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The SEC's Pay-To-Play Rule Proposal for Investment Advisers

What's Behind It & What Are the Next Steps?

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Just over ten years ago, on Aug. 4, 1999, the Securities and Exchange Commission (SEC) proposed a rule designed to prohibit so-called "pay-to-play practices" by investment advisers doing business with public pension plans. At issue was a practice investigated and prosecuted by the SEC's Enforcement Division just prior to the rule's proposal—the use of political contributions by investment advisers to influence the award of advisory contracts by public pension funds. The SEC argued that—by directing political contributions to public officials who were 1) in a position to influence the award of the advisory contracts;

CONTINUED ON PAGE 4

Content HIGHLIGHTS

Ethics and Compliance Enforcement Decisions—The Information Gap
By Ronald E. Berenbeim & Jeffrey M. Kaplan............9

Pres Obama: Strong Rules Needed to Guard Against Systemic Risk
A Speech by Pres. Barack Obama............................16

Complete Table of Contents listed on page 2.

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Table of CONTENTS

The SEC's Pay-To-Play Rule Proposal for Investment Advisers: What's Behind It & What Are the Next Steps?
By Elizabeth P. Gray & David W. Blass 1

From the EDITOR
Gregg Wirth, Managing Editor 3

Ethics and Compliance Enforcement Decisions—The Information Gap
By Ronald E. Berenbeim & Jeffrey M. Kaplan 9

Pres Obama: Strong Rules Needed to Guard Against Systemic Risk
A Speech by Pres. Barack Obama 16

SEC/SRO Update
By Peter H. Schwartz & Crystal L. Gordon 21

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From the EDITOR

Wall Street Lawyers Wary as Judge Sets Trial for *SEC v. BofA*

What started out as a routine—if high-profile—failure-to-disclose charge by the Securities and Exchange Commission against Bank of America has morphed into a tangled web of scuttled settlement plans, congressional inquiry, and multiple subpoenas that now has some legal observers questioning the central thesis of punitive penalties and class action lawsuits.

On September 14, Manhattan federal judge Jed Rakoff issued an order rejecting the SEC's proposed $33 million settlement with BofA and setting Feb. 1 as the trial date. Judge Rakoff had sent the two parties back to the drawing board in August after complaining, among other things, that the parties had not adequately assessed blame in the matter. The SEC's complaint stems from its allegations that BofA failed to disclose to shareholders that it intended to pay more than $5 billion in bonuses to Merrill Lynch executives in connection with its takeover of the company. Indeed, in its proxy documents on the deal, BofA specifically said it would not be paying such bonuses.

In his order, Rakoff criticized how the SEC/BofA settlement would be paid by *current* shareholders to make amends for the alleged past misdeeds of BofA executives and their advisors. Rakoff had harsh words for both parties as well as for the law firms that represented BofA—Wachtell, Lipton, Rosen & Katz and Shearman & Sterling. And in a portion of the order guaranteed to give Wall Street lawyers the flop sweats, Rakoff asked why—if, as the SEC was claiming in its briefs, BofA's lawyers had actually made some of the key decisions in regards to the disclosure (or lack of it)—the Commission wasn't pursuing penalties against those law firms.

Rakoff's order could be seen as a swipe against the landmark 2008 Supreme Court decision, *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.,* which finally put to rest the question of whether third-party players, including law firms, could be sued for a client company's fraud. In fact, Rakoff's ruling could give strength to recent legislation proposed in August by Sen. Arlen Specter (D-PA) that would hold liable individuals or firms that provide "substantial assistance" to a fraud, and essentially gut *Stoneridge* (For more on Sen. Specter's plan, see "From the Editors" in the September 2009 issue of *Wall Street Lawyer*, vol. 13, no. 9).

Stoneridge aside, some legal scribes have taken Rakoff's comments a step further. *BusinessWeek* used Rakoff's legal decision as a springboard to question whether shareholder class action lawsuits make any sense at all. The magazine argued, like Rakoff implied, that current shareholders get penalized twice—once by the fraud, then again by having to pay the monetary penalty for it.

With deep thoughts and potential impact like this swirling about this case, it may be a very interesting fall for all involved. Mark your calendars for Feb. 1. We will.

In this issue… The October issue of *Wall Street Lawyer* features authors Elizabeth Gray and David Blass of Willkie Farr & Gallagher, who examine the SEC's recent pay-for-play rule proposal and assess how it might impact the investment advisory community. Coming out of the New York State Retirement Fund scandal, the SEC's new rule will likely disrupt many of the common, long-time business practices among advisors and their fund clients, the authors write.

Calling for stories… *Wall Street Lawyer* always is looking for interesting story ideas concerning evolving regulations, new litigation trends, recent court decisions and the latest developments. If you or someone at your firm has an idea for an article—please contact our managing editor, Gregg Wirth, at gregg@gwirth.com.

——GREGG WIRTH, MANAGING EDITOR

CONTINUED FROM PAGE 1

and 2) willing to compromise their fiduciary obligations—advisers were able to obtain lucrative investment advisory contracts with public pension funds.[1]

The 1999 rule proposal broadly limited campaign contributions by investment advisers doing business with public funds, and was viewed as controversial. One prominent trade association commented at the time that the proposal interfered with investment advisers' ability to participate in the political process, noting that the SEC's "prohibiting specified campaign contributions—*without regard for the intent underlying such contributions*—involves sensitive constitutional issues that should not be swept away without due regard for and consideration of an individual's right to participate fully in our political processes."[2] The SEC never adopted a final pay-to-play rule, and the proposal was dormant until this year when the SEC reconsidered the 1999 proposal in light of the $5 billion New York Common Retirement Fund scandal.

Now, 10 years after the first rule was proposed and once again following allegations of an expansive scandal involving investment advisers and a public pension fund, the SEC has proposed a revised version of its pay-to-play proposal that goes significantly beyond the 1999 version.[3] The SEC's newest pay-to-play rule proposal is likely to be viewed by industry participants as a controversial and potentially over-reaching reaction to the New York Retirement Fund scandal. One of its more controversial aspects, which was not in the 1999 rule proposal, is to ban outright the common practice of paying a third party, such as a placement agent, solicitor or other intermediary, to solicit investment advisory business from government entities. Despite the proposal's extensive prohibitions and its broad reach, a number of factors may influence the SEC in favor of adopting the proposed rule or an amended version of it. The scope of the New York Retirement Fund scandal, the acceptance by a number of private equity firms of the New York Attorney General's (NYAG's) "Public Pension Fund Reform Code of Conduct" which includes restrictions similar to those proposed by the SEC, and the SEC's view that it currently possesses limited authority to prosecute pay-to-play cases make it more likely that the SEC this time will adopt some version of the proposed pay-to-play rule.

This article explores the background behind the SEC's 2009 proposal and explains in some detail the effect of the proposal if the SEC adopts it as proposed. We also explore some aspects of the proposal that we believe likely will draw comment from industry participants and others.

The SEC's Justification for the Rule Proposal: Recent Enforcement Actions and Investigations

As with the 1999 rule proposal, the SEC's proposal was preceded by a high-profile pay-to-play scandal, this time centered in New York.[4] Earlier this year, the SEC and the NYAG instituted a proceeding into an alleged pay-to-play scandal in the New York State Retirement Fund.[5] The SEC has thus far charged six individuals who it alleges were directly involved in the making or receipt of improper payments, along with nine entities that were closely related to those individuals. Most of the individuals charged by the SEC have been either placement agents who allegedly coerced investment advisers into paying fees to obtain investments from the retirement funds and used the fees to corrupt state officials, or investment advisers who allegedly paid fees knowing that they would be put to improper use. While the facts uncovered thus far seem to point to the existence of a wide-ranging scheme to defraud the Retirement Fund, no individuals have settled or resolved claims with the SEC, although four have pled guilty to NYAG charges.

According to the SEC's Amended Complaint, the scheme began in 2003 and was orchestrated by David Loglisci, former deputy controller and chief investment officer of the Retirement Fund, and Henry Morris, an experienced political fundraiser and strategist. Prosecutors subsequently charged several other individuals, including former hedge fund executive Barrett Wissman and Raymond Harding, head of the New York Liberal Party. The SEC claims that the scheme affected the placement of approximately $5 billion in investments made by the New York Retirement Fund—or just over half of all the alternative investments made by the fund during the relevant period. Over the course of several years and dozens of separate

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transactions, the defendants allegedly extracted kickbacks by informing asset managers that the managers needed to pay a "fee" in order to obtain an investment from the Retirement Fund. The defendants purportedly collected tens of millions of dollars, at times using the proceeds of the scheme to pay off individuals who had learned of the kickbacks.

Four of the six individuals charged by the NYAG in the scheme pleaded guilty to NYAG charges.[6] Most recently, on Oct. 6, Raymond Harding and Saul Meyer pleaded guilty to felony securities fraud. Harding admitted to having provided the support of his political party to the New York State Comptroller in exchange for being "inserted… as a placement agent" in several transactions performed by the Retirement Fund.[7] Meyer, an investment adviser, admitted to having recommended investments which he believed were inappropriate in exchange for investment from the fund, as well as surreptitiously funneling over $300,000 in management fees to Henry Morris, the New York State Comptroller's aide.[8] Meyer also admitted to similar conduct regarding public pension funds in New Mexico.

While the SEC has successfully prosecuted and litigated pay-to-play cases in the past, its arsenal for bringing such charges is limited, with most cases based on direct or indirect violations of the antifraud provisions the Advisers Act of 1940 and Securities Exchange Act of 1934 as it did in the New York Retirement Fund case.[9] However, the investigation and prosecution of such antifraud charges are time-consuming and challenging because they involve developing proof of scienter, *i.e.*, proof of reckless or knowing misconduct. In the context of pay-to-play cases, such charges generally require proof that the payments made were in fact bribes and that there was inadequate disclosures of the illegal payments. The SEC's proposed rule, in contrast, contains an absolute prohibition of certain conduct which, if violated, would result in liability without proof of scienter.

For example, in the New York Retirement Fund complaint the SEC has alleged that the investment advisers knew or were reckless in not knowing that a conflict of interest existed between the placement agent and the state retirement fund. By failing to disclose these conflicts in dealing with the New York Retirement Fund, the SEC has alleged, the investment advisers violated the antifraud provisions of the Advisers Act as well as the Exchange Act. Although certain officials of the Retirement Fund knew of the conflicts of interest because they were involved in the scheme, the SEC contends that the advisers nonetheless deprived the Retirement Fund of material information by depriving the *non-corrupt* officials of information.[10] In short, according to the SEC, the investment advisers' fraud consisted of failing to disclose to "*relevant* members of the Retirement Fund's investment staff the true nature and intended beneficiary of the payments [to the placement agents]" (*emphasis added*).[11] This precluded the New York Retirement Fund from making an "independent assessment of the merits of such an investment free from any conflicts of interest."[12]

Although the current pay-to-play focus began with an investigation into investments made by a single public pension fund, regulators now are exploring whether there is an industry-wide problem with the manner in which investment advisers solicit investments from public pension funds. The SEC has stated that it is interested in finders' fees and other payments and the work done in exchange for those payments. The agency has requested information from pension fund managers, placement agents, and other intermediaries.[13] The SEC's Division of Enforcement on August 5 announced the creation of a Municipal Securities and Public Pensions Unit within the Division.[14] In addition, the NYAG established the Public Pension Fund Reform Code of Conduct, which resembles in many respects the SEC's proposed rule and to which a number of private equity firms doing business with the New York Retirement Fund have already agreed to comply. The NYAG has also created a multi-state task force consisting of 36 state attorneys general dedicated to investigating pension fund abuse.[15]

Proposed Rule 206(4)-5: The SEC Attempts to Address Bad Practices by a Few by Proposing a Rule that Applies to the Entire Industry

Faced with the growing New York scandal and related enforcement actions, the SEC proposed Advisers Act Rule 206(4)-5 in July. The rule's

scope is broad, applying to all SEC investment advisers and unregistered hedge fund advisers, private equity fund advisers and other investment advisers that rely on the private adviser exemption from registration in Section 203(b)(3) of the Advisers Act.[16] The rule proposal would implement three significant new limitations on the ability of those investment advisers to manage money on behalf of a public pension plan or any other "government entity."[17] The limitations would apply when an investment adviser subject to the rule seeks to manage government assets or seeks to solicit government entities as investors in certain pooled vehicles, including registered investment companies, private investment funds and bank collective trust funds.

The SEC based its rule proposal on rules G-37 and G-38 of the Municipal Securities Rulemaking Board (MSRB), which address pay-to-play practices in the municipal securities markets, and also on the SEC's 1999 proposed (but never adopted) pay-to-play rule. Following is a summary of the limitations under the current rule proposal:

Two-year "time out" for contributors

The proposed rule generally would prohibit an investment adviser subject to the rule from receiving compensation for the provision of investment advisory services to a government entity for two years after the adviser or any of its "covered associates" makes a contribution to any state treasurer, comptroller or other elected official who can influence the selection of the adviser. The SEC would deem an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest to be providing investment advisory services directly to the government entity.[18] The SEC proposes to define "covered associates" to include any of the adviser's general partners, managing members and executive officers, and any employee who solicits a government entity for the investment adviser.[19] The two-year "time out" resulting from a political contribution would follow an employee if he or she moved to a different adviser or was promoted within the firm to become a covered associate. Such a restriction may create a difficult oversight challenge for many advisers. An investment adviser seeking to hire or promote an individual would have to "look back" at the potential employee's history of political contributions to determine whether he or she had made any donations within the prior two years.

The SEC proposes two narrow *de minimis* exceptions from the two-year time-out provision. One exception would be available for contributions by a covered associate who is a natural person made to an official for whom the covered associate was entitled to vote at the time of the contributions that, in the aggregate, do not exceed $250 to any one official per election. The other exception would be available, subject to certain timing restrictions, if a covered associate made a contribution of less than $250 to an official for whom the covered associate was *not* eligible to vote if that contribution were later returned to the covered associate. An adviser could not rely on the second exemption more than twice within a year and only once per year for any one covered associate.

Ban on payments to third parties who solicit government entities for investment advisory services

The proposed rule would ban the common practice of paying a third party, such as a placement agent, solicitor or other intermediary, to solicit investment advisory business from government entities. As noted above, the SEC would deem an investment adviser to a covered investment pool, such as a hedge fund, in which a government entity invests to be providing investment advisory services directly to the government entity. In effect, the SEC's proposal would ban the ability of managers of investment pools to pay third parties to solicit investors in these funds. In explaining why it was taking such a drastic approach, the SEC stated that its enforcement investigations revealed in some instances that third-party solicitors played a significant role in alleged pay-to-play arrangements and noted the "apparent difficulties for advisers to monitor the activities of their third-party solicitors." This aspect of the rule proposal would, in practice, prohibit entirely a current and important industry function and may be subject to criticism by industry participants that it is not proportionate to the problems the SEC claims it is seeking to address.

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Currently, when registered advisers pay a third party, such as a placement agent, to solicit pension funds or other clients for the provision of advisory services, the advisers generally must comply with Rule 206(4)-3 under the Advisers Act (the Cash Solicitation Rule). The Cash Solicitation Rule permits a registered adviser to pay a cash fee to a person soliciting clients for an adviser only if the solicitor is not subject to court order or administrative sanction, and the fee is paid pursuant to a written agreement to which the adviser is a party.[20] In most cases, the agreement must include a description of the solicitation activities to be undertaken and the solicitor must provide potential investors with:

1. A copy of the written disclosure statement required by SEC Rule 204-3 (the written disclosure rule); and
2. A separate disclosure statement which describes the affiliation between the solicitor and the adviser and its effect on the overall fee that the advisor will charge.

The SEC has suggested that the disclosures required by the Cash Solicitation Rule do not adequately deter pay-to-play practices.

Prohibition on soliciting or coordinating contributions

The proposed rule would prohibit an investment adviser from soliciting or coordinating contributions for an official of a government entity to which the investment adviser is seeking to provide investment advisory services, or soliciting or coordinating payments to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity. In addition to restricting the conduct described above, the SEC's rule proposal would require an investment adviser to monitor and retain records relating to the political contributions of its employees and would provide that an investment adviser could not do indirectly anything it would be prohibited from doing directly.

Next Steps: The Comment Process

The SEC has requested comments on the rule proposal by Oct. 6, 2009. We anticipate that the proposal will elicit critical comments from industry participants who will raise significant objections to the proposal, as they did when the SEC initially proposed the earlier "pay-to-play" rule in 1999. Some investment advisers with smaller operations argued in 1999 that the rule proposal had an anti-competitive effect, making it more difficult for smaller pension fund managers to become aware of those advisers. According to that argument, by eliminating the use of placement agents, the proposal favors large advisors with access to public pension funds while eliminating an important avenue of access to small, less well-known advisors. These arguments may be buttressed by a recent decision by the U.S. Court of Appeals for the District of Columbia Circuit remanding to the SEC a rule adopted by the SEC regarding situations in which certain equity-indexed annuities are securities. In remanding the rule to the SEC for reconsideration, the court noted that the SEC had failed to properly consider the competitive effects of the rule.[21]

We also expect there to be comments that the proposal's prohibition of placement agents and other third parties to solicit pension funds and other state and municipal advisory clients significantly downplays their beneficial use. For example, the use of placement agents to aid in this time-consuming task in the world of a private equity fund is common. Most fund sponsors do not have internal marketing teams, yet many phone calls and due diligence meetings are required. There is a compelling argument that placement agents provide an additional, knowledgeable resource for investment professionals, including advice on which investors might be interested in a particular type of fund and in developing the marketing plan and offering materials. This may be particularly true for advisers to smaller funds without existing relationships to large investors like pension funds.

The SEC proposed the rule under Section 206(4) of the Advisers Act.[22] We anticipate that some industry participants will question the SEC's use of its authority under Section 206(4) of the Advisers Act—an anti-fraud provision—to ban entirely payments to third-party solicitors of government entities even in instances in which there is no indication of fraud. We also anticipate some industry participants will question whether aspects of the

rule proposal are consistent with Constitutional rights of freedom of speech. Investment advisers with large operations may point to the logistical difficulties involved in monitoring the two-year look-back provision relating to potential employees' history of past political contributions. At any rate, we anticipate that commenters may echo those from 1999 in challenging the SEC's prohibiting campaign contributions without regard to their intent.

Preparing for Pay-to-Play Restrictions

Notwithstanding the likely critical response by industry participants to the rule proposal, recent settlements regarding the New York Retirement Fund indicate that the SEC and the NYAG intend to permanently increase scrutiny on firms that do business with pension funds. Seven private equity firms, including the Carlyle Group and HM Capital, entered into agreements with the NYAG (without being charged with violating the law) that include restrictions similar to those contained in the SEC's proposed rule. As part of the settlements, the firms agreed to pay monetary fines and to adopt the NYAG's "Public Pension Fund Reform Code of Conduct," a set of rules drafted by the NYAG which closely resemble the SEC's proposed rule.[23] The NYAG's Code of Conduct contains provisions which (i) ban the use of placement agents by firms seeking to manage public pension funds; (ii) prohibit an investment firm from doing business with a public pension fund for two years after making a campaign donation to certain officials; and (iii) impose certain disclosure and record-keeping requirements. The firms that settled most recently with the NYAG are HM Capital, Levine Leichtman Captial Partners, Access Capital Partners, and Falconhead Capital, all of whom announced their settlement on Sept. 17.[24] In addition to regulators, pension funds themselves have instituted new measures in response to the scandal. On Sept. 24, New York became the seventeenth State to restrict campaign donations to officials who might influence investments by public pension funds. New York State Comptroller Thomas DiNapoli issued an executive order prohibiting any firm that makes a donation to the state comptroller, or a candidate for that office, from seeking pension business for two years following the donation.[25]

It is likely that some form of the proposed pay-to-play rule will be adopted by the SEC. Investment advisers should consider, in light of the increased regulatory scrutiny, implementing policies intended to provide transparency to their relationships with public pension funds and placement agents, including (1) carefully monitoring and recording political contributions made by officers, directors and employees to the campaigns of officials who might influence public investments; and (2) performing due diligence on, and obtaining appropriate representation from, any placement agents used to obtain investment advisory business from public pension funds. Investment advisers should also be aware that certain political contributions that may be legal at the time they are made may result in increased regulatory scrutiny or become the basis for subsequent allegations of conflicts of interest.

NOTES

1. *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 1812 (Aug. 4, 1999), available at http://sec.gov/rules/proposed/ia-1812.htm.
2. Comment Letter of David G. Tittsworth, Executive Director, The Investment Counsel Association of America, March 15, 2000 (emphasis in original); available at http://sec.gov/rules/proposed/s71999/tittswo1.htm.
3. *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 2910 (Aug. 3, 2009), available at http://sec.gov/rules/proposed/2009/ia-2910.pdf.
4. The scandal preceding the 1999 proposed rulemaking centered on the Connecticut state retirement fund. *See SEC v. William A. DiBella, et al.*, No. 3:04 CV 1342 (EBB), Compl. at 2 (D. Conn. Aug. 12, 2004).
5. Indictment, *People v. Henry "Hank" Morris and David Loglisci*, Indictment No. 25/2009 (Sup. Ct. New York), available at www.oag.state.ny.us (NYAG Indictment).
6. *See* "Guilty Pleas from Two in New York Pension Case," *Wall St. J.*, Oct. 7, 2009, at C1.
7. *See* Allocution of Raymond Harding, available at www.wsj.com; *see also* "Cuomo Announces Guilty Pleas by Former Liberal Party Chair and National Pension Adviser in Continuing Investigation of Pay-to-Play at the State Pension Fund," available at www.oag.state.ny.us.
8. *See* Allocution of Saul Meyer, available at www.wsj.com; *see also* "Cuomo Announces Guilty

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Pleas by Former Liberal Party Chair and National Pension Adviser in Continuing Investigation of Pay-to-Play at the State Pension Fund," available at www.oag.state.ny.us.

9. Compliant, *SEC v. Henry Morris, David J. Loglisci, et al.* Complaint No. 09-CV-2518 (CM) Amended Complaint (U.S. District Court—Southern District of New York), available at http://www.sec.gov/litigation/complaints/2009/comp21001.pdf (SEC Complaint).
10. *See* SEC Complaint at 3.
11. SEC Complaint at 12.
12. SEC Complaint at 4.
13. *See* "Riverstone Settlement: It May All Come Back to Chooch," *Wall St. J.*, June 11, 2009. On June 10th, *The Wall Street Journal* reported that the SEC has requested information from Goldman Sachs Group Inc., Credit Suisse Group, UBS AG, Bank of America, and Merrill Lynch. *See* "SEC Asks Wall Street for Its Pension Data," *Wall St. J.*, June 10, 2009.
14. *See* Remarks by Robert Khuzami, Director of the SEC's Division of Enforcement, before the New York City Bar Association, *available at* http://www.sec.gov/news/speech/2009/spch080509rk.htm.
15. *See* "Pay-to-Play Probes Go Nationwide," *Wall St. J.*, May 2, 2009, at B3.
16. Section 203(b)(3) of the Advisers Act exempts from the requirement to register under the Advisers Act investment advisers that have had fewer than 15 clients during the course of the prior 12-month period and that generally do not hold themselves out to the public as investment advisers. Legislative proposals have been introduced recently to largely eliminate this exemption.
17. Under the proposal, the term "government entity" would be defined as "any State or political subdivision of a State, including any agency, authority, or instrumentality of the State or political subdivision, a plan, program, or pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof; and officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity." This term would include any public pension plan, any 529 college savings plans and any tax-deferred retirement plans established under Section 403(b) or Section 457 of the Internal Revenue Code of 1986.
18. *See* proposed rule 206(4)-5(c).
19. A political action committee controlled by the investment adviser or any of its covered associates also would be a covered associate.
20. In a recent letter, however, the staff of the Division of Investment Management provided its interpretation that Rule 206(4)-3 under the Advisers Act generally does not apply to a registered investment adviser's cash payment to a person solely to compensate that person for soliciting investors or prospective investors for, or referring investors or prospective investors to, an investment pool managed by the adviser. Mayer Brown LLP, SEC Staff Letter (July 28, 2008), *available at* http://sec.gov/divisions/investment/noaction/2008/mayerbrown072808-206.htm#P40_9135.
21. *American Equity Investment Life Insurance Company v. SEC* (D.C. Cir. 2009), No. 09-1021.
22. Section 206(4) of the Advisers Act authorizes the SEC to adopt rules "reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."
23. *See, e.g.*, "HM Capital, Private Equity Firms Settle Cuomo Probe," *Bloomberg*, Sept. 17, 2009.
24. *See* "Group of Investment Firms Will Cut Placement Agents," *Wall St. J.*, Sept. 18, 2009, at C4.
25. *See* "New York Tightens Pension Rules," *Wall St. J.*, Sept. 24, 2009, at C3.

Ethics and Compliance Enforcement Decisions–The Information Gap

BY RONALD E. BERENBEIM & JEFFREY M. KAPLAN

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Senior executives and corporate directors want to know whether companies have "received credit" (i.e., avoided prosecution or obtained sentence reductions) for having effective ethics and compliance programs—but such information is in short supply.

The Corporate Sentencing Guidelines provisions concerning crediting corporate ethics and compliance programs began as an experiment. Underscoring this point, Judge William Wilkins, the Sentencing Commission's first chair, warned organizations in 1993 that if they ignored "this exploratory invitation to shield against potential liability with well designed and rigorously implemented compliance systems, it is doubtful that this new approach will endure."[1] Since then, many companies have responded with a proliferation of ethics and compliance programs that have far exceeded early expectations with respect to prevalence, design and rigor.[2]

Following the lead of the Guidelines, the Department of Justice (DOJ) has since 1999 had a formal policy of considering Ethics & Compliance (E&C) programs when determining whether or not to bring charges against organizations for the offenses of their employees and other agents. Originally contained in what was known as the "Holder Memo"—because it was authored by then-Deputy Attorney General Eric Holder—this policy has gone through various subsequent iterations, initially in the well-known "Thompson Memo" (2003); then in the "McNulty Memo" (2006); and most recently has been codified in the U.S. Attorneys' Manual.

While not nearly as detailed as DOJ policy, in 2001 the Securities Exchange Commission (SEC) established a policy which weighed E&C programs (among other things) in enforcement proceedings. Additionally, some SEC cases have examined E&C programs in Foreign Corrupt Practices Act (FCPA) (1977) enforcement proceedings. For example, in the Wabtec case (2008), the SEC faulted the corporate defendant for not having an anti-corruption policy and not providing anti-corruption training to any of its "employees, agents, or subsidiaries."[3] Earlier in the Monsanto case (2005), the SEC faulted the company for not conducting compliance audits of its Indonesian affiliates.[4]

Despite the Guidelines' incentives for companies to develop and implement organizational ethics and compliance programs—and the similar policies subsequently adopted by other enforcement agencies—case examples that are critical to affirming the incentives' credibility are hard to find. Ethics and compliance officers believe that having such information, particularly with respect to programs in effect before the government's investigation began, would strengthen efforts to establish or improve programs before a company gets into trouble.[5]

Company Need for More Information about Enforcement Decisions

In September 2007, The Conference Board surveyed the members of two major ethics and compliance professional associations—the Ethics and Compliance Officers Association (ECOA) and the Society of Corporate Compliance and Ethics (SCCE). Nearly half of the respondents stated that they were eager to know whether companies had "received credit" in enforcement proceedings (such as avoiding prosecution or reduced sentences) for having an effective ethics and compliance program.

Yet information about specific cases of this kind is in short supply. At least with respect to sentencing cases, this is evidently due to the fact that very few corporate defendants have received E&C program credit. That is, according to government records, since the Sentencing Commission began reporting statistics on organizational defendants in 1993, only three out of the 2,811 organizations that were sentenced received mitigation credit for an effective E&C program as outlined in the Corporate Sentencing Guidelines.[6] This low number may be explained in part by the fact that many organizational defendants are small companies which are less likely to receive credit because: (1) smaller companies tend to have less formal E&C

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programs than do larger companies; and (2) prosecutions of smaller companies tend to involve, more than prosecutions of large companies, the culpable involvement of high-level personnel which disqualifies a company from receiving program credit under the Guidelines.

Additionally, there have been very few publicized cases of companies that have received credit under either the DOJ or SEC policies for having effective pre-existing (*i.e.*, in existence at the time of the offense) E&C programs. The causes of this information shortfall are more complex than is the case with the Sentencing Guidelines.

Lack of information about governmental practices for crediting ethics and compliance system effectiveness in specific enforcement decisions has potential impact on program innovation and efficacy. Ethics and compliance professionals want and need this information. In the September 2007 surveys referenced earlier, 95% of the responding members said more information about "credit" given to companies by the government in enforcement and sentencing situations would help them promote and implement their programs. When asked whether or not the government provided sufficient information on this subject, only 13% said yes.

By contrast, there are many publicly available examples where settlement-based programs—as opposed to programs in effect at the time of an offense—were rewarded. For example, the Guidelines require that where a corporate defendant with more than 50 employees does not have an E&C program, such a program be imposed as a condition of probation.[7] Additionally, there have been countless examples of the DOJ or SEC imposing E&C programs on corporate defendants in connection with settlements.

However, from an ethics and compliance incentives perspective, publicly recognizing settlement-based programs (but not pre-existing ones) in enforcement decisions is hardly optimal. In essence, it sends a message that the companies need not be concerned with E&C programs until after a violation, and thereby undercuts the important law enforcement policy of deterrence.

When was the E&C program implemented?

When it comes to the enforcement use of ethics and compliance programs, there is an important distinction to be made between four distinct temporal categories:[8]

- **Type 1** Pre-existing programs—in place at the time of the offense.
- **Type 2** Post-offense/pre-investigation referred to as pre-investigation programs—implemented, at least in part, subsequent to the violation but prior to the initiation of the government's investigation (or the company's learning of such investigation).
- **Type 3** Investigation-based programs—commenced voluntarily and not pursuant to a settlement, but subsequent to the company's learning of a government investigation.
- **Type 4** Settlement-based program—implemented as part of a settlement agreement.

A few examples of credit for pre-existing and pre-investigation programs (*i.e.*, Types 1 and 2) were found but there are many more examples of Type 3 and Type 4 situations.[9] For instance, a paper co-authored by a high-ranking SEC attorney entitled "What does law enforcement regard as an effective compliance program?" notes one of the cases listed involved Type 1 or 2 program assessments.[10]

Reasons Given Why Specific Case Examples are Rare

There are two reasons for the relative paucity of public examples of Type 1 and Type 2 cases. The first is that there may, in fact, not be many such cases (although it is doubtful that this is the principal reason). In this connection, former-U.S. Deputy Attorney General Paul McNulty says that this may be due, in part, to the fact that "it is easier for prosecutors to look at remediation and cooperation" than E&C program effectiveness in an enforcement proceeding.[11]

The second reason is that while many such cases actually exist, they are difficult to identify. In this context, it is noteworthy that only six U.S.

attorneys responded to a DOJ survey sent out at the request of The Conference Board seeking such information.[12] Additionally, while state attorneys general were somewhat more responsive to a similar questionnaire, they did not provide information regarding consideration of pre-existing and pre-investigation programs in enforcement and sentencing decisions.

Of course, delineating the relative weight given in decisions of this type is often not an easy matter, and this, in turn, may also explain why prosecutors are reluctant to provide (or indeed have difficulty in providing) ethics and compliance "case" information. Because ethics and compliance programs touch many aspects of what is considered in a charging decision, prosecutors may be crediting programs without necessarily knowing that they are doing so. According to McNulty, this could be a "good problem," since it means programs are being credited to a very substantial, albeit not measurable, degree.[13]

However, the potential benefit of prosecutors crediting E&C programs can get lost if this is indeed occurring. Additionally, discussions with former and current government officials and private attorneys suggest that

- some enforcement personnel may not want to provide specifics of their E&C-based charging decisions for fear that this will create precedent that can be used "against" the government;
- examining an E&C program as it existed at some past time (meaning the time of the offense) may as a practical (*i.e.*, evidentiary) matter be difficult; and
- some enforcement personnel may not feel that they have sufficient expertise to assess the efficacy of a program.

These discussions highlight the inherent tension between transparency and the need to preserve discretion—the latter based on prosecutors' concerns that defense lawyers will use such information to "box them in" in future similar, but not identical cases. As then-Deputy Assistant Attorney General Barry Sabin put it: "It is in the natural 'DNA' of a prosecutor not to provide this sort of information."[14]

Nonetheless, it seems clear that federal prosecutors do credit E&C programs on some occasions (even if they are not public about the fact). Doing so is, unambiguously, the expectation of the DOJ, which sets forth in the U.S. Attorneys' Manual criteria for assessing such programs in the context of criminal investigations. This includes questions applicable to the program generally, such as: "Is it well designed?" or "Does it work?"[15] Additionally, prosecutors—in utilizing the criteria in the U.S. Attorneys' Manual and the Sentencing Guidelines—will sometimes analyze specific program elements. For instance, in the key area of E&C training and communications, prosecutors may seek to determine if a company's E&C training was "real" and "user-friendly," and whether or not internal communications were tailored to risks based on the nature of the company's business and the geographic jurisdictions in which it operates.[16]

Additionally, according to McNulty, when seeking to demonstrate the effectiveness of their programs, companies should not "underestimate the impact of culture on presentation to DOJ,"[17] which further underscores that E&C programs matter in charging decisions. Finally, wherever the specific compliance needs of individual business sectors are a relevant consideration, prosecutors will, as they are instructed to do by the U.S. Attorneys' Manual, consult with regulatory investigative agencies about such needs in determining whether or not to bring charges.[18]

A Synopsis of Recent Revisions to the DOJ's E&C Assessment Policy

In August 2008, the DOJ issued revised standards concerning charging corporations and other business organizations with criminal offenses and, for the first time, included these standards in the U.S. Attorneys' Manual. Although much of the language of the E&C-related provisions comes from the 2006 memo authored by McNulty (which, in turn, was based on prior iterations of DOJ E&C assessment policy), a close reading reveals:[19]

- *a somewhat heightened expectation of E&C efforts*. The revised policy instructs prosecutors to ask whether E&C programs are being applied "earnestly" and in good faith.

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- *elimination of earlier policy language stating that the very fact of a violation "may suggest that corporate management is not adequately enforcing its program."* This rewording is a helpful modification of the previous version which could have made proof of program efficacy unduly difficult.
- *E&C crediting decisions are not of an all-or-nothing nature.* The new policy establishes that a truly effective compliance program can result in a decision not to charge the corporation or to mitigate charges or sanctions against the corporation.
- *an expectation that programs be "reviewed and revised" as well as designed and implemented.* The new wording underscores the benefit of periodic E&C program assessments.
- *a focus on the sufficiency of discipline for E&C violations.* When determining the effectiveness of an E&C program, prosecutors are asked to consider "disciplinary action against past violators uncovered by the prior compliance program."[20]

What Information is Needed and Why It Can Make a Difference

As memories of Enron and WorldCom and other events that drove compliance efforts recede, the dedication of time and resources that effective E&C efforts require may meet with increasing resistance. Budget cuts due to the recession may further induce senior management to ask: "Is the government's commitment to E&C programs real? Or is it a mere paper policy?"

Absent proof that meaningful E&C program incentives have in fact been provided in enforcement proceedings involving the pre-existing program category, companies might come to believe that the government values such programs only as a post-violation remedy. If this notion prevails, there will be little or no enforcement-related incentive for companies to institute programs for purely preventive means, which would undercut the key E&C program-related deterrence goals of federal prosecution and sentencing policy.

Government willingness to divulge more information about pre-existing program credit in enforcement proceedings is subject to certain concerns. However, these concerns can be successfully addressed.

First, prosecutorial concern that crediting E&C programs in a transparent way may be used "against" the government in future cases is understandable. However, because under DOJ prosecution standards and other E&C crediting criteria, the ultimate use of the information is at the government's discretion (*i.e.*, the policies do not create legal rights for any private individual), this should not impede greater transparency with regards to the application of E&C crediting criteria in enforcement decisions.

Indeed, when it comes to self-disclosure or cooperation—both areas closely related to E&C program crediting—the government does in fact frequently provide very public examples of how it rewards those who act as "good corporate citizens." The government's public recognition of actual self-disclosure and cooperation cases is presumably based on its understanding that the act of publicizing individual cases where companies were rewarded for acting consistently with government policy will encourage other companies to act accordingly. Moreover, evidently publicizing cases of self-disclosure and cooperation does not limit the government's flexibility in enforcement decisions generally. Taking the same approach with E&C programs (*i.e.*, showing that the government actually rewards those who seek to prevent wrongdoing as well as those who facilitate prosecutions) could lead to similar benefits and would be no more limiting to the government.

Second, some prosecutors may believe that, as a practical matter, it can be difficult to determine how effective an E&C program was at the time an offense occurred, which is typically years after an investigation. One way companies can respond to this concern is to compile annual E&C reports that detail all key aspects of their respective programs at a particular time. This practice is indeed already in place in some organizations. If the government were to signal that such reports could be helpful in an enforcement review, the practice of creating annual E&C reports would likely become widespread and could provide a

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firmer foundation for pre-existing program government assessments than often exists now.

Third, some prosecutors evidently feel that they do not have sufficient expertise and experience to evaluate companies' E&C programs in a meaningful manner. However, among the various attorneys in enforcement agencies there should be sufficient collective experience for such assessments, assuming an effort is made to marshal that experience. And if the available information is not sufficient in a complex or close-call case, the DOJ can—as it did in the well-known Western District of Pennsylvania's Mellon Bank criminal tax case—retain an E&C expert at the target company's expense to evaluate its program.[21]

Additionally, the private sector can take steps to further enhance governmental understanding of E&C program value. Through groups such as the ECOA, SCCE, the Ethics Resource Center, and the Association of Corporate Counsel, it can develop programs for ways of capturing and communicating information about E&C cases for dissemination to both the public and private sector.

Moreover, these groups and others can develop presentation materials and other resources for prosecutors on E&C programs; for example, by offering to instruct prosecutors on how to assess E&C programs at the DOJ's National Advocacy Center (NAC) when courses in white collar crime are scheduled. Another potentially effective approach is for NAC instructors to develop web-based broadcasts and reference materials using national experts.

Additionally, the government has recognized that clarity and consistency are important factors when it comes to promoting E&C program effectiveness—and this, in turn, supports a policy of greater transparency with regard to crediting E&C enforcement decisions. In this connection, a May 23, 2007 letter of comment submitted by then-Assistant Attorney General Alice Fisher to the General Services Administration addressed the need for at least some degree of uniformity in approach. This letter, written in connection with a then-pending proposal to require federal contractors to implement E&C programs, formally encouraged the Federal Acquisition Regulation (FAR) Council to utilize the Sentencing Guidelines definition of such a program rather than some other standard.[22] Among the reasons for this suggestion noted by the DOJ was that using the Guidelines standard would avoid confusion among companies subject to FAR requirements and provide more systematic guidance at the federal policy level.[23] Presumably, the same concern for promoting consistency underscores the need for consistency in connection with the use of E&C programs in individual charging decisions.

In addition to the need for consistency, DOJ sought more specific guidance for government contractors because the Department has been concerned about the low number of voluntary defense procurement disclosures in recent years. The Department sees an important connection between strong compliance programs and more voluntary disclosures and for this reason is interested in promoting stronger government contractor E&C programs.[24] This, too, supports the benefit to the government of doing more to encourage program implementation through the greater use of charging practice transparency.

While the above discussion is directed at federal enforcement, the same considerations are applicable to the states. That is, given the important role that state government enforcement officials play in business regulation, there should be more state policies promoting E&C programs through the application of E&C credit in enforcement decisions. These could be modeled on the Sentencing Guidelines or DOJ policy.

Finally, prosecutors—whether at the federal or state levels—should develop institutional processes to gather and disseminate E&C case information to the public. Absent such an effort, many E&C cases may continue to go unnoticed, resulting in a diminution of incentives for company program implementation and innovation. As noted above, weakening E&C programs in this way runs counter to governmental policy of promoting deterrence.

Ultimately, agencies'—state as well as federal—pooling of E&C knowledge and resources to support enforcement attorneys for program evaluations will provide a greater foundation of internal expertise that can counteract any institutional resistance to crediting E&C programs. There are a number of different ways that this "pooling" objective can be achieved. One approach is through the use of task forces or committees within agen-

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cies such as DOJ. Another way would be an office-by-office designation of an E&C "point person" who could be responsible not only for marshalling expertise within that office, but also help gather information periodically for use in the above-described communications efforts.

NOTES

1. Preface to Kaplan & Murphy, *Compliance Programs and the Corporate Sentencing Guidelines* (St. Paul, Minnesota, Thomson Pub. 1993.)
2. See for example, Ronald E. Berenbeim, *Universal Conduct—an Ethics and Compliance Benchmarking Survey*, The Conference Board, Research Report RR-1393-06.
3. Available at www.sec.gov/litigation/complaints/2008.
4. See complaint in "Securities and Exchange Commission vs. Monsanto" (DDC 2005), www.sec.gov/litigation/complaints/comp.
5. *See* http://www.conferenceboard.org/ethicsandcompliancecases for examples of governmental use of ethics and compliance criteria at various different stages of enforcement proceedings.
6. *United States Sentencing Commission Annual Sourcebook*, FY 1993 – 2008, Table 54. As part of its statutory mission, the Sentencing Commission must collect and report data on all defendants sentenced in federal court, including organizational defendants. The Commission's collection of data is based on the presentence report presented to the court by the probation officer assigned to each case. This presentence report contains information about "aggravating" and "mitigating" factors that raise or lower a defendant's ultimate sentence. In the case of corporate and other organizational defendants, a determination by the court that a company appearing for sentencing (whether following trial or a negotiated guilty plea involving settlement negotiations with federal prosecutors) had an "effective compliance and ethics program" (which is a mitigating factor under §8C2.5(f)(1)) must appear in the presentence report adopted by the sentencing court in order to appear in the Commission's data files and annual statistics.
7. *Corporate Sentencing Guidelines*, USSG §8D1.1 (a) (1). For the five year period between 2003 and 2007, probation was ordered in 70% to 75% of the organizational cases sentenced annually; for fiscal years 2003 and 2004, E&C programs were ordered to be implemented in approximately 12% of such cases; and for fiscal years 2005 and 2006 that number increased to 20%, and increased again to 24% in fiscal year 2007. However, there was a substantial drop in FY 2008 to 6%. These percentages translate into the following numbers of organizational defendants whose probationary terms at their criminal sentencing included the implementation of an E&C program:
   FY 2003: 24
   FY 2004: 21
   FY 2005: 35
   FY 2006: 41
   FY 2007: 47
   FY 2008: 12
   United States Sentencing Commission Annual Sourcebook, FY 2003-2007, Table 53.
8. *See* http://www.conferenceboard.org/ethicsandcompliancecases. These categories were developed by The Conference Board Research Working Group on The Use of Ethics and Compliance Criteria in Governmental Decision-Making.
9. Early examples include deferred prosecutions involving Lucas Aerospace Communications & Electronics, Inc. and C.R. Bard Inc. (both in 1994), Consolidated Edison (1995), Tyson Foods (1997), and Metcalf & Eddy, Inc. (1999). More recently there have been a great many others. The number of non-prosecution agreements—which typically involve compliance requirements—has also increased in recent years. *See* Lawrence Finder, Ryan McConnell and Scott Mitchell, "Betting the Corporation: Compliance or Defiance? Compliance Programs in the Context of Deferred and Non-Prosecution Agreements." *Corporate Counsel Review*, (forthcoming). And, there have been many cases in which the SEC imposed compliance requirements in connection with a settlement. *See* Timothy Coleman and Peter Bresnan, "What does law enforcement regard as an effective compliance program?" (New York, Practising Law Institute, Corporate Compliance Institute, 2006): pp. 211-220.
10. *See* Coleman and Bresnan.
11. Former Deputy Attorney General Paul McNulty, in a statement made to The Conference Board Research Working Group on The Use of Ethics and Compliance Criteria in Governmental Decision-Making, on Oct. 3, 2008(McNulty Statement). These comments are Mr. McNulty's personal views and do not reflect DOJ policy.
12. One of the six responses received was from the Office of the U.S. Attorney for the Southern District of New York. That response did not include a reference to a case involving an E&C program that was found in a press release. Responses of U.S. attorneys can be found at http://www.conference-board.org/ethicsandcompliancecasees.
13. Remarks of U.S. Attorney for the Western District of Pennsylvania, Mary Beth Buchanan, in a statement made to a Research Working Group on the Use of Ethics and Compliance Criteria in Governmental Decision-Making by The Conference Board on Oct.

3, 2008. (Buchanan is also former director of the Executive Office for the United States Attorneys and Member, Advisory Committee to the United States Sentencing Commission). These comments are Ms. Buchanan's personal views and do not reflect DOJ policy.
14. Then Deputy Assistant Attorney General Barry Sabin, in a statement to The Conference Board Research Working Group on The Use of Ethics and Compliance Criteria in Governmental Decision-Making, Nov. 15, 2007(Sabin Statement). These comments are Mr. Sabin's personal view and do not reflect DOJ policy.
15. Sabin Statement, discussing U.S. Attorneys' Manual.
16. Sabin Statement.
17. McNulty Statement.
18. U.S. Attorneys' Manual section 9-28.800.
19. Specifically, the Holder and Thompson memos.
20. Adapted with permission from Kaplan & Walker LLP, "Crediting Compliance and Ethics Programs: The Latest from the Department of Justice," (law firm memo, September 2008).
21. A criminal tax case in the Western District of Pennsylvania involving Mellon Bank. *See* Cristy Ford and David Hess, "Can Corporate Monitorships Improve Corporate Compliance?" Journal of Corporation Law (forthcoming).
22. The recently-effective business ethics and integrity rules for government contractors and additional proposals for their modification are discussed at www.ethics.org/erc-publications/ethics-today and www.ethics.org/ethics-today/0808/policy-report-codes. The rules as published for comment are available at 73 Federal Reg. 219 (Nov. 12, 2008).
23. The FAR Amendments align with most but not all of the Corporate Sentencing Guidelines E&C requirements.
24. Sabin Statement.

Pres Obama: Strong Rules Needed to Guard Against Systemic Risk

A SPEECH BY PRES. BARACK OBAMA

President Barack Obama spoke about the need for financial industry regulatory reform at the Federal Hall in New York City on Sept. 14—one year after the failure of Lehman Bros. accelerated a meltdown in the financial sector. This is a partial transcript of his remarks.

[…] It was one year ago today that we experienced just such a crisis. As investors and pension-holders watched with dread and dismay, and after a series of emergency meetings often conducted in the dead of the night, several of the world's largest and oldest financial institutions had fallen, either bankrupt, bought, or bailed out: Lehman Brothers, Merrill Lynch, AIG, Washington Mutual, Wachovia. A week before this began, Fannie Mae and Freddie Mac had been taken over by the government. Other large firms teetered on the brink of insolvency. Credit markets froze as banks refused to lend not only to families and businesses, but to one another. Five trillion dollars of Americans' household wealth evaporated in the span of just three months. That was just one year ago.

Congress and the previous administration took difficult but necessary action in the days and months that followed. Nonetheless, when this administration walked through the door in January, the situation remained urgent. The markets had fallen sharply; credit was not flowing. It was feared that the largest banks—those that remained standing—had too little capital and far too much exposure to risky loans. And the consequences had spread far beyond the streets of lower Manhattan. This was no longer just a financial crisis; it had become a full-blown economic crisis, with home prices sinking and businesses struggling to access affordable credit, and the economy shedding an average of 700,000 jobs every single month.

We could not separate what was happening in the corridors of our financial institutions from what was happening on the factory floors and around the kitchen tables. Home foreclosures linked those who took out home loans and those who repackaged those loans as securities. A lack of access to affordable credit threatened the health of large firms and small businesses, as well as all those whose jobs depended on them. And a weakened financial system weakened the broader economy, which in turn further weakened the financial system.

[…] Eight months later, the work of recovery continues. And though I will never be satisfied while people are out of work and our financial system is weakened, we can be confident that the storms of the past two years are beginning to break. In fact, while there continues to be a

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need for government involvement to stabilize the financial system, that necessity is waning. […]

While full recovery of the financial system will take a great deal more time and work, the growing stability resulting from these interventions means we're beginning to return to normalcy. But here's what I want to emphasize today: Normalcy cannot lead to complacency.

Unfortunately, there are some in the financial industry who are misreading this moment. Instead of learning the lessons of Lehman and the crisis from which we're still recovering, they're choosing to ignore those lessons. I'm convinced they do so not just at their own peril, but at our nation's. So I want everybody here to hear my words: We will not go back to the days of reckless behavior and unchecked excess that was at the heart of this crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses. Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall.

And that's why we need strong rules of the road to guard against the kind of systemic risks that we've seen. And we have a responsibility to write and enforce these rules to protect consumers of financial products, to protect taxpayers, and to protect our economy as a whole. Yes, there must—these rules must be developed in a way that doesn't stifle innovation and enterprise. And I want to say very clearly here today, we want to work with the financial industry to achieve that end. But the old ways that led to this crisis cannot stand. And to the extent that some have so readily returned to them underscores the need for change and change now. History cannot be allowed to repeat itself.

Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall.

So what we're calling for is for the financial industry to join us in a constructive effort to update the rules and regulatory structure to meet the challenges of this new century. That is what my administration seeks to do. We've sought ideas and input from industry leaders and policy experts, academics, consumer advocates, and the broader public. And we've worked closely with leaders in the Senate and the House, […] And we intend to pass regulatory reform through Congress.

And taken together, we're proposing the most ambitious overhaul of the financial regulatory system since the Great Depression. But I want to emphasize that these reforms are rooted in a simple principle: We ought to set clear rules of the road that promote transparency and accountability. That's how we'll make certain that markets foster responsibility, not recklessness. That's how we'll make certain that markets reward those who compete honestly and vigorously within the system, instead of those who are trying to game the system.

So let me outline specifically what we're talking about. First, we're proposing new rules to protect consumers and a new Consumer Financial Protection Agency to enforce those rules. This crisis was not just the result of decisions made by the mightiest of financial firms. It was also the result of decisions made by ordinary Americans to open credit cards and take on mortgages. And while there were many who took out loans they knew they couldn't afford, there were also millions of Americans who signed contracts they didn't fully understand offered by lenders who didn't always tell the truth.

This is in part because there is no single agency charged with making sure that doesn't happen. That's what we intend to change. The Consumer Financial Protection Agency will have the power to make certain that consumers get information that is clear and concise, and to prevent the worst kinds of abuses. Consumers shouldn't have to worry about loan contracts designed to be unintelligible, hidden fees attached to their mortgage, and financial penalties—whether through a credit card or a debit card—that appear without warning on their statements. And responsible lenders, including community banks, doing the right thing shouldn't have to worry about ruinous competition from unregulated competitors.

Now there are those who are suggesting that somehow this will restrict the choices available to consumers. Nothing could be further from the

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truth. The lack of clear rules in the past meant we had the wrong kind of innovation: The firm that could make its products look the best by doing the best job of hiding the real costs ended up getting the business. For example, we had "teaser" rates on credit cards and mortgages that lured people in and then surprised them with big rate increases. By setting ground rules, we'll increase the kind of competition that actually provides people better and greater choices, as companies compete to offer the best products, not the ones that are most complex or the most confusing.

Second, we've got to close the loopholes that were at the heart of the crisis. Where there were gaps in the rules, regulators lacked the authority to take action. Where there were overlaps, regulators often lacked accountability for inaction. These weaknesses in oversight engendered systematic, and systemic, abuse.

Under existing rules, some companies can actually shop for the regulator of their choice—and others, like hedge funds, can operate outside of the regulatory system altogether. We've seen the development of financial instruments—like derivatives and credit default swaps—without anyone examining the risks, or regulating all of the players. And we've seen lenders profit by providing loans to borrowers who they knew would never repay, because the lender offloaded the loan and the consequences to somebody else. Those who refused to game the system are at a disadvantage.

[W]e've got to close the loopholes that were at the heart of the crisis. Where there were gaps in the rules, regulators lacked the authority to take action.

Now, one of the main reasons this crisis could take place is that many agencies and regulators were responsible for oversight of individual financial firms and their subsidiaries, but no one was responsible for protecting the system as the whole—as a whole. In other words, regulators were charged with seeing the trees, but not the forest. And even then, some firms that posed a "systemic risk" were not regulated as strongly as others, exploiting loopholes in the system to take on greater risk with less scrutiny. As a result, the failure of one firm threatened the viability of many others. We were facing one of the largest financial crises in history, and those responsible for oversight were caught off guard and without the authority to act.

And that's why we'll create clear accountability and responsibility for regulating large financial firms that pose a systemic risk. While holding the Federal Reserve fully accountable for regulation of the largest, most interconnected firms, we'll create an oversight council to bring together regulators from across markets to share information, to identify gaps in regulation, and to tackle issues that don't fit neatly into an organizational chart. We'll also require these financial firms to meet stronger capital and liquidity requirements and observe greater constraints on their risky behavior. That's one of the lessons of the past year. The only way to avoid a crisis of this magnitude is to ensure that large firms can't take risks that threaten our entire financial system, and to make sure that they have the resources to weather even the worst of economic storms.

Even as we've proposed safeguards to make the failure of large and interconnected firms less likely, we've also created—proposed creating what's called "resolution authority" in the event that such a failure happens and poses a threat to the stability of the financial system. This is intended to put an end to the idea that some firms are "too big to fail." For a market to function, those who invest and lend in that market must believe that their money is actually at risk. And the system as a whole isn't safe until it is safe from the failure of any individual institution.

If a bank approaches insolvency, we have a process through the FDIC that protects depositors and maintains confidence in the banking system. This process was created during the Great Depression when the failure of one bank led to runs on other banks, which in turn threatened the banking system as a whole. That system works. But we don't have any kind of process in place to contain the failure of a Lehman Brothers or AIG or any of the largest and most interconnected financial firms in our country.

And that's why, when this crisis began, crucial decisions about what would happen to some of the world's biggest companies—companies em-

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ploying tens of thousands of people and holding trillions of dollars of assets—took place in hurried discussions in the middle of the night. That's why we've had to rely on taxpayer dollars. The only resolution authority we currently have that would prevent a financial meltdown involved tapping the Federal Reserve or the federal treasury. With so much at stake, we should not be forced to choose between allowing a company to fail into a rapid and chaotic dissolution that threatens the economy and innocent people, or, alternatively, forcing taxpayers to foot the bill. So our plan would put the cost of a firm's failures on those who own its stock and loaned it money. And if taxpayers ever have to step in again to prevent a second Great Depression, the financial industry will have to pay the taxpayer back—every cent.

[W]hen this crisis began, crucial decisions about what would happen to some of the world's biggest companies—companies employing tens of thousands of people and holding trillions of dollars of assets—took place in hurried discussions in the middle of the night. That's why we've had to rely on taxpayer dollars.

Finally, we need to close the gaps that exist not just within this country but among countries. The United States is leading a coordinated response to promote recovery and to restore prosperity among both the world's largest economies and the world's fastest growing economies. At a summit in London in April, leaders agreed to work together in an unprecedented way to spur global demand but also to address the underlying problems that caused such a deep and lasting global recession. And this work will continue next week in Pittsburgh when I convene the G20, which has proven to be an effective forum for coordinating policies among key developed and emerging economies and one that I see taking on an important role in the future.

Essential to this effort is reforming what's broken in the global financial system—a system that links economies and spreads both rewards and risks. For we know that abuses in financial markets anywhere can have an impact everywhere; and just as gaps in domestic regulation lead to a race to the bottom, so do gaps in regulation around the world. What we need instead is a global race to the top, including stronger capital standards, as I've called for today. As the United States is aggressively reforming our regulatory system, we're going to be working to ensure that the rest of the world does the same. […]

A healthy economy in the 21st century also depends on our ability to buy and sell goods in markets across the globe. And make no mistake, this administration is committed to pursuing expanded trade and new trade agreements. It is absolutely essential to our economic future. And each time that we have met—at the G20 and the G8—we have reaffirmed the need to fight against protectionism. But no trading system will work if we fail to enforce our trade agreements, those that have already been signed. So when—as happened this weekend—we invoke provisions of existing agreements, we do so not to be provocative or to promote self-defeating protectionism, we do so because enforcing trade agreements is part and parcel of maintaining an open and free trading system.

And just as we have to live up to our responsibilities on trade, we have to live up to our responsibilities on financial reform as well. I have urged leaders in Congress to pass regulatory reform this year and both Congressman [Barney] Frank and Senator [Chris] Dodd, who are leading this effort, have made it clear that that's what they intend to do. Now there will be those who defend the *status quo*—there always are. There will be those who argue we should do less or nothing at all. There will be those who engage in revisionist history or have selective memories, and don't seem to recall what we just went through last year. But to them I'd say only this: Do you really believe that the absence of sound regulation one year ago was good for the financial system? Do you believe the resulting decline in markets and wealth and unemployment, the wrenching hardship that families are going through all across the country, was somehow good for our economy? Was that good for the American people?

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Now there will be those who defend the status quo—there always are. There will be those who argue we should do less or nothing at all. There will be those who engage in revisionist history or have selective memories, and don't seem to recall what we just went through last year.

I have always been a strong believer in the power of the free market. I believe that jobs are best created not by government, but by businesses and entrepreneurs willing to take a risk on a good idea. I believe that the role of the government is not to disparage wealth, but to expand its reach; not to stifle markets, but to provide the ground rules and level playing field that helps to make those markets more vibrant—and that will allow us to better tap the creative and innovative potential of our people. For we know that it is the dynamism of our people that has been the source of America's progress and prosperity.

So I promise you, I did not run for President to bail out banks or intervene in capital markets. But it is important to note that the very absence of common-sense regulations able to keep up with a fast-paced financial sector is what created the need for that extraordinary intervention—not just with our administration, but the previous administration. The lack of sensible rules of the road, so often opposed by those who claim to speak for the free market, ironically led to a rescue far more intrusive than anything any of us—Democratic or Republican, progressive or conservative—would have ever proposed or predicted.

At the same time, we have to recognize that what's needed now goes beyond just the reforms that I've mentioned. For what took place one year ago was not merely a failure of regulation or legislation; it wasn't just a failure of oversight or foresight. It was also a failure of responsibility—it was fundamentally a failure of responsibility—that allowed Washington to become a place where problems—including structural problems in our financial system—were ignored rather than solved. It was a failure of responsibility that led homebuyers and derivative traders alike to take reckless risks that they couldn't afford to take. It was a collective failure of responsibility in Washington, on Wall Street, and across America that led to the near-collapse of our financial system one year ago.

So restoring a willingness to take responsibility—even when it's hard to do—is at the heart of what we must do. Here on Wall Street, you have a responsibility. The reforms I've laid out will pass and these changes will become law. But one of the most important ways to rebuild the system stronger than it was before is to rebuild trust stronger than before—and you don't have to wait for a new law to do that. You don't have to wait to use plain language in your dealings with consumers. You don't have to wait for legislation to put the 2009 bonuses of your senior executives up for a shareholder vote. You don't have to wait for a law to overhaul your pay system so that folks are rewarded for long-term performance instead of short-term gains.

The fact is, many of the firms that are now returning to prosperity owe a debt to the American people. They were not the cause of this crisis, and yet American taxpayers, through their government, had to take extraordinary action to stabilize the financial industry. They shouldered the burden of the bailout and they are still bearing the burden of the fallout—in lost jobs and lost homes and lost opportunities. It is neither right nor responsible after you've recovered with the help of your government to shirk your obligation to the goal of wider recovery, a more stable system, and a more broadly shared prosperity.

So I want to urge you to demonstrate that you take this obligation to heart. To put greater effort into helping families who need their mortgages modified under my administration's homeownership plan. To help small business owners who desperately need loans and who are bearing the brunt of the decline in available credit. To help communities that would benefit from the financing you could provide, or the community development institutions you could support. To come up with creative approaches to improve financial education and to bring banking to those who live and work entirely outside of the banking system. And, of course, to embrace serious financial reform, not resist it.

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The fact is, many of the firms that are now returning to prosperity owe a debt to the American people. They were not the cause of this crisis, and yet American taxpayers, through their government, had to take extraordinary action to stabilize the financial industry.

Just as we are asking the private sector to think about the long term, I recognize that Washington has to do so as well. When my administration came through the door, we not only faced a financial crisis and costly recession, we also found waiting a trillion dollar deficit. So yes, we have to take extraordinary action in the wake of an extraordinary economic crisis. But I am absolutely committed to putting this nation on a sound and secure fiscal footing. That's why we're pushing to restore pay-as-you-go rules in Congress, because I will not go along with the old Washington ways which said it was okay to pass spending bills and tax cuts without a plan to pay for it. That's why we're cutting programs that don't work or are out of date. That's why I've insisted that health insurance reform—as important as it is—not add a dime to the deficit, now or in the future.

There are those who would suggest that we must choose between markets unfettered by even the most modest of regulations, and markets weighed down by onerous regulations that suppress the spirit of enterprise and innovation. If there is one lesson we can learn from last year, it is that this is a false choice. Common-sense rules of the road don't hinder the market, they make the market stronger. Indeed, they are essential to ensuring that our markets function fairly and freely.

One year ago, we saw in stark relief how markets can spin out of control; how a lack of common-sense rules can lead to excess and abuse; how close we can come to the brink. One year later, it is incumbent upon us to put in place those reforms that will prevent this kind of crisis from ever happening again, reflecting painful but important lessons that we've learned, and that will help us move from a period of reckless irresponsibility, a period of crisis, to one of responsibility and prosperity. That's what we must do. And I'm confident that's what we will do. […]

SEC/SRO Update

SEC Establishes New Division of Risk, Strategy, and Financial Innovation; Madoff Report Ushers in a Potential Shift In SEC Funding; Chairman Schapiro Issues Open Letter to Broker-Dealer CEOs; SEC Proposes Flash Order Ban

BY PETER H. SCHWARTZ & CRYSTAL L. GORDON

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SEC Establishes New Division of Risk, Strategy, and Financial Innovation

On Sept. 16, the Securities and Exchange Commission Chairman Mary L. Schapiro announced that University of Texas School of Law Professor Henry T. C. Hu will serve as the Director of the newly-established Division of Risk, Strategy, and Financial Innovation.[1]

The new division will be responsible for three broad areas:

- risk and economic analysis;
- strategic research; and
- financial innovation.[2]

Specifically, the new division will perform all of the functions previously performed by the Office of Economic Analysis and the Office of Risk Assessment, along with the following:

- strategic and long-term analysis;

- identifying new developments and trends in financial markets and systemic risk;
- making recommendations as to how these new developments and trends affect the Commission's regulatory activities;
- conducting research and analysis in furtherance and support of the functions of the Commission and its divisions and offices; and
- providing training on new developments and trends and other matters.[3]

According to the SEC's press release, Prof. Hu's expertise in derivatives, hedge funds, derivative markets and other financial innovations should be, as Chairman Schapiro stated, "put to good use" as the leader of the new division. [4]

Chairman Schapiro believes that the "new division will enhance the [SEC's] capabilities and help identify developing risks and trends in the financial markets [b]y combining economic, financial, and legal analysis in a single group," adding "this new unit will foster a fresh approach to exchanging ideas and upgrading agency expertise."[5]

The SEC now has five divisions with the addition of the Division of Risk, Strategy and Financial Innovation, including the Division of Corporation Finance, the Division of Enforcement, the Division of Investment Management, and the Division of Trading and Markets.

Madoff Report Ushers in a Potential Shift in SEC Funding

In connection with the SEC's failure to detect Bernard Madoff's multibillion-dollar fraud and the release of the 22-page executive summary detailing such failure, Sen. Charles Schumer (D-NY), a member of the Senate Banking Committee, announced his intention to propose legislation that, if enacted, would change how the SEC is funded.

Sen. Schumer intends to propose legislation that would permit the SEC to use the fees collected from the institutions it regulates to fund its operations. Schumer estimates that under the proposed legislation, the SEC would see a 75% increase in its annual budget. In 2007, the SEC brought in $1.45 billion in fees but only secured $881 million in funding that year. A significant amount of the fees have been allocated to the federal government's general funds. Under the new legislation, the $1.45 billion in fees would be retained by the SEC, and allow it to bypass the congressional appropriations process to receive funds, according to news reports.[6]

Sen. Schumer said he hopes the potential increase in the SEC's budget that will result from the proposed legislation would allow the staff to better train, recruit, and retain skilled investigators and examiners as well as update the SEC's technology to better detect problems across the market.[7]

Notably, SEC Commissioner Luis Aguilar, among others, has publicly opposed any legislation that would permit the SEC to retain any fines obtained through enforcement actions. "I would not want any amount of the penalties to be part of the self-funding," said Mr. Aguilar, who supports instead the notion of allowing the SEC to keep the statutory fees it collects. "There's too great a potential for conflict."[8] For the fiscal year ended Sept. 30, 2008, the SEC collected $774 million in disgorgement amounts and another $256 million in penalties.[9]

Chairman Schapiro Issues Open Letter to Broker-Dealer CEOs

On August 31, Chairman Schapiro issued an open letter to remind CEOs of broker-dealer firms of their supervisory responsibilities following reports that special recruitment programs at some firms are premised on enhanced compensation arrangements.[10]

According to the press release that accompanied the letter, Schapiro's letter states that some enhanced compensation arrangements could induce brokers to engage in conduct that is not in investors' best interest, and it reminds CEOs that they have an obligation to police for such conflicts. In addition, the letter reminds CEOs that, as their firms grow, their supervisory and compliance infrastructures should retain sufficient size and capacity.

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SEC Proposes Flash Order Ban

On September 17, the SEC unanimously proposed a rule amendment that, if adopted, would prohibit the practice of flashing marketable orders.[11] According to the press release accompanying the announcement, a "flash order" enables a person who has not publicly displayed a quote to see orders less than a second before the public is given an opportunity to trade with those orders. The SEC has stated that "[i]nvestors who have access only to information displayed as public quotes may be harmed if market participants are able to flash orders and avoid the need to make the order publicly available."

According to Chairman Schapiro, "[f]lash orders may create a two-tiered market by allowing only selected participants to access information about the best available prices for listed securities." She also indicated that "[t]hese flash orders provide a momentary head-start in the trading arena that can produce inequities in the markets and create disincentives to display quotes."

Currently, flash orders are permitted as result of an exception to Rule 602 of Regulation NMS that exempts these orders from requirements that apply generally to other orders. The Commission stated its concern that the Rule 602 exception may no longer be necessary or appropriate in today's highly automated trading environment, and voted unanimously to propose the elimination of the flash order exception from Rule 602 and application of the restrictions on flash orders in a similar manner to rules for alternative trading systems and for locking and crossing quotations. If adopted, the proposed amendment would effectively prohibit all markets—including equity exchanges, options exchanges, and alternative trading systems—from displaying marketable flash orders.

In its proposal, the Commission seeks public comment and data on a broad range of issues relating to flash orders, including the costs and benefits associated with the proposal. It also seeks comment on whether the use of flash orders in the options markets should be evaluated differently than in the equity markets.

Public comments on the proposal must be received by the Commission by Nov. 23, 2009.

NOTES

1. SEC Release No. 2009-199 (Sept. 16, 2009), *available at* http://www.sec.gov/news/press/2009/2009-199.htm.
2. SEC Release No. 2009-199.
3. SEC Release No. 2009-199.
4. SEC Release No. 2009-199.
5. *See* SEC Rel. No. 2009-199.
6. *See* http://www.marketwatch.com/story/sen-schumer-eyes-proposal-to-expand-sec-funding-2009-09-03.
7. Wall Street Journal Blogs at http://blogs.wsj.com/washwire/2009/09/03/shocking-madoff-report-prompts-schumer-to-propose-a-self-funded-sec.
8. *See* http://www.investmentnews.com/article/20090908/REG/909089972.
9. *See* http://www.investmentnews.com/article/20090908/REG/909089972.
10. *See* SEC Press Rel. No. 2009-189 (Aug. 31, 2009), available at http://www.sec.gov/news/press/2009/2009-189.htm. The letter is available at http://www.sec.gov/news/press/2009/2009-181-letter.pdf.
11. *See* SEC Press Rel. No. 2009-201 (Sept. 17, 2009), available at http://www.sec.gov/news/press/2009/2009-201.htm. A copy of the proposed release is available at http://www.sec.gov/rules/proposed/2009/34-60684.pdf.

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