

Regulation of Market Abuse and SEC Enforcement Powers

U.S. Securities and Exchange Commission

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SEC Enforcement: FY 2003

- 679 total cases (up from 598 in 2002)
- Largest categories:
 - Financial fraud and issuer reporting (29%)
 - Offering fraud (16%)
 - Broker-dealer (20%)
 - Insider trading (7%)
 - Investment adviser/Investment company (9%)
 - Market manipulation (7%)

Elements of an Effective Enforcement Program

- Goals are: stop and deter illegal conduct; Disgorge illegal profits; Impose penalties; Bar professionals from the industry if they have committed fraud; Maintain confidence that your market is fair and honest.
- Possess comprehensive investigative powers, including subpoena authority.
- Maintain confidentiality of investigations.

Sources of Cases

- The public/victims
- Examinations
- Press
- SROs
- Broker-dealers
- Other law enforcement authorities
- Self Reporting

Information Gathering

- Informal or preliminary investigations
 - Voluntary cooperation
- Formal investigations
 - Subpoenas
 - Testimony

Compulsory Powers

- Subpoenas for documents
- Subpoenas for testimony
- SEC may may seek court order for subpoena enforcement

Sources of Information for Investigations

- Brokerage records (including tapes)
- Bank records
- Telephone records
- Internet Service Provider records
- Corporate records
- Beneficial ownership
- Accountant/auditor work papers
- Victims
- Informants

SEC Enforcement Actions

- Wells Process
- Settlements
- Administrative Proceedings
- Civil cases
- Criminal cases

Sanctions Available to SEC

- Civil court ordered injunctions
- Disgorgement of ill-gotten gains
- Penalties
- De-barmment

Civil/Criminal Issues

- Securities laws carry both civil and criminal penalties
- SEC has statutory authority to make referrals to DOJ
- Criminal cases have higher burden of proof
- Coordinating with the criminal authorities

Parallel Civil/Criminal System in US

- U.S. Federal securities laws carry both civil penalties (enforceable by the SEC and DOJ) and criminal penalties (enforceable by DOJ).
- SEC has independent law enforcement authority coupled with authority to refer cases and transfer files to DOJ. Securities Exchange Act of 1934, section 21(h)(9)(B).

U.S. Case Law: SEC v. Dresser Industries (1980)

- Held SEC's civil enforcement authority continues "undiminished" by parallel criminal investigation: "the SEC retain[s] full powers of investigation and civil enforcement action, even after Justice has begun a criminal investigation into the same alleged violations."

Gibraltar Case Law: Gibraltar Co. v. FSC

FSC's production of records to foreign regulatory authority was challenged where there was a parallel criminal investigation in the foreign country. Lower court quashed production.

Appellate holding: The "primary purpose" for which the FSC decided to use his powers to collect and share the information was to assist the foreign regulator for "its own supervisory and regulatory purposes" even if the information is likely to be passed to the criminal authorities.

Canadian Case Law

Jarvis and *Ling* cases prohibit the Canada Customs and Revenue Agency from gathering information from a taxpayer when the “predominant purpose” is the determination of penal liability. *See R. v. Jarvis*, 2002 SCC 73, at 3 (“Where the predominant purpose of an inquiry or question is the determination of penal liability, all charter protections that are relevant in the criminal context must apply.”).

International Enforcement Cooperation Tools

- MOUs: a formal regulator to regulator channel
- MLATs: a formal country to country criminal channel
- Informal channels:
 - Regulator to regulator in absence of MOU
 - Regulator to law enforcement

SEC's Authority to Assist Foreign Securities Authorities

- Section 21(a)(2) of Securities Exchange Act of 1934

On request from a foreign securities authority, “[t]he commission may, in its discretion, conduct such investigation as the commission deems necessary to collect information and evidence pertinent to the request for assistance. *Such assistance may be provided without regard to whether the facts stated in the request would also constitute a violation of the laws of the united states.*”

SEC will consider confidentiality, public interest, and reciprocity.

IOSCO Multilateral MOU

1. Information sharing:
 - Contemporaneous trading records
 - Bank records relating to securities transactions
 - Beneficial ownership of transactions
 - Beneficial ownership of non-natural persons
2. Confidentiality of information received
3. Permissible uses

Signing the IOSCO Multilateral MOU

- IOSCO members are in the process of applying to become signatories to the MOU.
- The MOU is open to IOSCO members who demonstrate their legal authority to comply with the MOU's key provisions. There are currently 24 signatories.
- Applications are submitted to verification teams, then a screening group, and decided on by a "committee of chairman" of the technical, emerging markets and executive committees.

Current Trends and Issues

- Real-time enforcement
- Restraining and repatriating assets
- Parallel investigations/prosecutions

Elements of “Real Time” Enforcement

- Take action to stop fraud and other investor harm expeditiously
- Take action to educate the public expeditiously
- Temporary Restraining Orders – Court order to stop the conduct, expedite discovery, restrain assets, order repatriation.
- Reward meaningful cooperation, self-policing and self-reporting.

Show Me the Money! Restraining the Proceeds of Securities Fraud

Civil Options:

- Administrative Restraints
- Bank Warning Letters
- Civil Litigation/Mareva Injunctions

Criminal Channels and Proceeds of Fraud

- MLAT requests
- Proceeds of Crime Legislation
- Working with Financial Intelligence Units

Financial Intelligence Units

- Empowered to collect and disseminate financial intelligence and suspicious transactions
- Egmont Group – Network of 90 FIUs around the world.

Investigation Strategies by Case Type

- Financial fraud
- Insider trading
- Manipulations

Financial Fraud

1. Revenue Recognition -- More than half of all fraud cases involving financial reporting involved manipulation of sales (revenues) – revenue recognition issues were behind 85 of the 381 restatements of public companies in 2002.
2. Shifting current expenses to later periods.
3. Failure to record or disclose liabilities.
4. Cookie-jar accounting – setting and reversing reserves.
5. Intentional misstatement of financial results in press releases.

Insider Trading - Definition

It is illegal for any person to purchase or sell a security on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information. Rule 10b5.

Insider Trading Examples

- Corporate officers, directors, and employees who traded after learning of significant confidential corporate developments
- Friends, business associates, family members and other “tippees” of such officers, directors, and employees, who traded the securities after receiving the information
- Employees of law, banking, brokerage and printing firms who were given such information to provide services to the corporation whose securities they traded.

Examples of Financial Fraud/Insider Trading Case

- AremisSoft Corporation –

AremisSoft Corp.

- Oct. 2001: Commission obtained emergency injunctive relief against AremisSoft Corp., an international software company with offices in New Jersey, London, Cyprus, and India, and two former officers.
 - SEC complaint alleged that they overstated the value of the Company's contracts, revenues and recent acquisitions, and that the two former officers engaged in massive insider trading during the period of the reporting fraud.
 - Court's Order restrained defendants from violations of the anti-fraud, reporting and other provisions of the federal securities laws pending a hearing, froze assets of individuals, and directed them to repatriate to U.S. proceeds of their sales of AremisSoft stock.

AremisSoft Corp.

- July 2002: AremisSoft consented to permanent injunctive relief and to revocation of the registration of AremisSoft's stock.
- Currently, with assistance of DOJ, SEC is seeking forfeiture and repatriation of over \$175 million held in two Isle of Man banks.
 - Accounts are restrained by Isle of Man at the request of US.
 - Funds are alleged to constitute proceeds of fraudulent insider trading in the stock of AremisSoft Corporation.
- Three former AremisSoft officers have been indicted.

ACLN, Ltd.

- Commission filed civil injunctive action against ACLN and three individuals who controlled the company.
- Commission is seeking from these defendants:
 - Disgorgement of ill-gotten gains
 - Civil money penalties
 - Injunctions, and
 - Officer and director bars and monetary penalties under the Insider Trading Sanctions Act.
- SEC and agencies of other governments froze \$45 million in bank accounts in Denmark, Netherlands, Luxembourg and Monaco, which SEC will seek to repatriate for distribution to defrauded shareholders.

ACLN, Ltd.

- SEC complaint alleged:

- A.C.L.N., a Cyprus corporation operating from Belgium, purportedly shipped used vehicles to North and East Africa and sold new cars in that region. In fact, ACLN was the vehicle for an elaborate financial fraud that resulted in losses of hundreds of millions of dollars to investors in the U.S. and abroad
- Individual defendants, who controlled the Company, constructed a fraudulent scheme to represent ACLN as a substantial business entity with escalating profits when it was essentially a shell company
- They caused ACLN to grossly misrepresent its revenues and income, fabricate an entire line of business, and claim ownership of assets that did not exist or it did not own.
- Falsifying its assets and results of operations allowed ACLN to obtain a listing for its stock on the Nasdaq NMS and subsequently on the NYSE

ACLN, Ltd.

- SEC complaint alleged:
 - ACLN significantly overstated the volume of its used car transactions, and claimed substantial revenue from a purported new car sales operation that, in fact, never existed;
 - ACLN grossly misrepresented the amount of its cash assets from 1998 through the third quarter of 2001. This deception was furthered through the creation of forged bank documents that ACLN provided to its auditors;
 - ACLN did not own the largest physical asset on its balance sheet, the car-carrier vessel the *Sea Atef*, and, in any event, significantly inflated the vessel's value;
 - Individual defendants exploited success of the fraud by selling over \$80 million of their holdings of ACLN stock at inflated prices through a complicated web of offshore corporations and bank accounts, created to facilitate the scheme.

International Boiler-Room

- Millennium Financial Ltd. -
 - Appeared to operate out of Uruguay, Mexico, Switzerland and Brazil - “virtual offices”
 - Cold calls to investors to tout pre-IPO US stocks at inflated prices – slick website/brochures
 - 700 investors solicited from at least 20 different countries
 - Raised \$US20 million
 - Investor funds wired through and to numerous countries: Guernsey, BVI, Seychelles, Spain, Isle of Man, Hong Kong and Nevis