are vetted at a high level.
2. *Self-reporting.* Companies should conduct an immediate and thorough investigation, and effectively disclose the misconduct to regulators and the public.
3. *Remediation.* Did the company sanction wrongdoers and modify internal controls?

4. *Cooperation with law enforcement authorities.* Cooperation must be meaningful from the outset of the Commission's investigation, and must not consist merely of reluctant responses to subpoenas.

See Remarks Before the American Institute of Certified Public Accountants, December 12, 2002, by Steven M. Cutler.

For those who do not cooperate – or whose conduct is clearly so severe that penalties are appropriate regardless of how much after-the-fact cooperation is provided – the penalties will be quite harsh. Linda Chatman Thomsen, the SEC's deputy director of the Enforcement Division, stated recently that officer and director bars will receive increased attention in the coming year. In addition, the SEC will spend more of its resources to enforce subpoenas,¹ and there will be tougher penalties for insider trading. Ms. Thomsen said that officer and director bars are "probably the biggest trend. The Commission has indicated a keen interest in keeping people who have abused their trust from being in a position to do so again." Along those same lines, the SEC Enforcement Division's chief counsel, Joan McKown, recently has acknowledged that SOX makes it easier for the SEC to obtain officer and director bars. Under SOX, Ms. McKown noted that the enforcement staff has only to prove that the defendant is unfit to serve as an officer or director of a public company, not that the individual is "substantially" unfit. McKown said, "Conventional wisdom for the defense bar [had been] loss of gain and a one-time penalty. I think we are moving away from that." McKown also noted there have been recent cases where defendants faced one and one-half or double or treble penalties.

Another ominous development materialized on April 9, 2003, when the Senate passed by a 95 to 5 vote a tax bill that includes a provision empowering the SEC to impose severe fines on any securities law violator without the necessity of federal court action. *See* S. 476. Senators Carl Levin of Michigan and Bill Nelson of Florida succeeded in adding the SEC-related amendment to a tax bill concerning public disclosures for charitable organizations. If passed by the House and signed into law, the amendment would give the SEC new powers to impose civil penalties through administrative proceedings, and would raise the maximum limits for such violations to: a) \$100,000 for a violation of any statutory provision, regulation or rule (\$200,000 for an entity violator); b) \$500,000 for a violation involving fraud or reckless disregard for the violated statutory or regulatory requirement (\$1 million for entity violators); and c) \$1 million if the violation involves both fraud and a loss or significant risk of loss to others (\$2 million for

¹ As an example, on March 12, 2003, the SEC filed an application in the U.S. District Court for the Central District of California to compel testimony from the former Chairman and former CFO of Gemstar-TV Guide International, Inc. The enforcement action came after counsel for the witnesses backed out of an earlier commitment to produce the witnesses for testimony in March. The witnesses claimed they needed more time to prepare for the testimony, so three days before they were due to testify the witnesses' counsel indicated the witnesses would not appear. The SEC refused to grant a three-week extension and brought the enforcement action despite the fact the witnesses had recently received approximately 170 boxes of documents and hundreds of thousands of emails related to certain subject transactions.

entities). These administrative proceedings would be appealable to the Commission, then to federal court. The SEC has been seeking this additional authority for some time, but Senator Levin was unable to include a similar provision in the Sarbanes-Oxley Act of 2002 before debate on that act closed. Thus, it may soon be easier for the SEC to secure civil money penalties, and the amounts of those penalties could grow dramatically.

The New Federalism.

Steven Cutler recently commented on the interactions between state and federal securities regulators. Mr. Cutler emphasized the importance of avoiding “re-Balkanizing” the securities markets, but observed that Congress continues to believe in a regulatory system where both federal and state agencies have specific and valuable functions. *See* Steven M. Cutler, Remarks at the F. Hodge O’Neill Corporate and Securities Law Symposium, Washington University School of Law, February 21, 2003 (“It is clear that protecting investors from fraud must remain central to our missions.”). *Id.* Mr. Cutler also emphasized the need for state regulators to cooperate with their federal counterparts when competing federal interests are implicated by state enforcement actions. *Id.*

Indications from at least some state regulators are that such a sentiment is not well-received. New York Attorney General Eliot Spitzer said in a recent speech, “What they want to do now more than anything else is to shackle the hands of those who want to enforce the law.”² Other state regulators are seeking increasing enforcement powers to combat corporate misconduct. California Attorney General Bill Lockyer announced on March 6, 2003, through a bill authored by State Senator Martha Escutia, that California would seek to create a new crime for providing false statements to state investigators with respect to securities code, commodities code and antitrust investigations. *See* SB 434.

Yet there are some signs that federal and state securities regulators are attempting to work together. Steven Cutler recently announced a coordinated approach among the SEC, the New York Stock Exchange, the NASD, the New York Attorney General’s Office, and the North American Securities Administrators Association to develop a coordinated approach addressing research analyst conflicts and to outlaw IPO “spinning” practices. *See* Steven M. Cutler, statement at the Announcement of Agreement In Principal of Research Analyst Issues, December 20, 2002.

Further, the President recently indicated the importance of having a unified Federal regulator and law enforcement community, coupled with state regulators, working to rid U.S. capital markets of the taint of corporate fraud. On July 9, 2002, President Bush signed an executive order establishing the Corporate Fraud Task Force. The Task Force has members from the Department of Justice, the FBI, and the United States Attorneys from several key districts such as the Southern District of New York, the Northern District of Illinois, the Northern District

² Mr. Spitzer’s comments came at the annual meeting of the Consumer Federation of America on February 27, 2003.

of California, and the Southern District of Texas. The Task Force will also receive input from the Secretary of the Treasury, the Chairman of the SEC, and several other key Federal regulatory agencies.

The President charged the Task Force with providing direction for the investigation and prosecution of cases involving securities fraud, accounting fraud, mail and wire fraud, and other financial crimes committed by commercial entities and their officers, directors and professional advisors. The Task Force was specifically directed to provide recommendations for allocating prosecutorial resources and enhancing efforts to recover the proceeds from financial crimes, and to take action to enhance cooperation among federal, state, and local authorities regarding the prosecution of these crimes. Former SEC chairman Harvey Pitt commented that one way the Corporate Fraud Task Force can contribute to solving the problem of corporate fraud is to create a comprehensive response to financial fraud that involves both civil and, in some instances, criminal remedies. “By creating a dually enforceable system of laws, the drafters of the securities statutes understood that not all securities violations warrant the same degree of punishment. When criminal sanctions are warranted, coordination between the civil and criminal agencies gives life and meaning to that scheme. Imposition of jail time ensures a violator will be out of the securities or accounting fraud business in a way that an administrative or court order may not and exceeds the deterrent effect that the SEC can achieve on its own.” Harvey L. Pitt, Remarks before the U.S. Department of Justice Corporate Fraud Conference, Washington, D.C., September 26, 2002.

New Guidance from The Department of Justice.

Earlier this year, the Department of Justice issued important revisions to its own memorandum on corporate cooperation. The DOJ memorandum states that a corporation “impedes” a federal criminal investigation if it broadly asserts that the company represents current or former employees, directs employees to decline to be interviewed, and fails to disclose promptly illegal conduct that comes to the company’s attention. See Principals of Federal Prosecution of Business Organizations, dated January 20, 2003. The factors the DOJ uses when deciding whether to pursue criminal charges against a corporation closely track those used by the SEC to determine whether and to what extent to bring an enforcement action. For instance, the DOJ examines: (a) the nature of the wrongdoing; (b) the pervasiveness of the misconduct; (c) the company’s timely and voluntary disclosure of its own wrongdoing and its cooperation with the government’s investigation; (d) the adequacy of internal corporate controls and other corrective actions taken by the organization; and (e) the harm caused by the illegal conduct. One additional factor the DOJ considers is whether non-criminal sanctions are sufficient to deter and punish the misconduct.

II. RECENT HIGH-PROFILE SEC ENFORCEMENT ACTIONS

The following are some of the more significant SEC enforcement cases from the last year, with a particular emphasis on cases that the SEC itself has considered to be important.

A. *Qwest Communications International, Inc., February 25, 2003.*

The Commission filed fraud charges against eight current and former officers and employees of Qwest Communications International, Inc. ("Qwest") alleging that they fraudulently inflated Qwest's revenue in 2000 and 2001 by approximately \$144 million in order to meet analysts' expectations. The action was filed in the District of Colorado on February 25, 2003, and seeks injunctive relief, civil monetary penalties, disgorgement (including compensation, bonuses and stock trading profits), and permanent officer and director bars.

The Commission's complaint alleges that when the defendants recognized that Qwest would not meet quarterly revenue targets for the third quarter of 2000 and the second quarter of 2001, defendants fraudulently bridged the gap by improperly recognizing revenue for two large transactions. In one of the transactions, the SEC charges that the former Qwest CFO and Senior VP of Global Business, the former Assistant Controller, and others hatched an elaborate plan to inflate the revenue associated with the sale of internet equipment to the Arizona School Facilities Board ("ASFB"). The fraudulent conduct the SEC points to involved improperly separating the equipment sale from installation services and wrongfully characterizing the sale proceeds under Generally Accepted Accounting Principles ("GAAP"). The SEC's allegations include contentions that the defendants prepared false letter agreements for ASFB and fraudulent internal memoranda. As a result of this fraudulent transaction, Qwest improperly recognized approximately \$34 million in revenue for the second quarter of 2001. Without this transaction, Qwest would have failed to meet analysts' projections.

The other transaction detailed in the Commission's complaint involve two current Qwest executives, including the current CFO of Qwest's Corporate Planning and Operational Finance Unit and involves the fraudulent characterization of a transaction with Genuity, Inc. as two separate contracts. Qwest is alleged to have improperly recognized \$100 million in revenue by purporting to sell equipment to Genuity at an improperly inflated price while simultaneously agreeing to provide Genuity services at a loss to Qwest.

The SEC investigation is being closely coordinated with other law-enforcement agencies. On February 25, 2003, simultaneously with the filing of the SEC's enforcement actions, four of the eight SEC defendants were named by the United States attorney in a 12-count criminal indictment for conduct involving the two transactions detailed above.

B. *Enron Corp.*

1. *Andrew S. Fastow, October 2, 2002.*

In what is now one of the most infamous of alleged financial frauds, the SEC filed a civil enforcement action against Andrew S. Fastow, the former CFO of Enron Corp. ("Enron"), alleging a complex series of securities fraud violations. The SEC indicated that it brought its action in the U.S. District Court for the Southern District of Texas in coordination with the Justice Department's Enron Task Force, which filed a related criminal complaint against Fastow. "Mr. Fastow's actions, . . . have undermined investor confidence in our markets and our system of financial reporting," said Steven M. Cutler. The SEC is seeking disgorgement of all ill gotten

gains, including all compensation received subsequent to the commencement of Mr. Fastow's alleged fraud, civil money penalties, permanent officer and director bar, and other relief.

The Commission's complaint arises from Mr. Fastow's actions related to six Enron transactions, three of which were the subject of an earlier settled action against former Enron employee Michael Kopper. The SEC alleges that the transactions were part of a scheme to hide Fastow's interest in and control of entities in order to keep the entities off Enron's balance sheet. Fastow allegedly was motivated by the desire for self enrichment and the need to mislead analysts about Enron's true financial condition.

Specifically, the SEC alleges that in early 1997, Enron needed to divest itself of electricity-generating windmill farms to meet certain energy regulations. Enron did not want to relinquish control over the windmill farms, so Fastow selected certain individuals to act as nominal investors in entities referred to as "RADR" to purchase the windmill farms. The RADR entities generated \$2.7 million in illegal profits in July 2000. Then, Enron repurchased the facilities from the entities, generating an additional gain of \$1.8 million. Next, in 1997 Enron and the California Public Employees' Retirement System ("CalPERS") were joint partners in an off-balance sheet investment vehicle called Joint Energy Development Limited Partnership ("JEDI"). When CalPERS wanted to cash out of its investment in JEDI, Fastow helped form a special purpose entity called Chewco to buy CalPERS' interest and allow Enron to continue to account for JEDI's off-balance sheet entity. According to the Commission, Fastow secretly controlled Chewco and received a share of Chewco's profits as kickbacks. Third, the SEC alleges Fastow unlawfully enriched himself using another off-balance sheet partnership he controlled, LJM Caymen, LP ("LJM1"). Fastow arranged for Enron to buy out two of the limited partners from LJM1, stating that National Westminster Bank wanted \$20 million for its interest, but Fastow gave only \$1 million of that sum and pocketed the rest, according to the SEC.

Two of the remaining three fraudulent transactions for which the SEC brought suit against Fastow, are alleged to be sham transactions: a) the sale of three Nigerian barges, where Fastow made oral promises that Enron would arrange to buy back its interest in the barges from a financial institution within six months; and b) the Cuiba Project where Fastow arranged financing for a power point in Cuiba, Brazil, from an allegedly independent buyer but with an unwritten side agreement requiring Enron to buy back the interest in the project. The final unlawful transaction for which the SEC brought suit against Fastow is the Raptor I Avici transaction. There, Enron entered into a complex series of transactions with an entity called Raptor I, which was used to manipulate Enron's balance sheet and income statement. Fastow and others are accused of backdating documents to make it appear that Enron locked in the value of its investment in a company called Avici Systems Inc. ("Avici") when Avici's stock was trading at its all-time high.

2. *Merrill Lynch & Co., Inc., Daniel H. Bayly, Thomas W. Davis, Robert S. First, Schuyler M. Tilney, March 17, 2003.*

In the United States District Court for the Southern District of Texas, the SEC charged Merrill Lynch & Co., Inc. ("Merrill"), and four of its former senior executives with aiding and abetting the securities fraud Enron committed. Simultaneously, the Commission agreed to settle

its claims against Merrill. Under the terms of the settlement, Merrill will pay \$80 million in disgorgement, penalties and interest, and agree to the entry of a permanent anti-fraud injunction. The Commission indicated that it intends to have the \$80 million from Merrill paid into a court fund for distribution to victims of the Enron fraud under Section 308(a) of the Sarbanes-Oxley Act of 2002 (the "Fair Fund" provision). The four individual defendants are contesting the SEC's complaint.

Of the \$80 million, Merrill agreed to pay to settle this dispute, \$37.5 million constitutes a civil penalty. The Commission specifically noted that its agreement to settle the matter stemmed in part from Merrill's decision to terminate two of the named defendants after they refused to testify before the Commission and assert their Fifth Amendment rights. Plus, Merrill brought the energy wash trade transaction discussed below to the Commission's attention when it believed the staff was unaware of its existence.

The complaint charges that in December 1999, senior Enron executives approached Merrill with a transaction for parking certain assets. Namely, Merrill bought an interest in three Nigerian barges from Enron under the express promise that Enron would later arrange the sale of Merrill's interest within six months at a specific rate of return. Thus, the transaction was no more than a bridge loan, because the risks of ownership did not pass to Merrill. Further, Merrill had no experience with barge ownership, nor did it have significant experience in Africa. According to the Commission, Merrill knew that Enron intended to record \$28 million in revenue associated with the barge transaction and that Merrill entered into the transaction solely to accommodate Enron.

Next, the SEC claims that also in December 1999, Merrill and Enron entered into two energy option contracts that Merrill knew fraudulently inflated Enron's income by approximately \$50 million dollars. Merrill believed that the two trades were essentially a wash, but also knew the transaction would significantly impact Enron's reported financial results, so Merrill demanded a multi-million dollar fee. Enron ultimately agreed to pay over \$17 million to Merrill.

3. *Michael W. Krautz and Kevin A. Howard, March 12, 2003.*

The SEC charged two additional officers of Enron with violating federal securities laws. Specifically, Michael W. Krautz, a former senior executive of accounting and Kevin A. Howard, the former chief financial officer for Enron Broadband Services, Inc., a wholly-owned Enron subsidiary, are charged with violations of both the Securities Act and the Exchange Act. The Commission seeks disgorgement, civil money penalties, a permanent officer and director bar, and other related relief. Simultaneously, the Justice Department's Enron Task Force filed related criminal charges against both Howard and Krautz.

The Commission's complaint was filed in the United States District Court for the Southern District of Texas and alleges that the two defendants engaged in a scheme to overstate the reported earnings of Enron and its broadband services subsidiary by approximately \$111 million during the fourth quarter of 2000 and the first quarter of 2001. The SEC charges that Howard and Krautz were involved in a scheme known as "Project Braveheart," involving the fraudulent sale of certain assets to accelerate revenue recognition on an agreement to develop

and provide video-on-demand services. The SEC claims Howard and Krautz formed a purported joint venture to control the subject agreement, but the purported joint venture partner, a financial institution, was never a true partner because Enron guaranteed the results of Project Braveheart. The Commission claims that the illegal scheme resulted in Enron overstating its reported income for 2000 by \$53 million dollars and the first quarter of 2001 by \$58 million dollars.

C. *HealthSouth Corporation and Richard M. Scrushy, March 19, 2003.*

The SEC announced the temporary suspension of trading in the securities of HealthSouth Corporation (“HealthSouth”) for two days (March 19–20, 2003) under Section 12(k) of the Exchange Act. The Commission announced its extraordinary temporary trading suspension because of questions regarding the accuracy of publicly disclosed information concerning HealthSouth’s earnings, assets, and current financial condition. The SEC filed its complaint in the United States District Court for the Northern District of Alabama, alleging fraud in violation of federal securities laws and seeking disgorgement, a temporary freeze, permanent injunctive relief, civil money penalties, and a permanent officer and director bar.

HealthSouth is headquartered in Birmingham, Alabama, and is the largest provider of outpatient surgery, diagnostic and rehabilitative health care services. HealthSouth owns and operates 1,800 different facilities through the United States and abroad. The Commission claims that HealthSouth overstated its earnings by at least \$1.4 billion dollars because its chief executive officer and chairman of the board, Richard M. Scrushy (“Scrushy”) insisted that HealthSouth employees fraudulently ensure that HealthSouth books meet Wall Street expectations. The Commission specifically alleges that Scrushy violated the CEO certification requirement from the Sarbanes–Oxley Act of 2002 regarding HealthSouth’s financial condition in its August 14, 2000, Form 10–K.

The SEC alleges that defendants, driven by Scrushy, established a program for systematically falsifying HealthSouth’s financial results in order to meet Wall Street expectations. Finally, defendants took steps to fraudulently lower Wall Street expectations by blaming a revenue shortfall on May 2002 Medicare billing guidance. News reports indicated that FBI agents entered the HealthSouth headquarters to execute document subpoenas.

On March 31, 2003, the SEC charged two former HealthSouth Chief Financial Officers with insider trading and with aiding and abetting Scrushy’s fraudulent reporting of HealthSouth’s financial performance. In addition, William Owens and Weston Smith pleaded guilty to criminal fraud charges and agreed to cooperate with a government probe. The SEC is seeking disgorgement of ill-gotten gains, civil money penalties, and permanent officer and director bars against Owens and Smith.

D. *ImClone Systems, Inc./Samuel Waksal, March 11, 2003.*

The Commission agreed to a partial resolution of its insider trading case against Samuel Waksal, the former CEO of ImClone Systems, Inc. (“ImClone”). Waksal agreed to disgorge over \$800,000 from unlawful trades, and agreed to a permanent officer and director bar.

The SEC complaint alleges that between December 26 and 28, 2001, Waksal attempted to sell ImClone's shares worth nearly \$5 million, directed his daughter to sell all of her ImClone stock, purchased 210 ImClone put options through a Swiss account, and tipped a family member to sell his ImClone stock. All of these allegations stem from actions Waksal took after learning that the U.S. Food and Drug Administration ("FDA") was expected to reject ImClone's application to approve ImClone's primary product, a cancer treatment drug. According to the SEC complaint, Bristol-Myers Squibb Company, a development and distribution partner of ImClone's product, learned on December 25, 2001, that the FDA would reject the ImClone drug application on December 28, 2001. Waksal learned of this non-public information on December 26, and beginning immediately to sell his ImClone shares, those of his daughter, and Waksal also began tipping other friends and family with ImClone stock.

E. WorldCom, Inc., November 26, 2002.

The Commission filed its initial complaint against WorldCom on June 26, 2002, just one day after WorldCom, Inc. ("WorldCom") announced its intention to restate its financial results for the first quarter of 2002 and all four quarters of 2001. The Commission alleges that WorldCom fraudulently overstated its income by improperly transferring certain costs to its capital accounts in violation of GAAP. The SEC claimed that WorldCom was motivated to meet the expectations of Wall Street analysts. According to the SEC, WorldCom began in 2001 to engage in an improper accounting scheme that involved its accounting for "line costs." Line costs are fees WorldCom pays to third party communication network providers for access rights. Under GAAP, these fees must be expensed, but WorldCom's senior management directed that the line costs be transferred to WorldCom's capital accounts in sufficient amount to keep WorldCom's earnings in line with analyst expectations. The scheme involved an improper reporting of over \$3 billion in these line costs.

In October 2002, the SEC announced the first of what is expected to be a series of settlements of WorldCom-related enforcement actions. In the first matter, the SEC announced that a judgment of permanent injunction was entered against WorldCom ordering, *inter alia*, an extensive review of WorldCom's corporate governance policies and practices, an extensive review of WorldCom's internal accounting and control policies and practices, and orders that WorldCom provide training and education for its officers and employees to minimize the possibility of future violations. The court deferred any determination regarding civil money penalties to be paid by WorldCom. Moreover, the court continued its appointment of a corporate monitor to ensure WorldCom does not commit future securities laws violations, and retained jurisdiction over WorldCom.

As further example of the SEC's increased attention in its enforcement activities on individual accountability, the Commission commenced an enforcement action against WorldCom's Controller, David F. Myers, on September 26, 2002. The SEC brought another enforcement action against WorldCom's former Director of Accounting, Buford "Buddy" Yeats, Jr. on October 7, 2002. The SEC's fourth enforcement action was brought against former WorldCom accounting managers, Betty L. Vincin and Troy M. Normand on October 10, 2002. Judge Rakoff entered officer and director bars against Myers and Yeats on November 14, 2002. Further action in this case is expected.

F. *Quintus Corp./Alan K. Anderson, May 20, 2002.*

The former Chief Executive Officer of Quintus Corp. ("Quintus"), Alan K. Anderson, was charged with an especially egregious financial fraud. According to the Commission, Anderson personally forged contracts, emails, purchase orders, letters and audit confirmations in order to boost Quintus' financial results. Anderson created three fraudulent transactions ranging in size from \$2 million to \$7 million, for a total of \$13.7 million in fraudulent sales. The Commission also charged that Anderson caused Quintus to improperly recognize \$3 million in revenue from a barter transaction contingent on Quintus' agreement to purchase \$4 million of product from the customer in violation of GAAP. In one case, Anderson altered a \$1.5 million purchase order to make it appear that the customer ordered \$6 million of Quintus products and services. Anderson's fraud caused Quintus to overstate its revenue in three quarters in amounts from 37% to 60% per quarter. Quintus is now being liquidated through bankruptcy proceedings. Finally, the U.S. Attorney for the Northern District of California charged Anderson with one count of securities fraud based upon the above activity.

G. *Unify Corp., May 20, 2002.*

The SEC brought fraud charges against the former CEO and CFO of Unify Corp. ("Unify"). The Commission alleges that the former Unify officers caused Unify to improperly recognize revenue on fraudulent transactions they knew were subject to illegal side agreements or were barter transactions that violated GAAP. The Commission charges that the former Unify officers engaged in several instances of "round-tripping" where Unify provided its funds to customers in order to buy Unify products with no reasonable expectations that the customers would ever repay Unify. The former CEO during the course of his fraud sold all of his Unify stock for gross proceeds of \$8.2 million. Again, the U.S. Attorney's Office for the Northern District of California simultaneously announced that it was charging both officers with criminal securities fraud.

H. *Legato Systems, Inc., May 20, 2002.*

The Commission brought an enforcement action for securities fraud against Legato Systems, Inc.'s ("Legato") former vice president of worldwide sales David Malmstedt and the former vice president of North American sales Mark Huetteman for allegedly causing Legato to fraudulently record millions of dollars in revenue that were contingent upon Legato's resellers' ability to sell the product to an end customer. Legato develops and sells software for managing data storage functions for computer networks. The Commission alleges that fraud at Legato caused Legato to overstate its revenue for three fiscal quarters in amounts ranging from 6% to 20% per quarter. In a related matter, the Commission simultaneously issued a cease-and-desist order settling its investigation against Legato and its former CFO, Steven Wise.

I. *Rite Aid Corp., June 21, 2002.*

The SEC and the U.S. Attorney of Middle District of Pennsylvania simultaneously announced securities fraud charges against several former senior executives of Rite Aid Corp. ("Rite Aid"). The Commission's complaint charges former CEO Martin Grass, former CFO Frank Bergonzi, and former chairman Franklyn Brown with orchestrating a wide-ranging

accounting fraud. The Commission alleges that Rite Aid overstated its income in every quarter from May 1997 through May 1999. Ultimately, Rite Aid was forced to restate its pre-tax income by \$2.3 billion and net income by \$1.6 billion, the largest restatement ever recorded to that date. The Commission also charges that former CEO Grass caused Rite Aid to fail to disclose certain related-party transactions where Grass sought to enrich himself, and that Grass fabricated Finance Committee minutes for a meeting that never occurred. Through its complaint, the Commission is seeking disgorgement of annual bonuses and the imposition of civil penalties against all defendants.

The SEC also announced settled cease-and-desist proceedings against both Rite Aid and the Company's former Chief Operating Officer Timothy Noonan. The Commission specifically noted in its release that the substantial cooperation of Rite Aid and Noonan in the investigation led to the resolution of the Commission's investigation on relatively light terms for both Rite Aid and Noonan.

Rite Aid's fraud had a number of elements. First, Rite Aid systematically inflated the deductions it took against amounts owed to defenders for damaged and outdated products. These improper adjustments resulted in overstatements of income of \$8 million in 1998 and \$28 million in 1999. Rite Aid did not record an accrued expense for stock appreciation rights it had granted to employees. This resulted in Rite Aid underreporting expenses of \$22 million in 1998 and \$33 million in 1999. Moreover, the Commission charges that Bergonzi lied to Rite Aid auditors when they asked about the SARs. Bergonzi, former Rite Aid CFO, directed Rite Aid's accounting staff to reverse amounts that had already been recorded for expenses, and the reversals were completely unjustified and later put back on the books in the subsequent quarter. Bergonzi also directed Rite Aid's accounting staff to make improper adjustments to reduce the costs of goods sold and accounts payable, resulting in an overstatement of Rite Aid pre-tax income of \$100 million for the second quarter of 1999. Rite Aid also overstated its 1999 pre-tax income when it overcharged vendors for undisclosed mark-downs on vendor products. The defendants are also charged with improperly causing Rite Aid to recognize \$17 million from a litigation settlement before the settlement was legally binding. The Commission also charged that defendants failed to account for Rite Aid's inventory "shrink", where certain Rite Aid inventory was either lost or stolen.

Grass, the former CEO, was also charged with failing to disclose his personal interest in three properties that Rite Aid leased for store locations and never disclosed another series of transactions where Rite Aid paid \$2.6 million to a partnership he controlled. Finally, the Commission charged Grass with fabricating minutes of a Rite Aid Finance Committee meeting where no such meeting occurred, and there was no authorization from the Committee to obtain a bank line of credit.

J. *Microsoft Corp., June 30, 2002.*

The Commission announced a settled enforcement action against Microsoft Corp. ("Microsoft"). The Commission found that Microsoft maintained seven reserve accounts in a manner that did not comply with GAAP, and that the reserves did not have an adequately substantiated basis. "This case emphasizes that the Commission will act against a public

company that will misuse financial statements with material inaccuracies, even in the absence of fraud charges," said Steven M. Cutler.

Microsoft consented to the Commission's cease-and-desist order. The Commission's findings included that Microsoft recorded reserves that did not have a proper basis under GAAP, and that the total balance for these accounts ranged from \$200 million to \$900 million. Further, Microsoft's 10-Qs and 10-Ks included adjustments to the reserve accounts that did not comply with GAAP by in some instances over reporting and in other instances under reporting income.

K. *Dynegy, Inc., September 24, 2002.*

The SEC announced a settled enforcement against Dynegy, Inc. ("Dynegy") regarding accounting improprieties and misleading public filings. Dynegy is a Houston-based energy production, distribution and trading company. The enforcement action arises from Dynegy's improper accounting for a \$300 million financing transaction involving special-purpose entities, and Dynegy's overstatement of its energy trading activity resulting from certain "round-trip" or "wash" trades.

Dynegy agreed to a cease-and-desist order and to pay a \$3 million penalty in a related civil suit in the U.S. district court for the Southern District of Texas. The Commission made special mention of the fact that the settlement agreement and stiff penalty on Dynegy were impacted by Dynegy's conduct after receiving its first contact by the Commission staff, as well as its cooperation in the subsequent investigation. The Commission stated that Dynegy disclosed the impact of its improper transaction only after the Commission staff expressed concern about the project. Moreover, Dynegy's former CFO falsely stated that the primary purpose of the special purpose entity was to secure a long-term natural gas supply. The Commission also noted that in determining to accept the settlement offer from Dynegy that Dynegy had taken steps to ensure its employees complied with Dynegy's new policy prohibiting round-trip trades and to otherwise correct its conduct. Steven M. Cutler noted, "The \$3 million penalty imposed directly against Dynegy in this case reflects the Commission's dissatisfaction with Dynegy's lack of full cooperation in the early stages of the Commission's investigation. . . Just as the Commission is prepared to reward companies that cooperate fully and completely with agency investigations, the Commission will also penalize those who do not."

The improper use of special purpose entities ("SPE") involved Dynegy's complex web of transactions designed to boost its 2001 operating cash flow by \$300 million and to reduce the gap between its net income and operating cash flow. The Commission found Dynegy committed securities fraud because the \$300 million loan to the SPE was presented as operating cash flow on Dynegy's 2001 statement of cash flows.

L. *Tyco International Ltd.*

1. *L. Dennis Kozlowski, Mark H. Swartz and Mark A. Belnick, September 12, 2002.*

The SEC filed a civil enforcement action against L. Dennis Kozlowski, the former CEO and chairman of Tyco International Ltd. ("Tyco"), Mark H. Swartz, the former Tyco CFO and Mark A. Belnick, Tyco's former Chief Legal Officer. Kozlowski and Swartz are accused of

granting themselves hundreds of millions of dollars in secret low-interest and interest-free loans from the company for personal expenses. They then caused Tyco to forgive tens of millions of dollars with those outstanding loans without disclosure to investors. Belnick is accused of failing to disclose receiving more than \$14 million of interest-free loans from the company to buy two residences and a New York apartment. All three defendants are accused of selling millions of dollars in Tyco stock before their fraud was revealed. The Commission seeks disgorgement from defendants of all compensation they received including, salary, bonuses, stock options and grants, repayment of all loans, civil money penalties, and permanent officer and director bars, among other relief.

Tyco is a manufacturing and service conglomerate involved in fire and security services, electronics and health care and specialty product and undersea telecommunications networks. The Commission accuses the three defendants of looting Tyco at the expense of stockholders. Specifically, from 1997 to 2002, Kozlowski is accused of taking a total of approximately \$270 million from a Tyco program designed to encourage Tyco employees to own Tyco shares. The loan program was intended to be used to pay taxes due as a result of divesting of Tyco shares, but Kozlowski allegedly only used \$25 million of his loans to cover taxes due, with the remaining \$242 million used for personal expenses, including yachts, fine art, estate jewelry, luxury apartments and vacation estates, all unrelated to Tyco. None of the loans were disclosed to shareholders. During the same period, Swartz took out approximately \$85 million in Tyco loans, but used only approximately \$13 million for taxes associated with the divesting of Tyco shares. Swartz is alleged to have used the remaining \$72 million for personal investments and business ventures. None of the loans were disclosed to shareholders.

From 1996 to 2002, Kozlowski also is charged with taking \$46 million in interest-free relocation loans intended for Tyco employees to assist them with costs associated with relocating Tyco's headquarters from New Hampshire to New York City, and then to Boca Raton, Florida. Kozlowski used at least \$28 million from those loans to purchase luxury properties, including a \$7 million Park Avenue apartment for his wife. Swartz took \$32 million in these interest-free relocation loans and used almost \$9 million for unauthorized purposes. Belnick took a total of \$14 million in relocation loans. None of these loans were disclosed to shareholders.

Kozlowski and Swartz in 1999 caused Tyco to forgive \$25 million from Kozlowski's outstanding loan balance and award \$12.5 million in credit against Swartz's outstanding balance. Then in September, 2002 Kozlowski is alleged to have engineered the cover for forgiveness of more than \$33 million of his relocation loans and more than \$16 million of Swartz's relocation loans. None of this executive compensation was discussed by the Tyco Board or disclosed to shareholders. Further, in June, 2001, Kozlowski and Swartz directed the acceleration of the vesting schedule for their Tyco stock options and realized a profit of approximately \$8 million and \$4 million respectively. Kozlowski and Swartz are also accused of engaging in undisclosed real estate transactions with Tyco and its subsidiaries. Finally, all three defendants are accused of fraudulent insider trading in Tyco stock.

2. *Frank E. Walsh, Jr., December 17, 2002.*

The SEC settled an enforcement action against Frank E. Walsh, a former Tyco International, Ltd. ("Tyco"), director for fraudulently signing a Tyco registration statement that

he knew contained a material misrepresentation. Walsh consented to a cease-and-desist order, permanent officer and director bar, and agreed to pay restitution of \$20 million.

This action is just one of the SEC's enforcement actions arising from the Commission's investigation of activities at Tyco. In this instance, L. Dennis Kozlowski, the former Tyco CEO, caused Tyco to pay Walsh a \$20 million finder's fee in connection with Tyco's June 2001 \$9.2 billion acquisition of the CIT Group, Inc. ("CIT"). The merger agreement associated with that deal, and incorporated by reference into the registration statement filed with the SEC, stated that Lehman Brothers and Goldman, Sachs & Co. were the only entities entitled to any sort of banking or finder's fee for representing Tyco. When Walsh signed the registration statement, he knew that was false because he knew that he would be paid a finder's fee for arranging the meeting between Kozlowski and CIT's CEO.

M. *Homestore.com Inc.*, September 25, 2002.

The SEC filed charges against three former senior executives of Homestore Inc. ("Homestore") alleging fraudulent scheme to inflate Homestore's online advertising revenue in 2001. The complaint was filed in U.S. District Court for the Central District of California against the former Chief Operating Officer, CFO, and former Vice President of Transactions for causing Homestore to overstate its advertising revenues by \$46 million for the first 3 quarters of 2001. Simultaneously, the U.S. Attorney's Office for the Central District of California announced that related criminal charges were filed against the three individual defendants. All three defendants agreed to settle the SEC's claims, to plead guilty to the criminal charges, and to cooperate with the government in the continuing Homestore investigation. The Commission charged the defendants with arranging fraudulent "round-trip" transactions to inflate advertising revenues and meet analysts' expectations. While this fraud was ongoing, the defendants engaged in illegal insider trading, and reaped profits ranging from \$169,000 to approximately \$3.2 million. As part of the deal with enforcement agencies, the defendants agreed to repay approximately \$4.6 million in illegal trading profits.

At the time of their fraud, Homestore was one of the leading internet portals for the state and related services. During 2000 and 2001, online advertising was one of Homestore's primary revenue sources. Defendants engaged in the complex series of round-trip barter transactions to inflate revenues in order to meet Wall Street estimates. Homestore paid inflated sums to vendors for services or products, and in turn the vendors used these funds to buy advertising from Homestore. The Commission's complaint alleges that the defendants knew that the round-trip transactions had no economic substance, and that the defendants lied to the company's independent auditors during the 2001 quarterly reviews. Two of the defendants agreed to permanent officer and director bars, while the third agreed to a 10-year bar. All three defendants agreed to disgorge all improper insider trading profits.

Importantly, the Commission announced that it would not bring any enforcement action at all against Homestore because of the "swift, extensive and extraordinary cooperation" in the SEC's investigation. Homestore's cooperation had included recording its discovery of misconduct immediately, conducting a thorough and independent internal investigation, sharing the results of the investigation with the government, including not asserting any applicable

privileges with respect to written materials, terminating the wrongdoers, and implementing remedial actions.

N. *ClearOne Communications Inc., January 15, 2003.*

The SEC filed a complaint in the U.S. district court for the District of Utah on January 15, 2002, seeking a TRO and preliminary and permanent injunctions against ClearOne Communications, Inc. ("ClearOne"), as well as ClearOne's Chairman, CEO and President and its Vice President of Finance. The complaint claims that the defendants committed securities fraud and lied to their auditors about those violations. The Commission seeks disgorgement of ill gotten gains, civil money penalties, and officer and director bars against the individual defendants, as well as an order preventing the destruction of relevant documents.

ClearOne is a provider of video and audio conferencing services, including the manufacture and sale of video and audio conferencing products. The Commission alleges that beginning with the first quarter of 2001, ClearOne fraudulently overstated its revenue by recording transactions with distributors as sales when those transactions did not meet GAAP. The defendants are alleged to have illegally inflated their reported revenue through a system of channel stuffing, with large amounts of inventory shipped to distributors at the end of each quarter with the understanding that the distributors did not have to pay for these products until they were resold to customers. The Commission also alleges that ClearOne's CEO convinced one customer to accept the shipment of \$1.2 million in inventory, but was not required to pay for that inventory until it sold it through to customers. The Commission alleges that the ClearOne CEO even had a nondistributor store 100 video teleconferencing units in his garage, and was not required to pay ClearOne unless he sold them.

O. *PNC Financial Services Group, Inc., July 18, 2002.*

The SEC issued a settled cease-and-desist order against the PNC Financial Services Group, Inc. ("PNC"). This was the first enforcement action arising from the Company's misuse of special purpose entities ("SPE"). The SEC order found that PNC violated GAAP when it transferred \$762 million of volatile or under-performing loans and venture capital assets from its financial statements to a third party financial institution in the second, third and fourth quarters of 2001. These improper transactions resulted in material overstatements of earnings, and the SEC found that PNC should have consolidated these special purpose entities into its financial statements. "Today's action demonstrates that the Commission will closely scrutinize transactions of special purpose entities," said Steven M. Cutler, "Public companies engage in transactions with special purpose entities not only which conversely comply with GAAP, but also must assure that they accurately portray the material elements of the economic risks and realities that they face as a result of these transactions."

PNC is a bank holding company that operates community banking, corporate banking, real estate finance, and other financial services primarily in Pennsylvania, New Jersey, Delaware, Ohio and Kentucky. The specific transactions that drew the attention of the SEC involved attempts by PNC to move certain under performing loans from its balance sheet to SPEs in which it retained the ability to control the upside in the event the loan portfolios began to perform better.

P. *Adelphia Communications Corporation/John J. Rigas, Timothy J. Rigas, Michael J. Rigas, James P. Rigas, James R. Brown and Michael C. Mulcahey, November 14, 2002.*

The SEC filed a complaint in the Southern District of New York against Adelphia Communications Corp. ("Adelphia"), its founder John J. Rigas, his three sons, and two other senior Adelphia executives alleging an extensive financial fraud.

Adelphia owns and operates cable television systems and related telecommunications businesses. The Commission charges that its case concerns one of the most extensive financial frauds ever to take place in a public company. From 1998 through March 2002, Adelphia systematically and fraudulently excluded billions of dollars from liabilities from its consolidated financial statements by hiding them on the books of off-balance sheet affiliates. Adelphia also inflated its earnings to meet Wall Street expectations. Specifically, Adelphia is alleged to have excluded from its annual and quarterly consolidated financial statements portions of its bank debt, and included a footnote to its financial statements that implicitly misrepresented that such debt had been included on Adelphia's balance sheet. The Commission charges that Adelphia kept approximately \$2.3 billion in undisclosed debt off its balance sheets as of December 31, 2001. Adelphia is also alleged to have regularly misrepresented, during that same time period, several key reporting metrics in order to meet Wall Street expectations. Namely, Adelphia inflated (1) the number of its basic cable subscribers; (2) the extent of its facilities upgrading; and (3) its earnings before interest, taxes, depreciation, and amortization. Finally, the Commission charges that Adelphia used a number of fraudulent misrepresentations and omissions to conceal rampant self-dealing by the Rigis family, including the improper use of Adelphia funds to pay for vacation properties and New York City apartments, the development of a golf course, the purchase of over \$772 million dollars in Adelphia common stock and over \$563 million dollars of Adelphian notes for the benefit of Rigis family members.

The SEC announced that Adelphia's former Vice President of Finance, James R. Brown, consented to the entry of a permanent injunction against him regarding future violations of federal securities laws. Mr. Brown also agreed to a permanent officer and director bar and to provide the court with an accounting. The Commission is still pursuing claims against Brown for disgorgement of ill-gotten gains and civil penalties.

Q. *The SEC Recently Filed Several Major Enforcement Actions Against Public Company Auditors.*

1. *Xerox Corporation/KPMG LLP, Joseph T. Boyle, Michael A. Conway, Anthony P. Dolanski, and Ronald A. Safran, January 29, 2003.*

The Commission's investigation into alleged financial misstatements at Xerox Corporation ("Xerox") from 1997 through 2000 continues to unfold. On January 29, 2003, the SEC filed a civil fraud action in the United States District Court for the Southern District of New York against KPMG LLP ("KPMG") and four of its partners, in connection with KPMG's audits of Xerox from 1997 through 2000. The SEC's complaint charges KPMG and four of its audit partners with fraud, and seeks disgorgement of all KPMG fees from 1997 through 2000, as well as civil money penalties and injunctive relief.

Specifically, the Commission charges that the defendants falsely represented that their Xerox audits were conducted in accordance with Generally Accepted Auditing Standards (“GAAS”), and that Xerox’s financial reports were prepared in accordance with GAAP.

The problems at Xerox apparently began as early as 1997 when the company allegedly began using what the SEC charges were “topside accounting devices” that violated GAAP and resulted in the improper reporting of increased equipment revenue. Xerox sells photocopying and other equipment, and often does so through a “sales type lease.” Beginning in at least 1997, the SEC alleges that Xerox changed its accounting procedures to treat more finance end service revenue as part of the value of the equipment, and allegedly allowing Xerox to recognize more of the revenue from new leases immediately in its financial statements. The SEC also alleges that Xerox improperly inflated its earnings by nearly \$500 million dollars through the release into earnings of excess reserves on the Xerox books. Xerox issued a \$6.1 billion dollar restatement of its equipment revenues and a \$1.9 billion dollar restatement of its pre-tax earnings for the years 1997 through 2000. On April 11, 2002, the SEC entered a final judgment that permanently enjoined Xerox from violating federal securities laws. Further, Xerox paid a \$10 million dollar civil penalty, agreed to restate its financial statements, and agreed to hire a consultant to review the company’s internal accounting controls and policies.

2. *Moret Ernst & Young Accountants, June 27, 2002.*

The SEC announced its first-ever auditor independence case against a foreign audit firm, and indicated that it settled its enforcement action against Moret Ernst & Young Accountants (“Moret”), a Dutch accounting firm. As part of the settled action, Moret agreed to pay a \$400,000 civil money penalty and agreed to comply with certain remedial measures. “Auditor independence has no geographic limitations,” said Paul R. Berger, an Associate Director of Enforcement.

The SEC charged that in its 1995 through 1997 audits of the financial statements for Baan Company, N.V. (“Baan”), a Dutch software company quoted on Nasdaq, Moret had a joint business relationship with Baan that impaired its independence as an auditor. According to the Commission, most of the improper relationships were set up to allow Moret consultants to assist Baan in implementing Baan software products for third parties. The SEC found that Moret consultants billed Baan approximately \$1.9 million dollars for these improper relationships.

3. *PricewaterhouseCoopers, LLP, July 17, 2002.*

The SEC announced it had entered a settled enforcement action against PricewaterhouseCoopers LLP (“PwC”) and its broker-dealer affiliate, PricewaterhouseCoopers Securities LLC for violating auditor independence rules. The Commission claims that PwC’s violations span five years from 1996 to 2001, and arose from PwC’s use of prohibited contingent fee arrangements with fourteen different audit clients, and PwC’s participation with two other clients in improper accounting costs that included PwC’s own consulting fees. The allegedly improper PwC contingent fee arrangements involve instances where PwC’s investment bankers were hired to perform financial advisory services for a fee that depended on the success of the transaction the client pursued, and the fee arrangements were claimed to violate accounting profession prohibitions. In addition, the SEC action concerned PwC’s participation in 1999 and

2000 in allegedly improper auditing of its own fees charged to two of its clients, Pinnacle Holdings, Inc. and Avon Products, Inc. In related matters, the Commission announced that it had entered agreed cease-and-desist proceedings with both Pinnacle and Avon regarding improper treatment of the PwC fees.

4. *Arthur Andersen LLP, June 15, 2002.*

The SEC announced that the jury in the United States District Court for the Southern District of Texas found Arthur Andersen LLP (“Andersen”) guilty of obstruction of justice in connection with Andersen partner and employee conduct related to Enron. Andersen informed the Commission that as a result of the conviction, it would cease practicing before the Commission by August 31, 2002. The Commission permitted Andersen to continue to make required filings on behalf of its clients until Andersen disbanded.

III. REGULATION FAIR DISCLOSURE: EARLY ENFORCEMENT ACTIVITY

The SEC adopted Regulation Fair Disclosure (“Regulation FD”) on August 10, 2000. Regulation FD targets the practice by public company insiders to selectively disclose material non-public information to analysts and institutional investors. Regulation FD requires that when an issuer discloses material information, it do so publicly. During the comment period for the new rule, many issuers and others sought guidance from the SEC concerning materiality, and the standards issuers should use when deciding whether disclosure under Regulation FD is required. Other comments on Regulation FD centered on whether and to what extent issuers could confirm prior guidance to analysts without implicating Regulation FD. Finally, some issuers indicated to the SEC they were unclear regarding how best to comply with Regulation FD. That is, it was unclear to many whether all communications be done through Form 8-K, press release, webcast, or other technological means. In seeming response to repeated calls for guidance from the Commission, the SEC brought its first enforcement actions under Regulation FD on November 25, 2002. In this regard, the SEC sent messages to issuers both with regard to the practical applications for Regulation FD, as well as the importance of early and vigorous cooperation with SEC investigators, and the self-reporting of violations.

A. *Siebel Systems, Inc., November 25, 2002.*

The SEC announced the filing of a settled cease-and-desist order in the United States District Court for the District of Columbia against Siebel Systems, Inc. (“Siebel”). As part of the agreement, Siebel agreed to an injunction prohibiting it from further violations of Regulation FD. Siebel also agreed to pay a \$250,000 civil penalty. Siebel’s violations stemmed from its CEO’s appearance at an invitation-only technology conference. Siebel’s CEO made positive comments about the company’s business based on material, non-public information that contrasted with earlier negative statements he had made about the company’s business in a public conference call three weeks earlier. The Commission found that immediately following the Siebel’s CEO disclosures, conference attendees purchased Siebel stock, or communicated the disclosures to others who did so. The CEO’s comments moved the Siebel stock price approximately 20% higher, and the Commission found that the CEO knew his comments were based on material, non-public information.

B. *Secure Computing Corporation, November 25, 2002.*

The SEC entered a settled enforcement cease-and-desist proceeding against Secure Computing Corporation (“Secure”) and John McNulty, the CEO and Chairman of Secure. Defendants agreed to a cease-and-desist order and agreed not to further violate Regulation FD. The SEC found that Secure violated Regulation FD when it disclosed material non-public information about a significant contract to two portfolio managers and to institutional advisors. Secure filed public press releases after the close of the stock markets following the disclosures, but the Commission found fault with the fact that the press release did not come soon enough.

Secure is a software company specializing in internet security products, and in early in 2002, it entered into an Original Equipment Manufacturing (“OEM”) agreement with a large computer networking company. Before the details regarding the significant OEM contract were public, McNulty had a conference call with a portfolio manager at an advisory firm. McNulty told the portfolio manager that Secure had entered into the OEM deal and identified the buyer by name. Secure did not make a general announcement about the OEM deal on the date of the McNulty conference call. The next day, McNulty had further conference calls with additional institutional investors at around 10:00 in the morning. Secure’s stock price and trading volume increased significantly from the previous day’s closing. Secure issued a press release at the close of the day’s trading on the second day of McNulty’s Regulation FD violations. The Commission found that the original disclosures were unintentional, but that Secure needed to make prompt public disclosure of the information. Instead McNulty made additional selective disclosures the next day.

C. *Raytheon Company and Franklyn A. Caine, November 25, 2002.*

The SEC entered an agreed cease-and-desist order against Raytheon Company (“Raytheon”) and Franklyn A. Caine (“Caine”), Raytheon’s Chief Financial Officer, for making selective disclosures in violation of Regulation FD. The defendants agreed to an injunction against further Regulation FD violations.

The Commission found the defendants violated Regulation FD when Caine selectively disclosed earnings guidance to certain sell-side equity analysts. The Commission found that Raytheon conducted an investor conference where it reiterated its annual earnings guidance, but did not provide any quarterly guidance. Subsequently, Caine directed his staff to contact each sell-side analysts for Raytheon, and told each of the analyst that Raytheon expected that distribution of its earnings to be less seasonal than the previous year. He also told certain analysts that their revenue estimates were “too high” or “aggressive.” After the one-on-one conversations with Raytheon management, the analysts lowered their earnings estimates for the next two quarters, and Raytheon’s stock price fell. The Commission found that the selective Raytheon disclosures were material because of the subject matter of the information (earnings guidance), the consistent reaction of the analyst was to lower their earnings estimates, along other indicators. Finally, the Commission found that the Raytheon violations were intentional because the defendants were at a minimum reckless in not knowing that the information being communicated was both material and non-public.

D. *Motorola, Inc., November 25, 2002.*

The SEC issued a report regarding a violation of Regulation FD by Motorola, Inc. (“Motorola”). The Commission found that Motorola violated Regulation FD when its Director of Investor Relations made private telephone calls to sell-side analysts where he clarified earlier public guidance regarding Motorola’s sales and order levels. In a press release and public conference call, Motorola said its sales and orders were experiencing “significant weakness” and that Motorola was going to miss its earnings estimate for the quarter. Subsequently, after seeing that certain analyst’s revenue models reflected that the analyst did not appreciate the significance of the Motorola guidance, Motorola contacted the analyst individually and clarified that by “significant” Motorola meant “25% or more.” The SEC report indicated that issuers should not make use of such code words or terms with special meaning.

The Commission decided not to enter into a formal cease-and-desist enforcement agreement because before engaging in the conduct the Commission found violated Regulation FD, Motorola officials specifically sought the advice of their in-house legal counsel concerning whether Regulation FD was implicated. However, the Commission signaled that under similar circumstances in the future, that issuers will not be entitled to the difference it gave Motorola because of the report the SEC issued.

E. *Schering-Plough Corp., March 12, 2003.*

It appears that the SEC may be filing another action for violation of Regulation FD, this time against Schering-Plough Corp. (“Schering-Plough”).

According to news reports, the SEC has launched an investigation into a series of Schering-Plough stock price drops that coincide with meetings between investors and the Schering-Plough CEO. Details regarding the investigation are not yet available, but Steven Cutler stated that, “We’ve got a number of active investigations in the pipeline.”

**IV. THE COMMISSION'S SECTION 21(A) REPORT: A NEW
EMPHASIS ON "SELF POLICING" AND VOLUNTARY
COOPERATION WITH THE SEC**

In October of 2001, the Commission issued a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 (the "Section 21(a) Report"), which included the Commission's "Statement on the Relationship of Cooperation to Agency Enforcement Decisions" (the "Statement on Cooperation").³ The Section 21(a) Report and Statement on Cooperation laid out thirteen criteria that will be considered by the Commission in determining whether, and how much, to credit a company under investigation for voluntary remedial actions and cooperation with Commission investigation efforts. In summarizing the Statement in the press release accompanying the Section 21(a) Report, the SEC highlighted four key concepts:

³ SEA Release No. 44969, AAE Release No. 1470 (Oct. 23, 2001).

- Public companies should have effective compliance procedures in place prior to the discovery of alleged wrongdoing.
- Companies should stress "self reporting" of misconduct, including disclosure to the public and to the regulators.
- Prompt remedial actions should be taken when wrongdoing is uncovered, including discipline and/or dismissal of the wrongdoers.
- Cooperation with law enforcement officials should be promptly given, including providing the SEC with all information about the alleged misconduct.

In encouraging swifter and greater cooperation from companies under investigation, the Statement on Cooperation poses a number of challenges for companies wishing to cooperate with the SEC, in light of the potential parallel exposure of the company in related civil proceedings, including the possible waiver of applicable attorney–client privilege.⁴ Nevertheless, it provides a useful "roadmap" for public companies wishing to eliminate potential exposure to SEC enforcement claims, and sets forth a strong philosophy on "self policing" that all public companies should take to heart. Some background on the underlying investigation in the *Seaboard* matter is instructive.

A. The Seaboard Investigation and Proceedings against Gisela de Leon–Meredith.

The Commission's Statement on Cooperation arose from an investigation of accounting misstatements by Ms. Gisela de Leon–Meredith, Controller of Chestnut Hill Farms ("CHF"), a wholly–owned subsidiary of Seaboard Corporation ("Seaboard" or the "Company"). Seaboard is a diversified international corporation engaged in, among other things, agricultural production, transportation, energy generation, and commodity brokering. CHF is primarily engaged in the production and marketing of agricultural products. One of the largest assets on CHF's balance sheet is "deferred farming costs," which consists of costs incurred in planting or growing agricultural products that have not yet been harvested. As harvesting occurs, these assets are amortized by expensing the costs against revenues generated by the harvested crops.

From 1995 through the first quarter of 2000, Ms. de Leon–Meredith made improper accounting entries overstating deferred farming costs and understating farming expenses. Although Ms. de Leon–Meredith knew by December of 1998 that the entries were improper and had caused deferred farming costs to be substantially overstated, she continued to make improper accounting entries through mid–2000 in an attempt to conceal her wrongdoing. Beginning in late 1999, Seaboard personnel began inquiring about unusual entries in CHF's monthly financial

⁴ See J. Sturc and E. Schneider, "Credit for Cooperation: The SEC's Section 21(a) Report", Insights (December 2001), in which the authors discuss the case law and risks associated with voluntary disclosures of privileged work product and other discovery materials to the SEC.

reports. Finally, in July of 2000, Ms. de Leon–Meredith confessed her actions to her immediate supervisor at CHF after being questioned about apparent discrepancies in deferred farming costs by Seaboard's internal auditors.

After the de Leon–Meredith confession, Seaboard's internal auditors promptly conducted a preliminary internal investigation and advised company management about the accounting misstatements. Management informed the Company's Audit Committee and full Board, which authorized the hiring of an outside law firm to conduct a complete investigation. Within days after this action was taken, Ms. de Leon–Meredith and two employees who had failed to properly supervise her were terminated. The following day, Seaboard informed the Commission, and publicly announced, that its financial results would be restated, which it did on August 28, 2001. The Company's stock price did not decline dramatically following the initial announcement of the restatement, or following the restatement itself.⁵

In response to Ms. de Leon–Meredith's conduct, the Company also endeavored to strengthen its financial reporting processes. It developed a detailed closing process for subsidiary accounting personnel, consolidated subsidiary accounting functions under a Seaboard accountant, began requiring the Seaboard controller to interview and approve the hiring of all subsidiary senior accounting personnel, hired three additional accountants to assist with preparation of CHF's financial statements, and redesigned CHF's minimum annual audit requirements.

During the Commission's investigation, the Company provided extensive cooperation with Commission staff. It produced to the Commission all information related to the underlying violations, including all details of its own internal investigation and the investigation conducted by outside counsel. It produced notes and transcripts of interviews with Ms. de Leon–Meredith and others, and at no time did it invoke attorney–client privilege, work product protection, or any other privileges or protections related to information requested by the Commission.

On October 23, 2001, after completing its investigation of the matter, the Commission initiated and settled a cease–and–desist proceeding against Ms. de Leon–Meredith, finding that she had engaged in various violations of the federal securities laws.⁶ In its "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions," issued the

⁵ The initial announcement was made in a press release issued after the close of trading on August 9, 2000. Seaboard stock closed at \$198.00 per share on August 9, 2000, and again at \$198.00 per share on August 10, 2000. The restatement was included in financial results released on August 28, 2001. Seaboard stock closed at \$276.00 per share on August 27, 2001, and at \$275.00 per share on August 30, 2001.

⁶ See Admin. Proc. No. 3-10626; Exchange Act Rel. No. 44970; Accounting and Auditing Enforcement Rel. No. 1471 (Oct. 23, 2001).

same day, the Commission concluded that no enforcement action would be taken against Seaboard.⁷

It is important to note the several key ways in which the facts in *Seaboard* are atypical of the situations usually confronting defense counsel. First, unlike the posture in which many public companies find themselves, there was no parallel civil class action litigation involved in *Seaboard*. Second, the Report noted the absence of any significant stock price decline as a result of the disclosure of adverse information. Third, the misconduct appears to have been confined to a single employee of a subsidiary operation who quickly confessed to her wrongdoing. Thus no complicated investigative steps or "self policing" seems to have been necessary. The complications that arise from more complex or pervasive financial manipulations were simply not present in the *Seaboard* situation.

B. The Section 21(a) Report's Guidelines on Cooperation.

In the Section 21(a) Report, the Commission explained that its decision not to take enforcement action against the Company was due to the actions taken by the Company after learning of the accounting misstatements, and the level of cooperation provided during the Commission's investigation. Specifically, the Company was given "credit" for "self-policing, self-reporting, remediation and cooperation," which minimized the necessary expenditure of government and shareholder resources and brought swifter relief to investors. The Commission noted, however, that a decision not to take any enforcement action against a company in response to securities violations is indeed an "extraordinary step," and that depending on the circumstances in a given case, the credit given in exchange for cooperation could also include reduced charges, lighter sanctions, or "mitigating language" in documents announcing enforcement actions.

Before laying out the criteria to be considered in determining whether and how much to credit cooperation of a company under investigation, the Commission warned that enforcement decisions remain highly fact-specific, and that in circumstances where violations are egregious and harm to investors is great, no amount of cooperation would justify a decision not to take enforcement action. The Commission emphasized that the criteria included in the Statement on Cooperation are simply points of consideration, subject to the ultimate "broad discretion" of the Commission to reach whatever result it deems to be in the best interests of investors in a given case.

The Commission then proceeded to set forth thirteen criteria to be considered in determining whether and to what extent a company should be rewarded for voluntarily initiating remedial actions and cooperating with Commission investigation efforts following discovery of securities violations.

⁷ See Exchange Act Rel. No. 44969; Accounting and Auditing Enforcement Rel. No. 1470 (Oct. 23, 2001).

1. What is the nature of the misconduct involved?
2. How did the misconduct arise?
3. Where in the organization did the misconduct occur?
4. How long did the misconduct last?
5. How much harm has the misconduct inflicted upon investors and other corporate constituencies?
6. How was the misconduct detected and who uncovered it?
7. How long after discovery of the misconduct did it take to implement an effective response?
8. What steps did the company take upon learning of the misconduct?
9. What processes did the company follow to resolve many of these issues and ferret out necessary information?
10. Did the company commit to learn the truth, fully and expeditiously?
11. Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation?
12. What assurances are there that the conduct is unlikely to recur?
13. Is the company the same company in which the misconduct occurred, or has it changed through a merger or bankruptcy reorganization?

On each of these points, the Commission expounded on the basic criteria with examples of how the criteria might be satisfied. For instance, on point 11 regarding cooperation with Commission staff, the Statement explicitly noted that companies may wish to consider waiving privileges and protections with regard to the Commission's requests for information. Recognizing that a waiver of privileges and other protections may put a company or its employees at risk in related civil and/or criminal actions, the Commission stated its opinion that a waiver of privilege pursuant to a confidentiality agreement with the Commission should not be deemed a waiver with respect to third parties.⁸

⁸ SEA Rel. No. 44969; Accounting and Auditing Enforcement Rel. No. 1470, at n.3.

C. The Section 21(a) Report's Effect Thus Far on Cooperation with Agency Investigations.

Since the Commission's issuance of the Statement on Cooperation, several highly publicized and widespread investigations into alleged accounting improprieties have been instigated, including Enron, Dynegy and Xerox. Although these investigations are ongoing, it is clear that cooperation will influence the SEC's decision whether to pursue enforcement actions. Indeed, in several instances, the Commission has chastised companies for alleged lack of cooperation.

As noted above, the SEC's Section 21(a) Report set out the criteria the Commission considers in determining whether and how much to credit company efforts at self-reporting, self-policing and remedial efforts when determining the type of enforcement action to bring for securities law violations. *See supra* Section IV.B. Since that report issued, the Commission has expressly noted in its press releases and other communications the impact these criteria have had on enforcement decisions.

For example, Dynegy agreed to a cease-and-desist order and to pay a \$3 million penalty in a related civil suit in the U.S. district court for the Southern District of Texas. The Commission made special mention of the fact that the settlement agreement and stiff penalty on Dynegy were impacted by Dynegy's conduct after receiving its first contact by the Commission staff, as well as its cooperation in the subsequent investigation. The Commission stated that Dynegy disclosed the impact of its improper transaction only after the Commission staff expressed concern about the project. Moreover, Dynegy's former CFO falsely stated that the primary purpose of the special purpose entity was to secure a long-term natural gas supply. The Commission also noted that in determining to accept the settlement offer from Dynegy that Dynegy had taken steps to ensure its employees complied with Dynegy's new policy prohibiting round-trip trades and to otherwise correct its conduct. Steven M. Cutler noted, "The \$3 million penalty imposed directly against Dynegy in this case reflects the Commission's dissatisfaction with Dynegy's lack of full cooperation in the early stages of the Commission's investigation. . . Just as the Commission is prepared to reward companies that cooperate fully and completely with agency investigations, the Commission will also penalize those who do not."

Similarly, the SEC levied a heavy penalty and took an especially hard stance against Xerox because of the company's perceived lack of full cooperation with the Commission's investigation. The problems at Xerox began as early as 1997 where the company began using a variety of "topside accounting devices" to manipulate its equipment revenue and earnings. The SEC charges that these "topside accounting devices" violated GAAP and resulted in the improper reporting of increased equipment revenue. After Xerox's fraudulent conduct was investigated and exposed – and Xerox hired a new auditor – Xerox was forced to issue a \$6.1 billion dollar restatement of its equipment revenues and a \$1.9 billion dollar restatement of its pre-tax earnings for the years 1997 through 2000. On April 11, 2002, the SEC entered a final judgment that permanently enjoined Xerox from violating federal securities laws. Further, Xerox paid a \$10 million dollar civil penalty, agreed to restate its financial statements, and agreed to hire a consultant to review the company's internal accounting controls and policies. "Xerox's senior management orchestrated a four-year scheme to discard the company's true operating performance," said Paul R. Berger, Associate Director of Enforcement for the SEC. "Such

conduct calls for stiff sanctions, including, in this case, the imposition of the largest fine ever obtained by the SEC against a public company in a financial fraud case. The penalty also reflects, in part, a sanction for the company's lack of full cooperation in the investigation."

V. CIVIL LITIGATION RISKS ARISING FROM SEC INVESTIGATIONS

Three recent decisions in high-profile financial fraud cases have given rise to a new challenge facing securities fraud class action defendants where the securities suit coincides with or follows a government investigation: namely, the prospect that when a parallel government investigation is underway, any effort by the company to cooperate with the government investigation by producing documents and other discovery materials will be rewarded with an order to produce those discovery materials immediately to the civil class action plaintiffs' lawyers, notwithstanding the PSLRA's automatic stay of discovery. These three decisions have set a very dangerous precedent for future cases involving parallel SEC enforcement investigations, or other regulatory or congressional inquiries.

A. Discovery of Documents Produced to Government Agencies.

1. *The Enron Case: The First Shoe Dropping.*

In the wake of the collapse of Enron, Judge Melinda Harmon of the United States District Court for the Southern District of Texas initially ordered Enron to produce to securities plaintiffs all documents and materials produced pursuant to subpoenas by any committee of the legislative branch of the federal government, or by the executive branch of the federal government in connection with investigations into its handling of its ERISA-governed pension plans. *Mark Newby v. Enron Corp.*, No. H-01-3624 (S.D. Tex. February 27, 2002) (Scheduling Order). The order also directed Enron to produce to plaintiffs copies of all transcripts of witness interviews or depositions given or taken in connection with such investigations. *Id.* In ordering this production, the judge relied on the following characterization of the preventative and practical purposes of the discovery stay under the PSLRA: "The automatic stay of discovery mandated by the PSLRA was designed to prevent fishing expeditions in frivolous securities lawsuits. It was not designed to keep secret from counsel in securities cases documents that have become available for review by means other than discovery in the securities case." February 27, 2002 Order at 3-4.

Several months later, the lead securities plaintiff moved to expand Judge Harmon's earlier ruling beyond ERISA-related documents to the production of all materials previously produced in response to government investigations. *See Mark Newby v. Enron Corp.*, No. H-01-3624 (S.D. Tex. Aug. 15, 2002) (Order). Enron and various individual officer defendants opposed the motion, arguing that the unambiguous language of the Reform Act permits only two exceptions to the ban on discovery during the pendency of motions to dismiss, and prohibits discovery requests, "whether a 'fishing expedition' or 'surgical strike.'" August 15, 2002 Order at 2. The court cited with approval plaintiff's argument that their request did not pose the threat of abusive litigation contemplated by the PSLRA, presumably because the pending government investigations counter any suggestion that this was merely a strike suit, and would impose only a slight burden on the corporation since the documents had already been produced. August 15,

2002 Order at 3. The court agreed with plaintiffs, noting that “discovery has already been made” and it should not be withheld from a party because of a statute designed to prevent discovery abuse. *Id.* The court ordered Enron to produce “copies of all documents and materials produced by the Debtor related to any inquiry or investigation” by any committee of the legislative branch or the executive branch, and any witness interviews or depositions relating to those inquiries or investigations. *Id.*

2. *Worldcom: The Next Shoe Dropping.*

Judge Denise Cotes also recently ordered WorldCom, Inc., a related non-party to the consolidated securities cases, to produce to securities plaintiffs documents and other materials already produced to other entities pursuant to various government investigations. *See In re Worldcom, Inc. Sec. Litig.*, No. 02–3288 (S.D.N.Y. Nov. 21, 2002) (Opinion and Order). In addition, the Court ordered WorldCom to produce documents and materials previously produced to counsel representing the Special Investigative Committee of the Board of Directors after counsel has produced their final report. *See* November 21, 2002 Order at 2. In contrast to the order in *Enron*, and pursuant to requests to the Court by the SEC and the U.S. Attorney, WorldCom was not ordered to produce any witness interview notes. *See id.*

In considering whether to grant plaintiff’s motion, the Court noted that the PSLRA allows courts to order particularized discovery when the court finds it is necessary to prevent undue prejudice to a party. *See* November 21, 2002 Order at 10 (citing 15 U.S.C. § 78u–4(b)(3)(B)). The court considered the following “circumstances” in deciding that the stay must be lifted to avoid such prejudice to the securities plaintiffs, and noted that none of these circumstances, standing alone, would justify lifting the stay.

First, like the court in *Enron*, the Worldcom court concluded that neither rationale underlying the PSLRA discovery stay was contravened by the plaintiff’s motion. The lead plaintiff had not filed the motion to initiate a “fishing expedition” and was not attempting to force defendants to settle a frivolous class action. *See* November 21, 2002 Order at 11. The court also noted that lifting the stay would not place an undue burden on the corporation since the requested documents had already been compiled and produced. *See id.* at 12.

In addition, unlike the *Enron* court, the court here explicitly considered “the unique circumstances of this case” to conclude that the stay must be lifted to avoid undue prejudice to the plaintiff investor class. The court noted that “[a]ll of the investigations and proceedings concerning WorldCom are moving apace,” and that without access to the requested documents, plaintiffs “would be prejudiced by its inability to make informed decisions about its litigation strategy in a rapidly shifting landscape” including upcoming settlement negotiations. *See id.* at 11. The court was not only concerned that the securities plaintiffs would be at an informational disadvantage in formulating their litigation strategy, but also that their lack of knowledge would place them at the end of the line for any recovery: “If [lead plaintiffs] must wait until the resolution of a motion to dismiss to obtain discovery and formulate its settlement or litigation strategy, it faces the very real risk that it will be left to pursue its action against defendants who no longer have anything or at least as much to offer.” *Id.*

3. *AOL Time Warner: Still Another Shoe.*

In a terse opinion, Judge Shirley Wohl Kram ordered defendants AOL Time Warner, Inc., AOL, and Time Warner to produce to securities plaintiffs documents and materials that defendants “produced to any committee of the legislative branch of the United States government or to any entity of the executive branch, including the Department of Justice and the Securities and Exchange Commission (“SEC”),” *In re AOL Time Warner, Inc. Sec. and ERISA Litig.*, 2003 WL 715752 (S.D.N.Y. Feb. 28, 2003) (slip op.). In granting plaintiffs’ motion for access to these materials, the Court cited both the *Enron* and *WorldCom* opinions detailed above, and concluded without analysis that plaintiffs would suffer “undue prejudice” unless they gained access to the subject materials. The Court’s implicit assumption is that where legislative, law enforcement, or regulatory bodies are conducting — or have conducted — parallel investigations, securities plaintiffs are by definition not engaged in a fishing expedition or strike suit against which the PSLRA’s automatic stay was designed to protect.

B. **Discovery of Work Product Materials Produced to Government Agencies.**

Recognizing the peril faced by defendants when producing documents to government agencies, many defense counsel now ask the government for written agreements that such productions will not be deemed to constitute a waiver of work product or attorney–client privilege protections. These requests are particularly important where, as is now frequently the case, a company has conducted an internal investigation, and agrees to produce a written report or other summary or synthesis of the results of such an investigation, which may include witnesses interviews, compilations of important documents, database summaries of facts, and chronologies. The SEC has responded favorably to such requests for work product protection. In fact, Peter Bresnan, Deputy Chief Litigation Counsel in the SEC’s Division of Enforcement, announced on March 28, 2003, that House Financial Services Committee Chairman Richard Baker plans to introduce legislation, recommended by the SEC, designed to help the Commission obtain internal investigative reports from issuers. The planned legislation would provide that where a company gives the SEC an internal investigation report that otherwise might be subject to a claim of attorney–client or work product privilege, the company would not waive the privilege.

In several recent cases, the courts have addressed whether non–waiver agreements among issuers and law enforcement agencies are enforceable against the demands of civil plaintiffs’ counsel to have such materials produced in the civil cases, notwithstanding any express provision between the company and the government that such materials were not meant to be shared with private plaintiffs.

1. *McKesson HBOC.*

In a recent case in the Delaware Chancery Court, the court adopted a selective waiver rule for disclosures of work product made to law enforcement agencies pursuant to a confidentiality agreement. *See Saito v. McKesson HBOC, Inc.*, 2002 WL 31458233, at *1 (Del.

Ch. Oct. 25, 2002). The court in *Saito* noted the conflicting case law on this issue in other jurisdictions, including in the Courts of Appeals, *see id.* at *7,⁹ however it determined that public policy supported a selective waiver rule because such a rule encourages cooperation with law enforcement investigations.

In this case, the plaintiffs in a derivative action brought a motion to compel production of certain documents, including materials that had been prepared by counsel while conducting an internal investigation at the request of the audit committee of the board of directors of McKesson HBOC, Inc. (“McKesson”). Among the documents sought were materials that had been produced by defendant to the SEC and the United States Attorney’s Office (“USAO”) after these law enforcement agencies had both entered into a confidentiality agreement with McKesson. Defendants asserted work product privilege as to all of the documents in question, and attorney client privilege as to some of them. *Id.* at *2.

Initially, the court determined that the documents in question clearly qualified as work product, and that the only remaining issue was whether McKesson had waived its privilege by producing these materials to SEC and/or the USAO, notwithstanding the existence of the confidentiality agreement. *Id.* The court noted that, like any privilege, the protection of work product may be waived, but that such waivers were rarely granted in Delaware because of their harsh result. *Id.* at *3. To waive protection for work product, the holder must know of the right, and voluntarily and intentionally choose to relinquish it. Further, disclosure of protected work product to a third party does not waive the privilege if the disclosing party had a reasonable expectation of privacy when it made the disclosure. *Id.* at *4. The party’s expectation of privacy in the disclosure is considered “reasonable” if 1) the party believed its disclosure was confidential, and 2) the law sanctions that expectation. *Id.*

The court rejected McKesson’s argument that it had a reasonable expectation of privacy in its disclosures pursuant to the confidentiality agreement because it shared a common interest with SEC and/or the USAO of “weeding out” wrongdoing at the company. *Id.* at *4–5. Cooperating voluntarily with the investigation did not transform McKesson’s relationship with the investigative agencies to a friendly one in which it had a reasonable expectation that privileged materials would be held in confidence.

The court accepted McKesson’s next argument, that it had a reasonable expectation of privacy when it made its disclosures to SEC and/or the USAO because they were made pursuant

⁹ One case cited by the court in *Saito* is particularly noteworthy. In *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289 (6th Cir. 2002) the court expressly rejected the concept of selective waiver in all forms. The court found that the defendant had waived the work product privilege for documents produced to the Department of Justice even though the disclosure was made pursuant to a confidentiality agreement. *Id.* at 307. In so doing, the court reasoned that waiver of the work product privilege is a “tactical litigation decision,” and allowing selective waiver would permit attorneys to use the privilege “as a sword rather than as a shield.” *Id.*

to a confidentiality agreement. *Id.* at *6.¹⁰ Pursuant to such an agreement, McKesson’s attorneys could reasonably expect that their preparations for litigation would not be used against them. Further, this expectation of privacy is one that the law should sanction, because “public policy seems to mandate that courts continue to protect the confidentially disclosed work product in order to encourage corporations to comply with law enforcement agencies.” *Id.* at *6. Because McKesson’s expectation of privacy was reasonable, its production of documents to the agencies pursuant to the agreement did not waive the work product privilege as to those agencies.

The court noted that other jurisdictions do not permit selective waiver of the work product privilege – that is, continuing to assert the privilege against other parties once the protected material has been disclosed to any party. *Id.* at *7. However, the court reasoned that such a rule is not basically unfair, as disclosing protected material to one adversary does not prejudice another adversary any more than if the initial waiver had not been made. Further, the rule here is narrow, permitting selective waiver only of work product produced to a law enforcement agency after a confidentiality agreement is in place. Finally, public policy favors a narrow rule of selective waiver, as it encourages cooperation with law enforcement. *Id.* at *7. On the last point, the court observed that a delicate balance already exists between a corporation’s interest in cooperating with an investigation in hopes of obtaining more lenient treatment, and forcing a law enforcement agency to “do its own legwork” at the risk of receiving harsher treatment. *Id.* at *8. If courts do not permit selective disclosure, and “amplify the risk of disclosure to include future private plaintiffs, the scales begin to tip further in favor of corporate noncompliance with investigative agencies.” *Id.*

The Delaware court’s decision in *McKesson* followed on the heels of a similar case in state court in Georgia, also involving McKesson. *See McKesson HBOC, Inc. et al. v. Adler*, 254 Ga. App. 500, 504 562 S.E.2d 809, 814 (2002). There, the trial court granted a shareholder plaintiff’s motion to obtain documents generated by McKesson during an internal investigation of the company’s financial reports led by the audit committee of the Board of Directors. *Id.* at 500. These documents had been produced to SEC pursuant to a confidentiality agreement, and McKesson argued that they were covered by both work product and attorney client privilege. *Id.* The Georgia court of appeals remanded to the district court the question of whether the documents were privileged under the work product doctrine, *id.* at 504, but found that the documents were not protected by the attorney client privilege. *Id.* The court reasoned that because McKesson’s audit committee authorized its attorneys and accountants to cooperate with the SEC in its investigation, the company “contemplated that the documents would be provided to a third party almost from the inception of the investigation,” and thus the privilege did not apply. *Id.* Though the court did not explicitly mention the confidentiality agreement in its analysis, this reasoning suggests that the court would consider such an agreement ineffective to prevent waiver of the privilege, and indeed positive evidence that the party did not intend the communications to be confidential.

¹⁰ The SEC had filed an amicus brief supporting McKesson’s position. 2002 WL 31458233, at *8 n.55.

VI. RECENT SEC REPORTS ON TRENDS IN SEC ENFORCEMENT ACTIONS

A. The SEC's Report Pursuant to Section 308(c) of the Sarbanes–Oxley Act of 2002 – Seeking Improvements for Restitution to Injured Investors.

Section 308 of the Sarbanes–Oxley Act required the SEC to conduct a review and analysis of its enforcement actions for the five years preceding enactment of the Sarbanes–Oxley Act in order to identify how those actions can best be used to provide restitution for injured investors. *See* Section 308(c) Report, issued January 24, 2003. Section 308(a) of the Sarbanes–Oxley Act (the so-called “Fair Fund” provision) authorizes the SEC to take civil money penalties and add them to disgorgement funds to benefit those harmed by securities law violators. The Section 308(c) Report makes several conclusions and recommendations for enhancing the ability of enforcement actions to provide money to those injured by the securities law violations.

As an initial matter, the SEC has long sought disgorgement of ill–gotten gains as an equitable remedy against a wide variety of securities law violators. The 308(c) Report found that before ordering disgorgement, courts in general have required a finding that a causal connection exists between the defendants' wrongdoing and the amounts to be disgorged. *See* Section 308(c) Report at 3. Although the Commission does not have to prove the exact amount of the illegal profits, it must show that the disgorgement it seeks is a reasonable approximation of profits connected to the alleged violation. *Id.* Not all disgorgement funds are distributed to those injured by securities law violators, even when the injured are readily identifiable. This is so because the disgorgement amounts are often small in relation to the number of investors entitled to a pro–rata distribution of payment such that the expense associated with distributing the disgorgement funds exceeds the benefit. In those instances, the disgorgement funds are transferred to the U.S. Treasury. *See* Section 308(c) Report at 4.

The Commission also obtains orders imposing civil money penalties in a wide variety of circumstances. The SEC can seek up to three times the amount of illegal profit in insider trading cases as a measure of a civil penalty. In other instances, the amount of the penalty depends on the nature of the conduct and the size of the loss. *See* Section 308(c) Report at 4. Prior to the passage of the Sarbanes–Oxley Act of 2002, the SEC paid any civil money penalties it received into the U.S. Treasury. Section 308(c) changes that result, and permits civil money penalties to be added to disgorgement funds under certain circumstances. *Id.* at 5.

In its five–year study of enforcement actions, the Commission staff studied a number of aspects of disgorgement and penalty cases. Collection of judgments from defendants, either from disgorgement or civil penalties, is a significant problem facing the SEC. With both disgorgement and civil penalties, payments by just a few defendants account for more than their share of all amounts collected – a fact no doubt attributable to the unequal ability of defendants to satisfy adverse judgments. *See* Section 308(c) Report at 6. Similarly, some defendants with few or no assets were faced with enormous penalty awards and disgorgement orders, thus skewing the Commission's collections statistics. *See id.* As a matter of policy, the SEC has increasingly sought disgorgement awards from individual defendants in issuer financial fraud cases, including not just ill–gotten insider stock gains, and also salary and bonus from certain

officers and directors such as with the Commission's investigations of Adelphia and Tyco. *See id.* at 8. The Commission is also increasingly seeking temporary restraining orders and asset freeze orders in order to preserve assets for later disgorgement and civil penalty orders. *Id.* at 9.

The Commission found that most of the money returned to injured investors comes from successful federal court actions. *See* Section 308(c) Report at 10. In some cases, the SEC is able to secure settlements where the disgorgement and penalty payments are added to compensation funds in a private securities class action settlements. The Commission also has sought on a number of occasions to appoint receivers to liquidate the assets for violators in order to maximize funds available for injured investors. *Id.* at 11.

As noted above, the Commission found that in a number of instances, the amount of disgorgement funds available for distribution to injured investors is too small to make those payments financially feasible, but in other instances before the passage of Sarbanes–Oxley, the Commission was not able to use funds recovered in satisfaction of civil penalty orders to compensate victims. The Section 308(c) Report identified a number of collection difficulties the SEC faces after it secures either a disgorgement order, civil penalty, or both. *See* Section 308(c) Report at 20–21. Some of these difficulties stem from the fact that states vary greatly in the assets that are protectable under homestead exemptions to collection actions. The Section 308(c) Report found that the Sarbanes–Oxley fair fund provision will add significantly to the amount of funds available for victim compensation. *See id.* at 22. Moreover, the SEC is committed to implementing a “real time” enforcement initiative and to seeking an increase number of asset freezes. *Id.* at 22–23. The Section 308(c) Report also recommends that the Commission aggressively asserts disgorgement and penalty claims in the future. *Id.* The Section 308(c) Report also makes a number of recommendations aimed at improving the ability of the Commission to collect judgments, including pursuing contempt citations against delinquent defendants. *See id.* at 25. The Section 308(c) Report also notes that under Sarbanes–Oxley, the SEC no longer has to file adversary proceedings in bankruptcy court in order to prove that most of its judgments are non–dischargeable. *Id.* at 29. Finally, the Commission is examining a number of initiatives to improve collection, including using outside contractors and private collection agencies. *Id.* at 30–32.

B. The SEC Report on Section 703 of the Sarbanes–Oxley Act of 2002 – Study and Report on Violations by Securities Professionals.

Section 703 of the Sarbanes–Oxley Act of 2002 directed the SEC staff to study the securities professionals found to have violated securities laws, both as primary violators and as aiders and abettors from 1998 through 2001. The SEC found that during that four–year period, 1,596 securities professionals aided and abetted violations of and/or violated federal securities laws in actions brought by the SEC. *See* Section 703 Report, issued January 24, 2003, at 1. Over half of the violators were either individuals associated with broker dealers or were broker/dealer firms and individuals associated with investment advisors. *Id.* Only thirteen of the 1,596 securities professionals found to be securities law violators were strictly either aiders and abettors. *Id.*

It was much more likely that in aiding and abetting circumstances the violators were also found to have been principal violators. *See* Section 703 Report at 1. The Section 703 Report

found that over the study's four-year period, 48 attorneys were found to have violated federal securities laws. *See id.* at 6. In addition, 43 securities professionals were prohibited from practicing before the Commission based on a criminal conviction, and another 84 securities professionals were prohibited from practicing before the Commission due to willful violations of federal securities laws or the imposition of permanent injunctions. *Id.*

The SEC's Section 703 Report found that the most commonly violated federal securities law is Section 10(b) of the Exchange Act, with 965 violations. An additional 879 fraud violations were found under Exchange Act Rule 10b-5. *See* Section 703 Report at 9. The most frequently imposed sanction – in 782 instances – was the imposition of a permanent injunction, followed closely by a permanent cease-and-desist order. *Id.*

Interestingly, the report found that over the four-year period, disgorgement orders totaled \$799,355,572. *See* Section 703 Report at 10. Of this amount, only \$167,044,188 has been collected. *Id.* The Commission reported similarly poor collection totals for civil penalties. The total amount of civil penalties for the four-year period was \$225,963,700. *Id.* However, only \$77,722,355 has been collected. *Id.*

C. The SEC's Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002. Study and Report on Causes of Financial Misstatements.

The SEC staff was also directed under Section 704 of the Sarbanes-Oxley Act to study enforcement actions over the five years preceding enactment of Sarbanes-Oxley in order to identify the parts of issuer financial reporting that are most susceptible to fraud or inappropriate earnings management. The Commission issued its report on January 24, 2003, after studying over 500 enforcement actions arising out of over 220 Division of Enforcement investigations during the five-year period. *See* Section 704 Report at 1. The Commission found that the largest number of enforcement actions were brought concerning improper revenue recognition, including the reporting of fictitious fails and improper timing of revenue recognition. *See id.* at 2. Another frequent area of abuse involved improper expense recognition, including improper capitalization, improper use of reserve, and other types of fraudulent understatement of expenses. Approximately 10% of enforcement actions concerned registration statements filed in connection with initial public offerings. *Id.*

Section 704 of the Sarbanes-Oxley Act of 2002 called for the study of SEC enforcement actions involving restatements of financial statements. The Commission identified 135 instances of such restatements in the enforcement matters it studied over the 5-year period preceding the enactment of Sarbanes-Oxley. *See* Section 704 Report at 4. As noted above, the most common area of financial reporting susceptible to fraud was improper revenue recognition. The Section 704 Report also found that senior management was implicated in nearly all of the instances of improper revenue recognition. *See id.* at 7. The most common types of revenue recognition fraud involved improper timing of revenue recognition (holding issuer books open after the close of a reporting period), improper contingent sales, fraudulently reported multiple element contracts as with the Xerox Corporation leases of its copier equipment. Another type of common revenue recognition fraud involved the reporting of fictitious revenue as the commission found with Cendant Corp. *See id.* at 11. Yet, another variety of fraudulent revenue recognition

involved the improper valuation of revenue. For instance, issuers were found to have improperly failed to report rights of return with sales. *Id.* at 12.

The Commission's study found that improper expense recognition is another area of significant fraud in issuer financial reporting. Examples of fraudulent expense reporting include improper capitalization or failure to record expenses or losses. Worldcom is a prime example. Worldcom overstated its income by approximately \$9 billion primarily by improperly characterizing certain expenses as capital assets. *See* Section 704 Report at 14–15. Similarly, senior management at Waste Management, Inc. fraudulently increased operating income reported by understating operating expenses. *Id.* at 15. Another common variety of financial fraud involved the overstatement of inventory values. For instance, senior management at Rite Aid Corporation failed to record nearly \$9 million in shrinkage of its physical inventory due to loss or theft. *See id.* at 16. Still other issuers improperly restructured or improperly used reserve accounts. Again, Xerox was a prime violator, along with Sunbeam Corporation and W.R. Grace & Co. *Id.* at 16–17. Specifically, Xerox used a \$400 million reserve account to artificially inflate earnings in order to meet analyst projections.

Another significant area of financial fraud involved issuers' improper accounting in connection with mergers or other business combinations. *See* Report at 19–22. The most common type of violation in this regard concerned either the improper valuation of assets or the fraudulent use of merger reserves. Again, Cendant was a prime violator of this time of financial fraud, overstating its operating income by more than \$500 million over a 3-year period. *Id.*

The SEC's study also found that issuer disclosures in management discussion and analysis ("MD&A") was an area ripe for fraud. *See* Section 704 Report at 22–24. For instance, issuers were found to have committed fraud in instances where MD&A disclosures did not include matters necessary to present an accurate picture of the issuer's financial condition, even where the reported financial disclosures were in conformity with GAAP. Some of the most egregious violations of this type of non-disclosure involved related party transactions. Executives at Adelphia and Rite Aid failed to disclose material transactions with entities and individuals controlled by or owned by senior management. *Id.* at 24–25. Included in this type of fraud were instances where issuers inappropriately accounted for nonmonetary or barter transactions and round-trip transactions where issuers recognized revenue despite the fact that the reported revenue did not meet economic reality. *See id.* at 25–27. The fraudulent use of pro forma or other non-GAAP financial measures in a number of enforcement actions resulted in proposed rule-making under the Sarbanes-Oxley Act. Fraudulent use of off-balance sheet transactions and other arrangements was a key contributor to a number of the most spectacular financial frauds the Commission had to address. Prime examples of this type of fraud included the PNC's improper transfer of \$762 million in troubled loans off its books, Adelphia's failure to record over \$2.3 billion in bank debt, Dynegy's improper accounting for a \$300 million transaction involving a special purpose entity, and of course, Enron's fraudulent use of special purpose entities and off-balance sheet arrangements. *Id.* at 28–30.

The Section 704 study also examined a number of instances where high-level issuer executives were implicated in financial fraud. The study found that these individuals were charged in 157 of 227 enforcement matters. *See* Report at 31. The number of officer and director bars sought by the Commission skyrocketed in 2002. In the four years preceding 2002,

the Commission sought between 36 and 51 bars per year. However, the SEC sought 126 officer and director bars in 2002. The study also found that the Commission also brought actions against 83 mid-level managers and 14 attorneys (including 3 outside counsel) for participating in the reporting of fraudulent financial numbers. *Id.* at 34–35.

The Commission found that auditors were charged in 57 of the 227 enforcement matters involving financial reporting fraud; and in 18 of the 57 of the enforcement matters, the auditing firm was charged. *See* Section 704 Report at 37. Arthur Anderson was obviously the most significant of these instances; not only for its role in the Enron disaster, but it was also charged in connection with the Waste Management, Inc. fraud. *Id.* at 37–38. The Commission concluded that most often audit failures arose where auditors accepted management representations without insisting on appropriate verification. *Id.* at 40.

The Commission makes a number of proposals based on the results of the Section 704 Report. First, the SEC notes that the Sarbanes–Oxley Act requires issuers, CEOs and CFOs to certify annual and quarterly reports; Section 303 of the Act makes it unlawful to mislead or fraudulently influence auditors; and Section 304 provides that CEOs and CFOs must reimburse issuers for bonuses and other incentive-based compensation where restatements result from noncompliance with securities laws. *See* Section 704 Report at 42. The Report also notes that the Sarbanes–Oxley Act expands the scope of officer and director bars by making it available as an administrative remedy, thus making it procedurally simpler and swifter to achieve. Section 305 of the Act also lowers the standard the Commission must show in order to achieve an officer and director bar from “substantial unfitness” to “unfitness.” *Id.* Finally, the Sarbanes–Oxley Act makes it easier for the SEC to seek officer and director bars for violations of the Section 10b of the Exchange Act and gives the SEC the power to escrow any extraordinary payments to executives while enforcement proceedings are pending. *Id.*

As part of its conclusion, the Commission made several important recommendations. First, the SEC proposes that the Commission adopt a uniform mechanism for restating financial statements. *See* Section 704 Report at 43–44. The Commission would also like to see additional rule making focusing on MD&A disclosure requirements so that an issuer’s true financial position is reported. *Id.* at 45. Third, the Commission recognizes that issuers often have concern that sharing internal legal analysis or attorney work product could result in a waiver that would subject the issuer to additional civil liability. The Commission proposes legislation that would insulate disclosure to the SEC from any client of a wider waiver. *Id.* at 45. Fourth, the Commission recommends enacting legislation that would grant the SEC access to grand jury materials to enhance the efficiency of law enforcement activities. *Id.* at 45–46. Finally, the Commission recommends enacting legislation providing for nationwide service of process for testimony in Commission civil actions. *Id.* This proposal would decrease Commission litigation expenses.

VII. RECENT SEC RULE-MAKING AFFECTING SEC ENFORCEMENT INVESTIGATIONS

The Sarbanes–Oxley Act of 2002 required the SEC to issue several new rules that are of particular interest in the SEC Enforcement arena are discussed below.

A. Attorney Conduct Rules under Sarbanes–Oxley Act.

On January 23, 2003, the SEC adopted the final rules to implement Section 307 of the Sarbanes–Oxley Act of 2002 and sets standards for professional conduct for attorneys “appearing and practicing before the Commission.”¹¹ The rules adopted by the Commission: (1) require attorneys to report evidence of material violations “of the latter” to the issuer’s chief legal counsel or chief executive officer; (2) require the attorney, if the chief legal officer or chief executive officer does not respond appropriately evidence of the violation to the Audit Committee, another committee of independent directors, or the full board; (3) clarify that the rules cover attorneys providing legal services to an issuer who have an attorney–client relationship with the issuer, and who have noticed that documents they are preparing or assisting in preparing will be filed with or submitted to the Commission; (4) provide that foreign attorneys who are not admitted to practice in the United States are not covered by the rule; (5) allow issuers to establish a “qualified legal compliance committee” as an alternative for reporting material violations (such committees must have at least one Audit Committee member or another committee of independent directors); (6) allow attorneys, without the consent of the issuer, to reveal confidential information related to the representation to the extent the attorney reasonably believes necessary to prevent the issuer from committing a material violation likely to cause substantial financial injury to the financial interests or property of an issuer, to prevent the issuer from committing an illegal act, or to rectify the consequence of a material violation or illegal act in which the attorney’s services have been used; (7) indicate that the Commission rules cannot preempt the ability of a state to impose more rigorous obligations on attorneys, but that the Commission rules govern in the event of conflict with state law; and (8) affirmatively state that the rules do not create a private right of action and that authority to enforce compliance is rested exclusively with the Commission.

The final rules define “evidence of a material violation” to confirm that the Commission intends an “objective” rather than a subjective triggering standard, involving credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur.

B. Rules Regarding Retention of Records Relevant to Audits and Reviews.

Under Section 802 of the Sarbanes–Oxley Act of 2002, the SEC adopted on January 22, 2003, rules regarding the documents accounting firms must maintain related to audits and reviews of issuer financial statements.¹² Rule 2–06(a) requires accounting firms to retain work

¹¹ The Commission extended the comment period for the “noisy withdrawal” provisions of the original proposed rule.

¹² Section 1102 of the Sarbanes–Oxley Act of 2002 makes it a criminal offense, punishable by fine or up to 20 years imprisonment, to “(1) alter, destroy, mutilate, or conceal a record, document, or other object, or attempts to do so, with the intent to impair the object’s integrity or

[Footnote continued on next page]

papers and other documents that form the basis of the audit or review, and memoranda, correspondence, communications, and other documents, including electronic records, that are created, sent or received in connection with the audit or review and contain conclusions, opinions, analyses, or financial data related to the audit. Firms must keep the records for seven years after the auditor concludes the audit or review. Rule 2-06(c) also states that records should be retained if they support or “cast doubt” on the final conclusion reached by the auditor.

[Footnote continued from previous page]

availability for use in an official proceeding; or (2) otherwise obstruct, influence, or impede any official proceeding, or attempt to do so.” *See* 18 U.S.C. § 1512(b). Thus, while no SEC rule requires issuers to maintain documents related to their audits and reviews of their financial statements, Sarbanes-Oxley criminalizes any attempt to obstruct justice by destroying any document that might be called for by an SEC or other law enforcement investigation.