SEC ANNOUNCES A "SWEEPING EXPANSION" OF ITS INVESTIGATIONS OF POSSIBLE MARKET MANIPULATION

The Securities and Exchange Commission ("SEC" or "Commission") announced on September 19th that it has formalized and expanded its investigation into the possible market manipulation of the securities of certain financial institutions.[1] The announcement also highlighted the Commission's cooperation with NYSE Regulation and the Financial Industry Regulatory Authority ("FINRA"), which are conducting separate but parallel inquiries into recent short selling activity.

Formal Order

The Commission publicly announced the approval of a formal order of investigation, in this case exercising its authority to use a single omnibus formal order to investigate industry-wide conduct at a diverse range of institutions.[2] With this broad-based formal order, SEC staff will be able to issue subpoenas and other demands for both documents and testimony, and as discussed below, the Commission can issue orders pursuant to Section 21(a) of the Exchange Act.

Orders Under Section 21(a)

The Commission also announced that it will require "[h]edge fund managers, broker-dealers, and institutional investors with significant trading activity in financial issuers or positions in credit default swaps" to "disclose under oath those positions to the Commission." The Commission will issue these orders pursuant to Section 21(a) of the Exchange Act, which allows the Commission to "require . . . any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated."[3]

Section 21(a) is more commonly known as the authority under which the Commission itself may issue findings resulting from investigations,[4] and the Commission has used its authority to compel sworn statements from parties sparingly in the past. The most notable use of this authority was in 2002, prior to the effective date of Sarbanes-Oxley, when the Commission ordered CEOs and CFOs of over 900 of the largest public companies to certify the material accuracy of their companies' financial statements or alternatively explain in writing why they could not so certify.[5] The

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[1] *See* SEC Press Release No. 2008-214 (Sept. 19, 2008); *see also* SEC Press Release No. 2008-209 (Sept. 17, 2008).

[2] The SEC may issue formal orders without identifying a specific target. *See SEC v. O'Brien*, 467 U.S. 735 (1984).

[3] Securities Exchange Act of 1934, Section 21(a)(1), 15 U.S.C. § 78u(a)(1).

[4] One of the most widely known examples of this use of Section 21(a) is the "Seaboard Report," which set forth certain acts of cooperation that the Commission would take into consideration when deciding whether and to what extent a party would be pursued for violations of the securities laws.

[5] *See* SEC File No. 4-460, *Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934* (June 27, 2002).

Commission has also used this power in a more targeted manner when, for example, it required WorldCom to explain all the facts and circumstances that led to its restatement.[6]

The Commission's 21(a) orders are not self-enforcing, but rather require the staff to file a public action in federal court to enforce compliance. And, while the Section 21(a) orders discussed above were used very publicly by the Commission, it has also used non-public orders as an additional tool to collect information for investigations.

The Commission's 21(a) orders should be taken with the same seriousness as other government law enforcement demands for sworn statements, and the consequences of filing such statements should not be underestimated. For example, at a minimum, it can be assumed that such statements, which are required to be made under penalty of perjury, will be shared with other agencies – particularly FINRA and the NYSE, which the SEC specifically noted for their cooperation in this investigation – and may also be made public. Furthermore, it is likely that these statements will be shared with state attorneys general, the Department of Justice, and other relevant bodies. Moreover, Section 21(a) specifically provides the Commission with discretion to publish responses to Section 21(a) orders, and the Commission published the responses to both the WorldCom and the pre-Sarbanes-Oxley CEO/CFO certification orders.

Responding to a Section 21(a) Order

In responding to a Section 21(a) order issued pursuant to the current market manipulation investigations, clients should consider the following:

- *Who will certify the response?* Section 21(a) calls for the statement to be made under oath, under penalty of perjury, unless otherwise specified.

- *Are there any limitations on the ability to respond fully to the order?* Section 21(a) states that the Commission can require a written statement "as to all the facts and circumstances." If there are limitations in the response, it would be wise to discuss these with the staff in advance of filing the statement. In addition, the limitations should be set forth in the response itself.

- *Does the order specify a particular form for the response?* Although Section 21(a) is silent as to form, it is likely that orders being issued pursuant to the market manipulation investigation will request that trading information be delivered in a specific format. Every effort should be made to gather all requested information and present it as requested.[7]

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[6] *See* WorldCom, Inc., File No. HO-09440, *Corrected Order Requiring the Filing of a Sworn Statement Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934* (June 26, 2002).

[7] WorldCom's initial response to the Commission's 21(a) order presented a chronology of events without going into significant detail. This response was publicly chastised by then-Chairman Harvey Pitt for failing to comply with requests in the 21(a) order.

- *How else might the SEC (or other agencies and potential plaintiffs) use the statements?* Nothing in Section 21(a) limits how the Commission may use the statements.

- *If anomalies or potential violations are identified, the staff will expect the company to conduct an immediate and thorough self-investigation.* Even though the staff cannot compel a company to investigate itself, such self-investigation and remediation has become the standard and may serve the company well in the event the staff does pursue an action.

- *Preserve all relevant documents.* Any Section 21(a) order will almost certainly include a document preservation request. In the SEC's September 17th press release, Chairman Cox specifically stated that institutions will be "required immediately to secure all of their communication records."[8] Failure to preserve documents can easily turn a civil inquiry into a criminal investigation.

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September 23, 2008

[8] SEC Press Release No. 2008-209 (Sept. 17, 2008).