

# Corporate Fraud Defense Report

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## SEC To Exempt Foreign Companies From Pay Disclosures

Following sweeping reforms to corporate disclosure requirements of executive pay, the SEC is considering an exemption for foreign businesses. In January, the SEC approved new regulations designed to increase transparency of several aspects of executive compensation, including pay for performance metrics, hidden rewards, retirement benefits and deferred compensation arrangements. However, the NYSE has voiced its concerns about imposing those requirements on foreign companies. Foreign issuers listed on U.S. exchanges already must comply with substantial reporting requirements, including § 404 of Sarbanes-Oxley, which demands that CEOs and CFOs of public companies evaluate internal controls over financial transactions and account for any weaknesses within 75 days of the end of a company's fiscal year. To avoid such regulations, an increasing number of companies are registering on the London Stock Exchange, causing NYSE's concern that still more federal regulations may affect its ability to compete with European markets. Under the SEC's proposal, foreign firms with U.S. listings would be exempt from providing a breakdown of each officer's pay, but would be required to report total annual executive compensation. SEC Rel. Nos. 33-8655; 53185; 71 Fed. Reg. No. 26, 2/8/06.

## Pro-Business, Non-Profit Group Challenges Sarbanes-Oxley

The Free Enterprise Fund, a non-profit organization (the "Fund"), has filed suit in district court in Washington, D.C., against the Public Company Accounting Oversight Board ("PCAOB") created under the Sarbanes-Oxley Act of 2002. The suit challenges the constitutionality of the Sarbanes-Oxley Act, arguing that the PCAOB's structure and operation violate separation of powers principles and the Appointments Clause of the United States Constitution. The Fund, represented by Ken Starr and a team of lawyers, alleges that the PCAOB is a government entity, but that it is free from the supervision or control of the President and only subject to limited review by the SEC, in violation of separation of powers principles. Further, the Fund argues that appointment of PCAOB members by the SEC violates Article II of the Constitution. *Free Enterprise Fund v. PCAOB*, Case No. 1:06-cv-00217-JR (D.D.C., Complaint filed 2/7/06).

## Supreme Court Expands Access to Federal Courts for National Banks

In *Wachovia Bank, Nat. Assoc. v. Schmidt*, the Supreme Court, reversing the Fourth Circuit, held that national banks, for purposes of diversity jurisdiction, are citizens of the State in which its main office is located. The Fourth Circuit had held that under 28 U.S.C. § 1348, a national bank is a citizen of every state in which it maintains a branch office. Thus, the Fourth Circuit found that because Wachovia, which has its main office in North Carolina and a branch office in South Carolina and the plaintiff was a citizen of South Carolina, that diversity jurisdiction was lacking and instructed the district court to dismiss the case. The reversal of the Fourth Circuit's decision puts national banks in the

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same standing as corporations, which are deemed to be citizens of only the state in which they are incorporated, and has significant consequences for national banks. The decision allows national banks to resort to federal court when bringing an action in a foreign state and to remove actions filed in a foreign state court to federal court. *Wachovia Bank, Nat. Assoc. v. Schmidt*, 126 S.Ct. 941 (2006).

### Investment Manager Indicted in Money Laundering Scheme

Martin Tremblay, the President and Managing Director of Dominion Investments, a Bahamian investment services provider, has been indicted on charges that he used Dominion to launder a billion dollars worth of illegal proceeds for numerous clients. The indictment specifies that, between 1998 and 2005, Tremblay received into Dominion-related bank accounts millions in proceeds from tax evasion and wire fraud schemes, securities fraud schemes, and sale of date rape drugs, cocaine, and hydroponic marijuana smuggled into the U.S. from Canada. Once the funds were received into Dominion-related bank accounts, Tremblay purportedly wire-transferred the funds to other bank accounts in the U.S., Canada, and around the world.

The indictment was the result of a sting operation that began in March 2005. Undercover agents met with Tremblay, who agreed to launder the proceeds of narcotics sales. According to the indictment, Tremblay carried out the scheme by depositing \$220,000 of purported narcotics money into Dominion accounts on three separate occasions. *U.S. v. Tremblay*, Case No. S1-06-Cr. (S.D.N.Y.). *Copy of indictment available upon request.*

### Former Bank of China Officials Indicted on RICO, Money Laundering Charges

Two former Bank of China managers, along with their wives and a relative of one of the couples, were indicted on 15 counts of racketeering, money laundering, and fraud arising from a scam in which the defendants allegedly stole at least \$485 million. According to the indictment, the defendants engaged in a RICO conspiracy from 1991 through October 2004 and created shell corporations in Hong Kong along with personal accounts that were used for funneling the Bank's money. The former managers allegedly laundered the stolen proceeds through Canada and the U.S., including Las Vegas casino accounts, and then immigrated to the U.S. from China by obtaining false identities and entering into sham marriages with naturalized U.S. citizens. The managers' true wives allegedly assisted in the money laundering and violated U.S. immigration laws by entering the U.S. illegally. They also allegedly obtained U.S. citizenship and passports using fraudulent methods. DOJ Press Rel., 1/31/06.

### SEC Hammers Schield for Document Destruction

The SEC has barred Marshall L. Schield from the industry and revoked his company's investment advisor registration. The SEC found that Schield and Schield Management Company destroyed emails, personal identification numbers, and altered Individual Position Reviews. The destruction came during an underlying SEC investigation of the company for failing to reimburse clients for trading errors. Schield argued that he had only destroyed emails that were "personally embarrassing" and that he had taken steps to prevent future violations. The administrative law judge assigned to the case found

Schild's arguments "not credible." *In the Matter of Schield Management Company*, SEC Admin. Proc. No. 3-11762, 1/31/06.

### SEC To Review High Risk Hedge Funds

An SEC rule scrutinizing high risk hedge funds has gone into effect. The regulation was prompted by the hedge fund industry's explosive growth. Traditionally unregulated, the hedge fund industry now has total assets of \$1 trillion and accounts for perhaps 20% of U.S. stock trading.

The new rule amends the 1940 Investment Adviser's Act to include the regulation of hedge funds. It requires hedge funds with more than \$25 million in assets, and which allow investors to redeem their shares within two years, to register with the SEC. Firms that the SEC determines are high risk will be scrutinized by the government every three years. Risk levels will be assessed through two evaluation tools. Once a year, information provided by firms will be evaluated using a risk assessment algorithm. In addition, the SEC will assess a firm's risk level during routine examinations of compliance policies and procedures. Those SEC evaluations will trump the algorithmic analyses, if the results differ.

While hundreds of hedge fund advisors have registered under the rule, many more have not. In addition, the new regulation is already being challenged in court, and some large hedge funds are seeking to circumvent the rule by extending their "lockup" period to two years. SEC Rel. No. IA-2333; 17 CFR Parts 275 and 279.

## Brokers and Financial Advisors Take Aim Against SEC Rule

At the end of March, 2006, a new SEC rule is scheduled to take effect requiring brokers providing financial planning advice through fee-based accounts to register with the SEC and be regulated as investment advisors. Both the Securities Industry Association (“SIA”) and the Financial Planning Association (“FPA”) are fighting this rule because it contains an exemption for brokers who give financial advice that is merely “incidental” to their business. However, while the SIA is urging the SEC to extend the March deadline, the FPA has filed a lawsuit against the SEC stating that the new rule violates the Investment Advisors Act of 1940. According to an FPA letter to its members, “the rule is so flawed that it can’t be fixed unless the SEC establishes clear boundaries on financial planning and clearly communicates these limits to the brokerage industry.” The rule as it now stands, the FPA letter contends, “fails to describe the differences between the services provided by brokers and financial planners, leaving considerable confusion among consumers.” SEC Rel. No. 34-42099; www.FPAnet.org; 17 CFR Part 275.

## Duty of Corporations to Indemnify, Pay Advancement Gains Strength

The Delaware Chancery Court ruled that where two former corporate officers or directors were officers and directors at the time they committed the offense for which the corporation itself was now suing them (including breach of fiduciary duty, fraud, and waste) and where the corporate bylaws provided for mandatory indemnification and advancement for officers and directors, the two were entitled to advance-

ment of expenses. The corporation, Radiancy, Inc., claimed that its allegations were largely related to the officers’ employment agreements and therefore implicated a discretionary indemnity and advancement provision applicable to employees and agents, rather than the mandatory officers and directors provision. The court disagreed, and ruled that, “*To decide otherwise when [Radiancy] has so clearly violated its contractual*

*“[T]he SEC is examining whether some hedge fund managers overstate their bond holdings in companies headed for bankruptcy to obtain a spot on the creditors’ committee.”*

*duty to provide advancement would be to weaken [advancement rights under] Delaware corporate law, and to encourage the very kind of reflexive challenges to advancement claims that have proliferated in such number before this court.”* A ruling on a third individual who claimed to be an eligible officer/director was deferred because the issue of the nature and timing of his status as an officer/director could not be decided without a jury trial. *Radiancy, Inc. v. Azar*, Case No. 1547-N (Del. Ch. Ct., 1/23/06).

## SEC Probes Role of Hedge Funds on Bankruptcy Panels

The SEC is conducting an unofficial investigation into the participation of hedge funds in bankruptcy proceedings. The investigation comes in the

midst of concerns about the potential for fraud and abuse of insider information that hedge fund managers gain by serving on creditors’ committees. In particular the SEC is examining whether some hedge fund managers overstate their bond holdings in companies headed for bankruptcy to obtain a spot on the creditors’ committee. Analysts have also noted concern that hedge fund managers on creditors’ committees may have the ability to influence the process to maximize their returns at the expense of other creditors, although doing so would violate the fiduciary duty all committee members have to those they represent. The investigation follows on the heels of the SEC filing a civil complaint against Blue River hedge fund manager Van Greenfield last November. The SEC claimed Greenfield gained a seat on the creditors’ committee of WorldCom by overstating the amount of WorldCom bonds he owned and that Blue River failed to establish internal procedures to prevent the misuse of confidential information Greenfield gained through his committee seat. While Greenfield settled with the SEC, given the fast-growing market for distressed debt and corresponding larger role for hedge fund managers, the SEC investigation has continued. SEC Rel. No. 52744, 11/7/05.

## FinCEN Comments on Sharing Suspicious Activity Reports With Parent Corp.

According to the Department of Treasury, Financial Crimes Enforcement Network (“FinCEN”), banks, broker-dealers, futures commissions merchants, and introducing commodities brokers may share Suspicious Activity Reports (“SAR”) with their head office or controlling companies. FinCEN defines a controlling company as a bank or savings and loan holding company, or a company that has direct or indirect power to direct

the management or policies of the financial institution or its parent, or to vote 25% or more of its voting shares. The Bank Secrecy Act otherwise generally prohibits anyone who files a SAR from disclosing such information except when requested by law enforcement or regulatory agencies. The guidance, however, requires financial institutions, as part of their anti-money laundering programs, to have written confidentiality agreements specifying that the parent company must protect the confidentiality of the SARs through appropriate internal controls. The agreements must specifically guard against disclosure requests from foreign governments. The parent company may not disclose a SAR or that it has been filed, but may disclose information about the customer and transaction reported. FinCEN is considering whether a depository institution may share a SAR with an affiliate other than its parent company, but until it issues such guidance, financial institutions should not share SARs with such affiliates. [www.fincen.gov/sarsharingguidance01202006.pdf](http://www.fincen.gov/sarsharingguidance01202006.pdf); <http://www.fincen.gov/sarsharingguidance01122006.pdf>.

### FinCEN Issues Guidance on Foreign Bank Recertifications

FinCEN recently issued guidance clarifying the date on which U.S. banks must complete recertifications regarding foreign banks holding correspondent accounts. The Bank Secrecy Act prohibits U.S. banks from establishing or managing a correspondent account in the U.S. on behalf of foreign shell banks, which are foreign banks that do not have a physical presence in any country. The Act also requires U.S. banks to keep records identifying the owners of foreign banks for which correspondent accounts are maintained, and to take appropriate steps to ensure that the accounts are not being used indirectly

to provide services to a foreign shell bank.

FinCEN's regulations issued in 2002 allowed certain financial institutions to receive a "safe harbor" for compliance by obtaining a certification from each foreign bank for which they maintain a correspondent account "at least once every three years." Because confusion arose as to when to start counting the three years, FinCEN's

*"All recertifications must be done on or before the three-year anniversary of the execution of the initial or previous certification."*

recent guidance clarifies the matter. All recertifications must be done on or before the three-year anniversary of the execution of the initial or previous certification. FinCEN Guidance No. FIN-2006-003\_2/3/06.

### Court Rules That PSLRA Does Not Mandate Dismissal With Prejudice

In *Belizan v. Hershon*, the D.C. Circuit ruled that the Private Securities Litigation Reform Act of 1995 ("PSLRA") does not require that a deficient complaint be dismissed *with prejudice*. In *Belizan*, various purchasers of debt securities sued an investment fund owner, its auditor and the seller of the securities for 1933 and 1934 Act violations. The district court found that the plaintiffs had failed to adequately plead their claims and ordered the case dismissed

with prejudice. Moreover, the court found that the plaintiffs' oral motion to amend their complaint was deficient.

On appeal, the D.C. Circuit vacated the district court's order and directed the district court to either enter a new order dismissing the case without prejudice or to explain its dismissal with prejudice. "The proper course" for the district court was to "determine whether the allegation of other facts consistent with the challenged pleading could not possibly meet the heightened pleading requirements of the PSLRA." If not, dismissal with prejudice was not justified. "[A] complaint that omits certain essential facts and thus fails to state a claim warrants dismissal pursuant to Rule 12(b)(6) but not dismissal with prejudice." Finally, the D.C. Circuit affirmed the district court's denial of the plaintiffs' oral request to amend their complaint because such a request was not a proper motion for leave to amend. *Belizan v. Hershon*, 434 F.3d 579 (D.C. Cir. 2006).

### Merck Not Liable for "Misleading" Accounting Policy Disclosure

On December 15, 2005, the Third Circuit affirmed the dismissal of securities fraud claims against Merck & Co. for making an allegedly misleading accounting policy disclosure, holding that the plaintiffs had failed to demonstrate materiality.

Plaintiffs had alleged that Merck first disclosed details of its revenue recognition policy in a registration statement filed in April 2002. On the day of the disclosure, Merck's stock price had increased. Two months later, *The Wall Street Journal* published an article analyzing Merck's disclosure and reported, for the first time, that Merck's revenue recognition policy had improperly recognized billions

of co-payments as revenue. The market's reaction was immediate, dropping Merck's stock from \$52.20 to \$49.98 the day of the disclosure, and eventually down to \$43.57.

Merck argued that, because its stock price rose immediately following its initial disclosure, which conveyed minimal information, the disclosure was immaterial as a matter of law. Plaintiffs argued that although Merck disclosed that it had recognized co-payments as revenue in April, it did not disclose the sum total of those co-payments. Plaintiffs claimed that this is why the stock price did not drop until *The Wall Street Journal* published the magnitude of the co-payment recognition. Although the Court agreed that Merck should have disclosed the amount of co-payments recognized as revenue in its April registration statement, the court held that Merck had disclosed the facts, and that "it is simply too much for us to say that every analyst following Merck, one of the largest companies in the world, was in the dark." The court also held that plaintiffs "failed to establish a material statement or omission by Merck, so Union did not sufficiently plead a section 10(b) or section 11 violation. Because of this, Union also fails to make a valid section 20(a) claim. *In re Merck & Co., Inc. Securities Litigation*, 432 F.3d 261 (3d Cir. 2005).

### Court Dismisses Securities Fraud Suit Against Energy Company

The district court (E.D. Wa.) dismissed a securities class action fraud suit against energy magnate Avista Corp. The plaintiffs' allegations focused on Avista's alleged misrepresentations that it had implemented comprehensive risk management procedures and controls over energy trading when, instead, it knowingly engaged in "repeated high-risk En-

ron trading schemes." The court had previously denied Avista's motion to dismiss.

The court reconsidered its prior order based on the recent U.S. Supreme Court decision in *Dura Pharmaceuticals, Inc. v. Broudo*, which reversed Ninth Circuit law on the standard required to withstand a motion to dismiss with respect to pleading loss causation. Under the new standard, a securities fraud plaintiff must allege facts showing that the alleged misrepresentations in the complaint proximately caused the alleged economic loss. The district court in *Avista* found that purchase price inflation due to the alleged misrepresentation, by itself, did not meet this standard.

The court also found that certain announcements by Avista's federal regulator, the Federal Energy Regulatory Commission (FERC), did not meet the pleading standard for loss causation because they did not contain factual information that revealed Avista's alleged misrepresentations or any fraud by Avista.

The court concluded that because the plaintiffs did not allege the necessary causal connection between Avista's alleged misrepresentations and the plaintiffs' alleged economic harm, loss causation was not adequately pleaded. *In re Avista Corp. Securities Litigation*, Case No. CV-02-328-FVS (E.D. Wash., 10/19/05).

### Third Circuit Clarifies When Mutual Fund Investors Are on Inquiry Notice

Upholding dismissal of individual investors' securities claims against the manager of their mutual fund, the 3rd Circuit examined the kinds of news reports sufficient to place investors on inquiry notice and start the statute of limitations running. Investors had sued Alliance Capital Management

claiming its mutual funds were improperly managed when the company continued to invest in Enron in the face of news reports chronicling Enron's decline. The 3rd Circuit decided that when the news reports describing Enron's decline were followed by the news that Alliance Capital had lost significant amounts by investing in Enron, the investors were on inquiry notice of their claims. As these reports occurred more than one year before plaintiffs' complaint was filed, their claims were time-barred. In so deciding, the court emphasized that news sufficient to put mutual fund investors on inquiry notice is not just storm warning showing that a company is in trouble; rather, public reports regarding a fund's holdings that would enable one to know whether he or she is invested in the troubled company are required to put the investors on inquiry notice. *Benak v. Alliance Capital Management L.P.*, 2006 WL 73440 (3d Cir., 1/13/06).

### No Subject Matter Jurisdiction in Securities Suit Against Foreign Defendants

A federal district court recently held that it did not have subject matter jurisdiction over a securities class action suit involving certain foreign defendants. The action was brought by purchasers of securities of China Aviation Oil (Singapore) Corporation Ltd. against the company and individual defendants, all residing in Singapore. The lead plaintiff in the suit, a New York resident, had purchased her shares through an Over-the-Counter Bulletin Board (OTCBB), and quotes for the shares are also found on the Pink Sheets, a centralized quotation service. Plaintiff alleged that China Aviation's web site contained false and misleading financial statements.

Applying the "conduct" and "effects" tests for federal subject matter jurisdiction, the court found that the plain-

tiff did not meet either test. There was no evidence that China Aviation's web site was maintained in the U.S., or that the company took actions to transmit the web site's information to U.S. investors. Instead, by clicking on the web site, U.S. investors caused the information to be transmitted to the U.S. In addition, the court noted that it was unaware of any court holding that the OTCBB or Pink Sheets are recognized as maintaining an efficient market. The court found that none of the allegations in the plaintiff's complaint indicated any activity by the defendants in the U.S. *Burke v. China Aviation Oil (Singapore) Corp.*, No. 05 Civ. 0060 (RPP), 2005 WL 3215147 (S.D.N.Y., 11/29/05).

### Court Rejects 10(b) Sell-To-Sue Requirement

Following a motion for reconsideration, a federal judge has reversed a decision to dismiss a class action for investors who bought and retained securities of Royal Dutch Shell Company and the Shell Transport and Trading Company ("Royal Dutch/Shell") during the class period. Plaintiffs allege that Royal Dutch/Shell made false and misleading statements regarding its oil and natural gas reserves. Citing *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005), defendants moved to dismiss the complaint, arguing that because the stock had recovered its lost value, putative class members who did not sell the subject securities within 90 days after the class period ended could not establish the loss or causation elements of a §10(b) claim. In an August 2005 opinion, the district court agreed. The case then was reassigned, and plaintiffs moved for reconsideration. The new judge reversed the prior ruling and held that to prove causation and economic loss, "a plaintiff alleging fraud is not necessarily required to sell the subject securities," and that

*Dura* "neither expressly nor implicitly mandates" otherwise. The court also looked to the statutory scheme for potential damages in connection with §10(b) violations, which does not require the sale of the securities, the fact that holding plaintiffs have long been permitted to litigate security fraud claims, and policy concerns against a "sell-to-sue" requirement. *In re Royal Dutch/Shell Transport Litigation*, Case No. 04374 (D.N.J., 12/12/05).

### Registered LLP Interests Held Not "Securities"

In *SEC v. Merchant Capital, LLC*, the court rejected the SEC's suit alleging a fraudulent scheme in the sale of general partnership interests in certain Colorado registered limited liability partnerships. The SEC alleged 1933 and 1934 Act violations and sought a temporary restraining order and preliminary and permanent injunctions. After denying the motion for preliminary injunction and holding a bench trial, the court directed the entry of judgment in favor of defendants.

The court made several key findings. First, the court found that the registered limited liability partnership interests were not "securities" a finding which was fatal to the SEC's complaint. In reaching its conclusion, the court noted that (1) the partnership interests were not "investment contracts"; (2) the partners had the power to control the partnerships; (3) the general partners were not so dependant on the unique entrepreneurial or managerial ability of a defendant to make it irreplaceable; and (4) the partners were not so inexperienced or unknowledgeable in business affairs that they were incapable of intelligently exercising their partnership powers. Finally, the court found the partnership interests could not be considered securities under the theory

that they were "certificates of interest or participation in a profit-sharing arrangement." *SEC v. Merchant Capital, LLC*, 400 F. Supp. 2d 1336 (N.D. Ga. 2005).

### Broker's Late Trading Violations Lead to Censure, Disgorgement, Fine

Tennessee-based Morgan Keegan & Co. consented to censure, disgorgement of almost \$419,000 in earnings, and a \$100,000 civil penalty to settle allegations that it permitted late trades by a hedge fund advisor in violation of two mutual fund prospectuses requiring net asset values to be determined as of the close of the NYSE. The allegations stemmed from an arrangement negotiated "through a series of miscommunications" between a hedge fund advisor and Morgan Keegan's Dallas, Texas branch for trades as late as 4:30 p.m ET, although Morgan Keegan's unwritten policy required trades to be submitted no later than 3:45 p.m. ET to be counted in that day's net asset values. The mutual funds involved required trades to be made no later than 4:00 p.m ET or as of the close of the NYSE. The arrangement led to a \$35 million initial deposit by the hedge fund advisor and resulted in 90 different late trades in two fund families during a five-month period. The amount of disgorgement represented the earnings of Morgan Keegan for these transactions during that period. *In re Morgan Keegan & Co.*, SEC Rel. No. 34-53521, 2/8/06.

### NASD Fines Firm, Research Analyst for Conflict of Interest Violations

On February 8, 2006, NASD announced that it had imposed a fine of \$350,000 against Sanford C. Bernstein & Co. LLC ("Sanford Bernstein") and \$200,000 against Charles B. Hintz, one of the firm's

research analysts, for violations of NASD's research analyst conflict of interest rules against trading contrary to an analyst's recommendation. The fines represent the largest NASD has imposed to date for violations of these rules, which went into effect in July 2002. NASD found Sanford Bernstein had favorable ratings on Morgan Stanley and Lehman Brothers securities that remained in effect while Hintz was selling his own shares in the two companies, which he had obtained in connection with his earlier employment by those firms. After NASD declined Hintz's request for an exemption from its rules prohibiting the sales, Hintz and Sanford Bernstein devised a plan which they believed would not violate NASD rules, whereby Hintz issued "final" reports on Morgan Stanley and Lehman before selling the shares. NASD, however, concluded that the plan did violate its rules because there was no bona fide termination of coverage, as Sanford Bernstein intended to resume coverage of both stocks shortly after the sales were complete. NASD also found that Hintz engaged in transactions in six securities held in a discretionary personal account that were contrary to his then-current recommendations. NASD Press Rel., 2/8/06.

### Court Refuses to Dismiss Mutual Fund Shareholders' Section 36(b) Complaint

A district court in Massachusetts refused to dismiss plaintiffs' 1940 Investment Company Act Section 36(b) claims, even though defendants argued that the complaint was "little more than boilerplate generalities and legal conclusions." Plaintiffs, ten shareholders in eleven MFS funds, alleged that MFS Co. and MFS distributors violated their fiduciary duties by charging disproportionately

large fees that bore "no reasonable relationship to the services rendered." Plaintiffs also alleged that the defendants "failed to pass on to the funds the benefits of economies of scale," charged excessive distribution fees, and paid broker-dealers excessive commissions for "soft dollars" that benefitted the defendants but not the funds.

While the court agreed that the plaintiffs could not simply allege the "legal conclusion that fees were excessive without any facts supporting that conclusion or by relying on generalizations about the securities industry and speculation," the court stated that plaintiffs had done "more than that," finding the allegations factual, and not merely conclusory, and finding that defendants were "on fair notice" of the plaintiffs' Section 36(b) claims. *Dumond v. Massachusetts Financial Serv. Co.*, Case No. 04-11458-GAO (D. Mass., 1/19/06).

### Hedge Fund Manager to Plead Guilty to Insider Trading Charges

Michael K.C. Tom, manager and co-owner of GTC Growth Fund, L.P. ("GTC"), a Massachusetts-based hedge fund, has agreed to plead guilty to allegations stemming from his purchase of stock in Charter One Financial, Inc. ("Charter One"), purportedly after receiving a tip that the company was about to be acquired. According to the criminal information against Tom, in April 2004, he received a phone call from Shengnan Wang, a portfolio analyst at Citizens Financial Group, Inc. ("Citizens") and an investor in GTC, who told Tom that Citizens was performing due diligence on Charter One in advance of a planned acquisition. Tom began to trade Charter One stock in his name as well as the names of his

relatives and GTC. In May, the day after Citizens announced the acquisition, Charter One's stock rose 22%, and Tom sold most of his securities, netting over \$740,000. Wang and her husband pled guilty to insider trading in November. The SEC has also filed civil charges against Tom, his brother, Wang, her husband, and Global Time Capital Management, LLC, the general partner of GTC. *U.S. v. Tom*, 05-CR-10361 (D. Mass., 12/28/05); *SEC v. Tom*, 1:05-cv-11966 (D. Mass., 9/29/05).

### SEC Action Against Accounting Firm Partners Moves Forward

On January 13, 2006, a federal court refused to dismiss the SEC's enforcement action against three individual accounting firm auditors for their role in a massive accounting fraud at Xerox Corporation from 1997 through 2000. The SEC alleges that the auditors permitted Xerox to manipulate its accounting practices in order to fill a \$3 billion gap between its actual operating results and the results it reported to the investing public. In 2002, after the scope of the fraud was exposed, Xerox issued a \$6.1 billion restatement of its revenues and a \$1.9 billion restatement of its pre-tax earnings for the years 1997-2000. The restatement was the largest financial restatement in American history up to that point.

The audit engagement partners argued that they could not be held liable as "primary violators" for misleading statements made in the accounting firm's audit opinion letters because the letters were issued in the accounting firm's name and did not include the signatures of any of the individual auditors. The court rejected the defendants' argument, and noted that the SEC, unlike a private plaintiff, is not required to prove reliance when

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it brings an enforcement action. Accordingly, the court found no reason to impose a requirement that a misstatement have been publicly attributed to a defendant for liability to attach, at least so long as the SEC is able to show that the defendant was sufficiently responsible for the statement and knew or had reason to know that the statement would be disseminated to investors. The court found it clear that the accounting firm partners who served as audit engagement partners were “properly considered responsible for the misstatements” made in their audit opinion letters. *SEC v. KPMG*, 2006 WL 176956 (S.D.N.Y. 2006).

## The Corporate Fraud Defense Report™

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