

Criminal Enforcement of the U.S. Securities Laws
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I. INTRODUCTION

The United States securities laws are enforced through both civil and criminal actions. On the civil side, the Securities and Exchange Commission (“SEC”) has broad investigative powers and can bring civil enforcement actions seeking monetary penalties, injunctions, bars against serving as a director or officer of a public company, and other civil remedies. The SEC’s civil enforcement is supplemented by the activities of self-regulatory organizations such as the major stock exchanges, state securities regulators, and private litigants. The SEC does not have authority to bring criminal actions. Criminal violations of the federal securities laws are prosecuted by the Department of Justice and the ninety three United States Attorneys offices throughout the country (collectively the “DOJ”). The DOJ may seek indictments for criminal violations of the securities laws on their own initiative or through formal or informal referrals from the SEC.

This paper focuses on the criminal enforcement of the U.S. securities laws. This paper first reviews the key criminal offenses that may be applicable to violations of the federal securities laws. This paper then reviews recent trends in criminal enforcement of the securities laws, including overviews of recent criminal prosecutions involving stock option backdating and insider trading.

II. KEY CRIMINAL OFFENSES

The DOJ may charge several types of crimes in bringing criminal charges for violations of the federal securities laws. Some of these crimes are securities-specific criminal offenses, which only apply to violations of the securities laws. Others are more general criminal offenses,

such as mail and wire fraud, which may be applicable to various types of alleged misconduct, including securities fraud. It is also common for the DOJ to prosecute offenses arising from the investigation process itself, such as obstruction of justice or making false statements.

A. Securities-Specific Criminal Provisions

Willful violations of the securities laws. Any person or entity may be subject to criminal prosecution for “willfully” violating the federal securities laws. For example, one of the key federal securities laws is the Securities Exchange Act of 1934. This act and the regulations promulgated thereunder, among other things, (i) require that public companies file annual, quarterly and periodic reports with the SEC that fairly and accurately present the company’s financial condition; (ii) require public companies to keep accurate books and records; (iii) prohibit improper insider trading; and (iv) prohibit the making of false or misleading statements to a public company’s auditors. Thus, any person who “willfully” violates one of these provisions (or any other provision of the Securities Exchange Act of 1934 or any rules or regulations promulgated thereunder) can be fined up to \$5,000,000 and/or imprisoned for not more than twenty years. *See* 15 U.S.C. § 78ff(a).¹ In the case of an entity, the fine may be up to \$25,000,000. *Id.*

The definition of “willful” conduct is not uniform among courts. Some require a specific intent to violate the law. Other courts require intent to perform an act that violated the law, but do not require knowledge that the act is illegal. The most common interpretation appears to require a defendant to have known his conduct was wrongful, but not necessarily to have known it was unlawful.

¹ A separate statute, the Securities Act of 1933, generally regulates the offering of securities to public investors and prohibits the making of any false or misleading statements in a registration statement. Any person who “willfully” makes a false or misleading statement in a registration statement (or otherwise violates a provision of the Securities Act of 1933 or any rules or regulations promulgated thereunder) can be fined up to \$10,000 and/or imprisoned for not more than five years. *See* 15 U.S.C. § 77x. There are also criminal penalties for violations of the Investment Company Act of 1940 and the Investment Advisers Act of 1940. *See* 15 U.S.C. §80a-48; 15 U.S.C. § 80b-17.

False certifications. Section 906 of the Sarbanes-Oxley Act of 2002 requires CEOs and CFOs to certify that their company's periodic financial reports comply with applicable requirements and fairly present, in all material respects, the financial condition and results of operations of the company. *See* 18 U.S.C. § 1350(a), (b). Any person who "knowingly" provides a false certification can be fined up to \$1,000,000 and/or imprisoned for not more than ten years. *See* 18 U.S.C. § 1350(c)(1). Any person who "willfully" provides a false certification can be fined up to \$5,000,000 and/or imprisoned for not more than twenty years. *See* 18 U.S.C. § 1350(c)(2). In one criminal prosecution, the government stated that for a defendant's conduct to violate this provision "[h]e must not only know that the periodic report contains materially false information, he must falsely certify . . . that the report is materially accurate, he must do so knowing that such a false certification is forbidden by law, and he must do so with the specific intent to violate the law." *United States v. Scrushy*, 2004 U.S. Dist. LEXIS 23820, at *14-15 (N.D. Ala. Nov. 23, 2004). As described above, some courts may require a less stringent showing of culpability to meet the definition of "willful," requiring only that the defendant knew his conduct was wrongful, not that he knew it was unlawful.

Securities fraud. The Sarbanes-Oxley Act of 2002 created a new criminal offense for knowingly executing, or attempting to execute, a fraudulent scheme in connection with the securities of a public company, or for fraudulently obtaining money or property in connection with the purchase or sale of such securities. *See* 18 U.S.C. § 1348. Violators of this provision can be fined and/or imprisoned for up to 25 years. *Id.* This provision was added by Congress as a broad, general securities fraud statute to supplement the already-existing criminal statutes.

B. General Criminal Provisions

Mail Fraud. The mail fraud statute, 18 U.S.C. § 1341, generally prohibits the use of the mails to execute a scheme to defraud a victim of money or property. To prove mail fraud, the government must generally prove that the defendant knowingly participated in a scheme to defraud using false statements, representations or omissions, acted with the specific intent to defraud, and that the defendant mailed something for purposes of carrying out the scheme. The penalty for mail fraud not affecting a financial institution is a fine and/or imprisonment for up to 20 years.

Wire Fraud. The wire fraud statute, 18 U.S.C. § 1343, generally prohibits the use of wire communications to execute a scheme to defraud a victim of money or property. The government must prove the same elements as for mail fraud, except the defendant must have used interstate wire communications facilities (rather than the mail) for purposes of carrying out the scheme. The penalty for wire fraud not affecting a financial institution is a fine and/or imprisonment for up to 20 years.

Retaliation against whistleblowers. It is a crime to knowingly take any action harmful to a person (including interference with the person's employment), with the intent to retaliate for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense. *See* 18 U.S.C. § 1513(e) Violators of this provision can be fined and/or imprisoned for up to 10 years. *Id.*

Attempt and Conspiracy. It is a crime to attempt or conspire to commit any offense under 18 U.S.C. chapter 63, which includes the general securities fraud statute, false certification statute, wire fraud and mail fraud. *See* 18 U.S.C. § 1349. The penalty for attempt or conspiracy is the same as that for the underlying offense. To prove a criminal conspiracy, the government must generally prove that the defendant and at least one other person entered into an unlawful

agreement to violate the law, that the defendant knowing and willfully joined in the agreement, and that one of the conspirators committed an overt act in furtherance of the agreement.

Aiding and Abetting. The general aiding and abetting statute, 18 U.S.C. § 2, provides that anyone who aids, abets, or induces the commission of a crime may be punished for a crime actually committed by another person. The government must prove that someone (called the “principal”) committed a crime, that the defendant associated himself with the crime, and that the defendant participated in the crime with the intent to help the principal commit it.

C. Process Offenses

Obstruction of Justice. The obstruction of justice statute, 18 U.S.C. § 1503, generally prohibits corruptly influencing the due administration of justice in a pending judicial proceeding, or attempting to do so.² The government must prove that there was a pending federal judicial proceeding (such as a grand jury proceeding), the defendant knew or was on notice of the proceeding, and acted corruptly with the specific intent to influence, obstruct or interfere with the proceeding or the due administration of justice. The penalty under the obstruction of justice statute is a fine and/or imprisonment for up to 10 years (so long as the obstruction does not involve a killing or attempted killing).

Similarly, a provision of the witness and document tampering statute makes it a crime to corruptly obstruct, influence or impede any official proceeding or attempt to do so. *See* 18 U.S.C. § 1512(c)(2). The penalty under this statute is a fine and/or imprisonment for up to 20 years.

Destruction of Documents. The Sarbanes-Oxley Act of 2002 included a new criminal offense covering document destruction that was intended to cover any gaps in pre-existing

² A companion statute, 18 U.S.C. § 1505, generally criminalizes the same behavior with respect to proceedings before federal agencies.

obstruction of justice statutes. The statute prohibits knowingly altering, destroying, concealing or falsifying a document or record with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any U.S. department or agency or in relation to or contemplation of any such matter or case. *See* 18 U.S.C. § 1519. Violators of this provision can be fined and/or imprisoned for up to 20 years. *Id.* Unlike the general obstruction of justice statute, this provision is not limited to conduct that obstructs a pending judicial proceeding; it extends to acts done in contemplation of a proceeding, such as acts done before an investigation has even begun.

In addition, a provision of the general witness and document tampering statute makes it a crime to “corruptly” alter, destroy, or conceal a document or record, or attempt to do so, with the intent to impair the document or object’s integrity or availability for use in an official proceeding, or to corruptly persuade another person to do so. *See* 18 U.S.C. § 1512 (b) and (c). Violators of this provision can be fined and/or imprisoned for up to 20 years. *Id.* This is the provision that accounting firm Arthur Andersen LLP was convicted of violating when, as Enron’s financial difficulties were becoming public, it allegedly instructed its employees to destroy documents pursuant to its document retention policy.³

False Statements. It is a crime to knowingly and willfully make a false or fraudulent statement in any matter within the jurisdiction of the executive, legislative, or judicial branch of the U.S. government. *See* 18 U.S.C. § 1001. For example, making a false, material statement to the SEC or a federal agent conducting an investigation may form the basis of a criminal charge for making false statements. The penalty for making a false statement not involving terrorism is

³ The conviction was overturned by the Supreme Court, which found that the jury instructions failed to properly instruct the jury on the requisite level of culpable intent. *See Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005).

a fine and/or imprisonment for up to 5 years. This is one of the crimes for which Martha Stewart was convicted.

Perjury. It is also a crime to willfully make false statements under oath. *See* 18 U.S.C. § 1621. The penalty for perjury is a fine and/or imprisonment for up to 5 years.

III. RECENT TRENDS AND PROSECUTIONS

In recent years, the government has focused more aggressively on criminal enforcement of the securities laws. This focus stems in large part from the corporate scandals of the early 2000s, in response to which President Bush created the Corporate Fraud Task Force in July 2002. This Task Force, comprised of DOJ and other government personnel, was created to provide direction for the investigation and prosecution of cases of securities fraud, accounting fraud, mail and wire fraud, and other financial crimes. In July 2007 the Task Force reported that it had obtained 1,236 corporate fraud convictions (including plea bargains) during the first five years of its existence. During the one year period ended September 30, 2007, the SEC reported that prosecutors filed indictments, informations, or contempts in 144 SEC-related criminal cases.

Most recently, the government's criminal enforcement of the securities laws has focused on stock option backdating and insider trading. The stock option backdating indictments seem to be winding down, while the focus on insider trading will likely continue. Another area of future potential focus is the disclosure by financial institutions regarding their exposure to subprime mortgages and the valuation of securities tied to the subprime mortgage market.

A. Stock Option Backdating

Stock options give the recipient the right to buy stock in the future at a pre-determined price, called the strike price. Stock options are commonly used as a form of incentive compensation for executives and employees; if the company performs well and the stock price

increases above the strike price of an employee's options, the employee can buy the stock at a discount. Under the relevant accounting rules in place at the time, any difference between the strike price of an option and the market price at the time the option was granted was required to be reported as a compensation expense on companies' income statements. In March of 2006, the Wall Street Journal published an article describing the results of an academic analysis which suggested that some companies' executives were receiving stock options at fortuitous times, such as when the stock was at a yearly low. This article triggered widespread scrutiny of companies' practices relating to the granting and pricing of stock options and the accounting for and disclosure of expenses related to stock options. It was quickly discovered that many companies were pricing options with the benefit of hindsight by purporting to date options as of a date prior to the actual grant date and at a time when the market value of the stock was lower – in effect building in a gain. These disclosures led to numerous restatements, internal inquiries, SEC investigations, shareholder lawsuits and executive resignations.

The DOJ brought a number of criminal actions in connection with alleged stock option backdating, including filing criminal charges against the former CEO and a former human resources executive of Brocade Communications Systems; the former CEO, former CFO, and former general counsel of Comverse Technology; the former general counsel of McAfee Inc.; the former CEO, former CFO, former controller and a former director of Engineered Support Systems; the former vice president of human resources at Broadcom Corporation; the former CFO of SafeNet, Inc.; and the former general counsel of Monster Worldwide, Inc.

The first criminal case brought, and the first to go to trial, was against Gregory Reyes, the former CEO of Brocade. Some time earlier, on January 6, 2005, Brocade issued a press release announcing that as a result of an ongoing internal review conducted by its audit committee (with

the assistance of outside counsel and accountants), it expected to restate its financial results to record additional stock-based compensation expense. Brocade subsequently completed its internal review, replaced Mr. Reyes as CEO, restated its financial results, and disclosed that the DOJ was working with the SEC in a joint investigation regarding Brocade's stock option granting practices.

On July 20, 2006, United States Attorney's Office for the Northern District of California announced the filing of criminal securities fraud charges against Mr. Reyes and Stephanie Jensen, Brocade's former Vice President of Human Resources, alleging that the two routinely backdated stock option grants to give employees favorably priced options without recording necessary compensation expenses. On August 10, 2006, a grand jury indicted Reyes (and Jensen) charging him with twelve counts consisting of securities fraud, mail fraud, conspiracy to commit securities and mail fraud, false SEC filings, falsifying books and records, and false statements to Brocade's accountants. The indictment alleged that Reyes was the sole member of Brocade's compensation committee (a so-called "committee of one"); that Reyes backdated committee meeting minutes so that it appeared that option grants had been approved on earlier dates when the closing price of Brocade's stock had been relatively low; that Reyes caused employment offer letters to be backdated so that it appears certain employees had been given stock option grants before they were actually employed; that Reyes provided the backdated minutes and records to Brocade's finance department, which records were relied on by Brocade's auditors; that Reyes made false and misleading representations to Brocade's auditors; and that Reyes knew that Brocade failed to report any compensation expenses in its financial statements for stock options that were in reality issued with strike prices below fair market value at the time

of grant. The indictment did not allege that Reyes personally benefited by receiving any backdated stock options.

Reyes pleaded not guilty, and his trial began in June 2007. At trial, it was essentially undisputed that Brocade had a practice of pricing its stock options with the benefit of hindsight and that Mr. Reyes had been aware of this practice. There was also no dispute that Brocade had not properly accounted for stock option compensation expenses. The key issue in dispute was Mr. Reyes' intent.⁴ The defense argued that the purpose of the option-granting process was to benefit and attract employees, not to defraud the company or its shareholders; that there was no evidence that Mr. Reyes had knowledge of the relevant accounting principles; that Brocade's finance department had, like many other companies, misapplied the relevant accounting principles; and that there was no evidence that Mr. Reyes knew that Brocade's financial statements, public filings and representation letters to its auditors were inaccurate. The prosecution, in contrast, argued that the evidence showed that Mr. Reyes knew his conduct was wrongful. The prosecution argued that circumstantial evidence established that Mr. Reyes knew his conduct was wrongful, pointing to (i) the false committee meeting minutes signed by Mr. Reyes, (ii) Mr. Reyes' alleged lies to investigators about the use of hindsight in granting options, (iii) Mr. Reyes' signing of SEC filings (incorrectly) describing Brocade's accounting for stock-based compensation (iv) an email sent by Mr. Reyes to a fellow director of another company, in which he wrote "it is illegal to back date option grants" in upper-case letters, (v) the testimony of a former human resources executive that Mr. Reyes said, in the context of being given back-

⁴ The defense also argued that stock option compensation charges, which are non-cash expenses, were not material to investors. The defense argument on materiality pointed out that analysts excluded non-cash expenses when they analyzed companies' financial statements, arguably suggesting that such non-cash expenses were not viewed as an important piece of information in investors' decisions to buy and sell Brocade securities.

dated meeting minutes to sign, that “it’s not illegal if you don’t get caught,” and (vi) the lack of any legitimate reason to back-date meeting minutes so as to falsify option grant dates.

On August 7, after six days of deliberation, the jury found Reyes guilty on the ten remaining counts of the indictment.⁵ Mr. Reyes filed motions for a judgment of acquittal, (arguing that the evidence was insufficient to convict him) and for a new trial and to dismiss the indictment (arguing the weight of the evidence was insufficient, prejudicial instructions by the court, and improper remarks by the prosecutor), both of which were denied. Mr. Reyes is scheduled to be sentenced on January 16, 2008.⁶ In a November 27, 2007 Order which was unsealed on December 6, the trial court calculated the applicable sentencing guideline range as 15-21 months, a much lower range than that sought by prosecutors.⁷

B. Insider Trading

It is not improper for company insiders (such as officers and directors or temporary insiders such as company advisors) to buy and sell stock in their companies. Such insider trading only violates the federal securities laws if the insider is in possession of material, non-public information. Outsiders to a company can also be liable for improper insider trading if they trade on material non-public information in violation of a duty owed to the source of the information or if the source of the information is an insider who breached his or her duties by disclosing the information in order to receive an improper personal benefit.

⁵ Two counts of the indictment were dismissed by the prosecution prior to the start of trial.

⁶ Mr. Reyes filed a second motion for new trial, based on newly discovered evidence that one of the government’s witnesses at trial may not have been entirely truthful in her testimony. This motion was also denied.

⁷ The sentencing guidelines are not mandatory, and the judge has discretion to depart from the guidelines when sentencing Mr. Reyes.

Prosecutors have recently been active in bringing criminal charges for alleged illegal insider trading.⁸ Examples of criminal prosecutions for insider trading during the past two years include:

- An executive at UBS Securities LLC and six others were charged as part of an alleged insider trading scheme in which the UBS executive allegedly sold information regarding upcoming upgrades and downgrades by UBS analysts.
- A vice president of Taro Pharmaceuticals Industries, Inc., his two sons, and a family friend were charged in connection with trading on inside information regarding the anticipated approval of Taro's application to the FDA for permission to market a new drug and Taro's forthcoming earnings announcements.
- A life insurance sales representative pleaded guilty to trading on inside information regarding the proposed acquisition of five California community banks which he learned through his position at a consulting firm that had sold insurance to the banks.
- A co-founder and manager of the hedge fund Global Time Capital Growth Fund pleaded guilty to insider trading in connection with receiving information from an analyst at Citizens Bank that the bank was completing its due diligence before purchasing a Cleveland-based bank.
- A former in-house attorney in Morgan Stanley's compliance department and her husband pleaded guilty to securities fraud charges in connection with an insider trading scheme in which they allegedly provided inside information to others which the in-house attorney had obtained about upcoming mergers and acquisitions. Three other individuals were charged as part of the same alleged scheme.
- Three former vice presidents at mortgage lender Countrywide Financial agreed to plead guilty to securities fraud for selling company stock and buying put options while in possession of inside information about the prospect of the company not meeting earnings projections.
- A former Credit Suisse banker was charged in connection with allegedly providing material non-public information to a banker in Pakistan about transactions in which Credit Suisse was acting as an advisor.
- The former general counsel of Amkor Technology, Inc. was convicted on securities fraud charges related to his trading in company stock while in possession of material non-public information regarding Amkor's financial condition, proposed mergers and/or acquisitions, and potential litigation exposure.

⁸ The SEC has also been active in bringing civil enforcement actions for insider trading.

- A former vice president of Morgan Stanley and her husband were charged with trading on inside information related to companies with which Morgan Stanley was involved in transactions.
- Two former employees of Goldman Sachs were charged for their alleged involvement in two insider trading schemes. In the first alleged scheme, the defendants allegedly obtained material non-public information from an investment banking analyst at Merrill Lynch regarding pending mergers or acquisitions being handled by Merrill Lynch. In the second alleged scheme, the defendants allegedly bribed employees of a printing plant to provide them the names of companies mentioned favorably in upcoming issues of Business Week magazine.
- The former CEO and COO of DHB Industries, Inc. were charged with insider trading (among other offenses) for selling stock while allegedly knowing that the company's financial statements were incorrect.

The government recently obtained a conviction in a high-profile insider trading case brought against Joseph Nacchio, the former CEO of Qwest. Mr. Nacchio was indicted in December 2005 on forty-two counts of insider trading, based on the allegation that he sold more than \$100 million worth of Qwest stock during the period January through May 2001 while knowing that Qwest would be unable to reach the earnings guidance it had provided to the public. On April 19, 2007, Nacchio was convicted on 19 counts of insider trading (the sales that occurred later in time) and acquitted on 23 other counts (the sales that occurred earlier in time). Mr. Nacchio was subsequently sentenced to serve 6 years in prison. He was also ordered to forfeit \$52 million in proceeds obtained through the sale of stock underlying his conviction and to pay a fine of \$19 million (the maximum fine permissible, \$1 million, for each count on which Nacchio was convicted). Mr. Nacchio has filed an appeal of his conviction.

IV. CONCLUSION

Prosecutors have at their disposal a wide variety of criminal statutes which may be applicable to violations of the federal securities laws. In recent years the government has stepped-up its criminal enforcement of the securities laws and we expect this trend to continue.

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