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SECURITIES ENFORCEMENT DEVELOPMENTS

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What follows are some recent developments in securities enforcement that our clients and other friends may find of interest:

President's Working Group Issues Policy Statement on Financial Market Developments

The President's Working Group on Financial Markets issued an interim report on the state of the nation's financial markets. The PWG is composed of the Secretary of the Treasury, the Chairman of the Federal Reserve, and the Chairs of the SEC and the CFTC. The report identifies some causes of the current turmoil in the financial markets and suggests regulatory improvements. The causes identified by the PWG include a breakdown in mortgage underwriting standards, significant erosion of market discipline by virtually all market participants, flaws in the assessments by credit rating agencies, risk management weaknesses at large U.S. and European financial institutions, and regulatory policies that failed to mitigate risk management weaknesses.

Our take:

From an enforcement perspective the significance of the report lies in what is omitted. While the report mentions predatory mortgage lending and adverts to conflicts of interests at credit rating agencies, it does not label fraud as a significant cause of current financial market turmoil. That suggests that the SEC will not direct its enforcement efforts towards determining the extent to market participants caused sub-prime losses or recklessly failed to anticipate them.

On the other hand, the enforcement staff knows that whenever markets are turbulent, some people behave in unattractive ways. We continue to expect the focus of the SEC enforcement investigations to be on how market participants acted once they realized that they faced significant losses.

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

Three Recent Judicial Decisions on Attorney-Client Privilege that Underline the Risks of Waiver in Internal Investigations

In In re Initial Public Offering Securities Litig., the U.S. District Court for SDNY once again rejected the selective waiver doctrine and held that the privilege had been waived in civil litigation by the defendants' production to the SEC and US Attorney of interview memos. The court reasoned that application of selective waiver in those circumstances would reduce the ability of defendants to resist SEC demands for disclosure and thus, perversely, put attorneys performing internal investigations in the position where they were reluctant to memorialize facts that substantiated liability. In Maxim v. Gifford, the Delaware Chancery Court held that a Company had waived the attorney-client privilege over all communications between a Board special committee investigating option backdating and the lawyers who conducted that investigation (including counsel's final report) by, among other things, disclosing that report to Board directors at a meeting attended by their personal lawyers and permitting those lawyers to use the fact of the report affirmatively in related civil litigation. And, in People v. Greenberg, an appellate court in New York held that *former* officers and directors of AIG (a Delaware corporation) were entitled to an order compelling AIG to produce documents reflecting legal advice that AIG had received and that the individuals had relied upon because the records were necessary to protect their personal responsibility interests – *i.e.*, to defend themselves in lawsuits brought by the NYAG against them.

Our take:

Courts continue to reject attempts at selective waiver. In recent years, companies have been more successful in resisting government demands for interview memoranda while finding other ways to cooperate with the government. The decision in In re IPO provides further grounds for resisting such requests. The Maxim and Greenberg cases highlight that, in the privilege waiver contests, one must worry about disclosures to friends (including former friends) as much as disclosures to adversaries. Disclosure within a company, if not carefully guarded, can result in a waiver of the privilege. The Maxim Court noted that individual counsel were present when the directors received the report and that the directors themselves were not permitted to take notes regarding the report. We wonder whether the result would have been different if counsel had been more careful to keep the roles of the directors in their official and individual capacities separate. This is yet another reason to keep lawyers for individual directors out of the boardroom.

Bally Case Raises Continuing Questions on Corporate Penalties

The SEC sued and simultaneously settled a case against Bally Fitness Holding Corporation, alleging a multi-year and $2 billion fraud amounting fraud. The settlement did not involve any penalty against the corporation, which entered bankruptcy in 2007 and emerged a private corporation. The SEC's entire explanation for the Commission's acceptance of the

settlement terms was that it "considered Bally's cooperation with the Commission staff in the investigation leading to this action and prompt commencement of remedial action."

Our take:

The Commission continues to be extremely reluctant to explain how it applies its corporate penalty and its cooperation policies to particular cases. In October, the Commission settled a case against Nortel Networks Corporation, acknowledged Nortel's "remedial efforts and cooperation," yet imposed a $35 million civil penalty. One can posit differences between the cases, and the Commission undoubtedly has good reasons for its decisions. But the Commission's unwillingness to state those reasons makes it harder for practitioners to convince clients of the utility of vigorous remedial measures and cooperation and counsels that the Commission may not be entirely settled in its approach.

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