

# Financial Services Alert

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## *Developments of Note*

### ➤ **Ninth Circuit Decision Permits Wider Scope for SEC-DOJ Cooperation in Parallel Civil and Criminal Proceedings**

In recent years, federal prosecutors and the Securities and Exchange Commission ("SEC") have come under criticism for their conduct of so-called "parallel" civil and criminal investigations. In a number of widely-discussed decisions in recent years, federal trial courts have ruled that the United States Department of Justice ("DOJ") and the SEC had crossed the line of permissible conduct in coordinating their investigations. Specifically, the courts have criticized conduct that they viewed as being aimed at lulling a potential criminal target into testifying or otherwise providing evidence in a related civil investigation. Recently, in *United States v. Stringer*, 521 F.3d 1189 (9<sup>th</sup> Cir. 2008), the federal Court of Appeals for the Ninth Circuit reversed one of those rulings, holding that there was nothing misleading or deceptive about the government's conduct. The Ninth Circuit's ruling in *Stringer* is instructive because it reinforces the courts' traditional acceptance of civil-criminal interagency cooperation and reflects a decidedly lower level of skepticism toward government conduct than has been shown in some recent trial court decisions. Where the district court in *Stringer* had found government deceit and trickery, the Court of Appeals found appropriate interagency cooperation and a discretionary government decision to play its criminal cards permissibly close to the vest. The decision in *Stringer* emphasizes the need for particular caution in responding to SEC subpoenas and requests for information where a parallel criminal investigation may be underway.

### **Traditional View – Parallel Proceedings Permissible Within Limits**

There is a century-long line of precedent holding that civil and criminal investigations may proceed simultaneously and in coordinated fashion. *See, e.g., Standard Sanitary Mfg. Co. v. United States*, 226 U.S. 20 (1912). The Supreme Court has held that requiring governmental agencies to choose either to forego criminal prosecution or to make an immediate choice between criminal or civil proceedings would "stultify enforcement of federal law." *United States v. Kordel*, 397 U.S. 1 (1970). In the SEC context, the federal securities laws explicitly empower the SEC to investigate possible securities laws violations and "to transmit the fruits of its investigations" to DOJ for criminal proceedings. *SEC v. Dresser Indus.*, 628 F.2d 1368 (D.C. Cir. 1980). In *Kordel*, the Supreme Court indicated that such

interagency cooperation is proper in the absence of “a violation of due process or a departure from proper standards in the administration of justice.” In particular, it is improper for the government to bring a civil action “solely” to obtain evidence for a criminal prosecution.

### More Recent Pullback

But more recently, in reviewing a wave of complex securities fraud investigations marked by close coordination between DOJ and the SEC, some courts have shown greater skepticism of the government’s methods. In the prosecution of the former Chairman of Healthsouth, Inc., the district court suppressed SEC testimony and dismissed the perjury counts of a criminal indictment, finding that the SEC and DOJ investigations had “improperly merged” and that government agents had acted in bad faith, employing “cloak and dagger” techniques. *United States v. Scrushy*, 366 F.Supp.2d 11 (N.D. Ala. 2005). It found that the U.S. Attorney’s Office had, in effect, directed the SEC both as to where to take Scrushy’s testimony and what to ask him, so as to enable DOJ to bring perjury charges in the desired district.

### The District Court Decision in *Stringer*

*Stringer* was another case involving close SEC-DOJ coordination, this time in the District of Oregon. In *Stringer*, the SEC initiated an informal investigation into the defendants and their company for possible securities fraud violations. Shortly thereafter, the U.S. Attorney’s Office and the FBI opened a criminal investigation and were granted the usual access to the SEC’s investigative files. After a meeting with the SEC staff, the criminal investigators decided to maintain a low profile while the SEC continued its work, expecting that the potential criminal targets would be more cooperative with civil investigators if they were not aware that there was an active criminal investigation.

During the two-year-long SEC investigation, SEC lawyers regularly shared information and discussed strategy with DOJ lawyers, though the grand jury had yet to begin taking testimony. The U.S. Attorney’s Office advised SEC staff of its interest in false testimony cases and explained how best to create the record for such cases. SEC staff from Los Angeles conducted interviews in Oregon, so that the District of Oregon would be an appropriate venue for any criminal false statement case filed. Among other steps taken to preserve secrecy of the criminal investigation, SEC lawyers asked court stenographers at the Oregon interviews not to mention the U.S. Attorney’s involvement in the case.

Along with subpoenas to testify, SEC staff also sent the defendants Form 1662, a standard SEC form that, among other things, advises witnesses of all “routine uses” of their testimony (including the sharing of information with criminal prosecutors) and of their Fifth Amendment right to refuse to testify. During SEC testimony, one of the defendants’ attorneys explicitly asked whether his client was being investigated by other governmental agencies “such as the U.S. Attorney’s Office in any jurisdiction.” The staff attorney responded by pointing to the “routine uses of information” section of Form 1662 and by stating the SEC enforcement staff’s policy not to answer such questions.

After the SEC brought charges, the U.S. Attorney’s Office obtained a criminal indictment of *Stringer* and the other defendants arising from the same conduct. The defendants moved to dismiss the indictment, claiming that their due process rights had been violated because the SEC investigation had essentially served as a wolf in sheep’s clothing – *i.e.*, while nominally a civil case, it had been directed by and served the criminal prosecutors. The district court agreed, finding that although the SEC’s investigation began before DOJ was involved, the U.S. Attorney’s Office had identified potential targets early in the investigation and in effect decided to gather information through the SEC instead of conducting its own investigation. The court found that the U.S. Attorney’s Office was “actively involved” with the SEC investigation and held that the government violated the defendants’ due process rights by conducting a criminal investigation in the guise of a civil investigation. More significantly, the court found that the government had engaged in “deceit and trickery” in order to conceal the criminal investigation. The court focused on the government’s instruction to court reporters to avoid

mentioning a criminal investigation and the SEC lawyers' unwillingness to acknowledge the known criminal investigation as "evasive and misleading" in light of the close cooperation between DOJ and the SEC. The trial court thus dismissed the indictments.

### **The Ninth Circuit Decision**

On appeal, the Ninth Circuit vacated the dismissal and reinstated the charges for trial. Adopting the more deferential approach to parallel SEC/DOJ proceedings traditionally taken by the federal courts, it held that nothing in the actual conduct of the SEC and US Attorney's Office amounted to affirmative misrepresentation or deceit. It found that while the SEC might have violated a defendant's Fifth Amendment privilege against self-incrimination had it provided no warnings about the risks of self-incrimination, the SEC Form 1662 provided ample notice of the possibility of a criminal investigation and the defendants' ability to invoke their Fifth Amendment rights. Further, the SEC had expressly warned the defendants at the beginning of each person's testimony that the facts developed in its investigation might constitute criminal violations. The defendants had thus waived their right against self-incrimination by choosing to testify. The court concluded that the government never gave the defendants false information concerning the existence of a criminal investigation. The court also held the government had not brought a civil action solely for the purpose of obtaining evidence for criminal prosecution – the SEC had commenced its investigation before the U.S. Attorney's Office became involved and in the end brought civil charges against the defendants. Thus the court found no "bad faith" on the part of the government.

### **Stringer's Implications**

In sum, the Ninth Circuit's ruling in *Stringer* is a reminder that the close coordination of criminal and civil investigations is commonplace and presumptively permissible. Courts are most likely to dismiss indictments or exclude evidence only where there is evidence of government deception or bad faith or where the civil investigation is truly a subterfuge for a criminal investigation. Therefore, in circumstances where the facts may allow for the possibility of a criminal investigation, a person or company responding to a subpoena or request for information from a government agency such as the SEC should carefully consider whether a related criminal investigation might be underway, and make decisions as to whether to testify or provide information with that consideration in mind.

### **➤ A Recap of Goodwin Procter and Navigant Consulting's Breakfast Briefing on AML and OFAC Compliance**

On June 5, 2008, Goodwin Procter, in conjunction with Navigant Consulting, hosted a breakfast briefing in Goodwin Procter's New York office regarding compliance with anti-money laundering ("AML") and Office of Foreign Assets Control ("OFAC") laws and regulations. The panelists from Goodwin Procter were Satish Kini, a partner in the firm's Financial Services Practice, and Rich Strassberg, Chair of the firm's White Collar Crime & Government Investigations Practice.

The Goodwin and Navigant panelists offered a variety of observations regarding the evolving nature of AML/OFAC compliance. To begin with, they noted that regulatory expectations for AML/OFAC compliance have changed in the seven years since the USA Patriot Act was initially enacted. Whereas in the past, regulators – and, particularly, the securities regulators – focused on whether financial institutions had written policies and procedures for AML/OFAC compliance, today, the focus is on effective *implementation* of those policies and procedures. Accordingly, institutions need to focus on matters such as training and communications (both from the top-down and bottom-up), governance structures, documentation, and systems integration.

In addition, the panelists noted that managing regulatory relationships must be viewed as a fundamental part of a well-functioning AML/OFAC compliance program. Using examples from recent enforcement actions, the panelists noted that institutions that fail to appreciate regulatory concerns and pressures may face regulatory skepticism that can complicate compliance efforts.

*Implementing Risk-Based AML/OFAC Programs.* The panelists observed that a key element in a well-functioning compliance program is an adequate consideration of the AML/OFAC risks posed to an institution. The panelists suggested that firms have a dynamic process to identify and manage risks presented by their specific product lines, their customer base, and the geographic reach of their operations. Institutions with enterprise-wide compliance programs were advised to assess risks both within business lines and on a consolidated basis. The best compliance programs, the panelists noted, have a feedback loop within the institution to monitor shifting risks.

The panelists also described risk-assessment pitfalls that they have observed. For example, they noted the need to avoid generic, off-the-shelf risk assessments; self-serving risk assessments; and risk assessments that fail to ask the right questions, are inadequate in scope, poorly documented, divorced from mitigation controls, or lack follow-through.

*Developing an Enterprise-Wide Compliance Program.* The panelists observed that regulators applaud corporate governance frameworks that provide a consolidated understanding of an organization's risk exposure to money laundering and terrorist financing. The panelists discussed the ways in which such a risk management framework can be established, including by taking into account the organization's risk exposure across all activities, business lines, and legal entities. The panelists advised that, in order to develop enterprise-wide compliance programs, management needs to play an active role in oversight, create a line of accountability, develop open lines of communication, and empower compliance professionals with the authority and flexibility to implement the program. Institutions also need to respond to changes in their business and develop common vocabularies across businesses (and between business and compliance) with regard to risk.

*Addressing and Managing Problems.* Finally, the panelists considered what to do when compliance problems arise. The panelists noted that one step may be an internal investigation to allow the firm to know the relevant facts and to demonstrate to regulators a proactive posture in addressing any problems. In this regard, the panelists noted that regulators often provide credit to institutions that self-report issues and remedy deficiencies prior to regulatory directives to do so.

Interested readers may request copies of the PowerPoint presentations from the breakfast session by contacting Satish Kini ([skini@goodwinprocter.com](mailto:skini@goodwinprocter.com); 202-346-4313).

### ➤ **Ninth Circuit Rules Against FDIC on Capital Guarantees by Parent Company of Federally Insured Bank**

The US Court of Appeals for the Ninth Circuit (the "Ninth Circuit") ruled against the FDIC on certain issues in a bankruptcy case in which the FDIC sought to collect on a guarantee by Imperial Credit Industries ("Imperial"), the bankrupt holding company for Southern Pacific Bank ("SPB"), of SPB's performance of a capital restoration plan. The FDIC demanded that Imperial pay its \$18,375,800 obligation under the guarantee after SPB failed to implement its capital plan. The case is *Wolkowitz v. Federal Deposit Insurance Corporation (In re: Imperial Credit Industries Inc.)*, No. 05-56072 (9<sup>th</sup> Cir. June 4, 2008). A central fact impacting the Ninth Circuit's decision was that Imperial converted from Chapter 11 bankruptcy to Chapter 7 bankruptcy during the course of litigation.

The issues on which the Ninth Circuit ruled against the FDIC were that (1) the district court erred in dismissing Imperial's claim that the performance guaranty was a fraudulent conveyance, and (2) the FDIC's claim for the \$18,375,800 was entitled only to ninth priority in a Chapter 7 proceeding rather than administrative priority. These two issues are discussed in turn below.

The Ninth Circuit declined to find Imperial's fraudulent conveyance claim barred for either of two reasons. First, the Ninth Circuit found that the claim could not be dismissed as a "trustee defense" that may only be brought by debtors who have cured their deficits to federal depository institutions as required under 11 U.S.C. §365(o), because the obligation to immediately cure deficits applies only to Chapter 11 proceedings and not Chapter 7 proceedings. In addition, the Ninth Circuit found that the

district court had erroneously interpreted 12 U.S.C. §1828(u)(1) in holding that the section did not make a distinction between assets and obligations. Rather, the Ninth Circuit found that there was such a distinction, and that §1828(u)(1) only prohibits bringing fraudulent conveyance claims against federal banking agencies based on transfers of assets. The Ninth Circuit rejected the FDIC's policy argument that limiting §1828(u)(1) to transfers of assets would render performance guarantees effectively unenforceable against insolvent parent companies of federally insured banks. It noted that it was only deciding on the issue of whether the fraudulent conveyance claim survived dismissal, not whether it would prevail on the merits and that the next step would be to determine whether the performance guaranty was a fraudulent conveyance.

As a result of converting from Chapter 11 to Chapter 7 bankruptcy, Imperial was able to avoid its obligation to immediately pay the \$18,375,800 to the FDIC under 11 U.S.C. §365(o). The Ninth Circuit noted that §365(o) mandates immediate payment of deficits to federal depository institutions as a condition to Chapter 11 bankruptcy. If the debtor cannot meet this condition, then it cannot benefit from Chapter 11 reorganization, but must proceed to Chapter 7 where the status of unsatisfied obligations to federal depository institutions under §365(o) would have whatever status was accorded to them under Chapter 7. The Ninth Circuit held that the FDIC's claim came within the section granting ninth priority (§507(a)(9)) for several reasons: (1) because the section has specific language about capital commitments; (2) because it was not an actual, necessary cost of preserving Imperial's estate and so not within the more general section according administrative priority; (3) because to hold otherwise would result in different outcomes for debtors who filed for Chapter 11 and converted to Chapter 7 from those who filed for Chapter 7 initially; and (4) because the only consequence of failing to immediately cure under §365(o) is that the debtor is prohibited from proceeding under Chapter 11, and not that the claim gets superpriority.

The FDIC is in the process of studying the ruling and has not yet commented on the decision.

### ➤ **FINRA Files Proposed Amendments to NASD Rule 2821 Governing Variable Annuity Sales and Exchanges**

The Financial Industry Regulatory Authority ("FINRA") has filed with the SEC proposed rule changes to NASD Rule 2821, which establishes suitability, supervisory and training requirements for sales and exchanges of deferred variable annuities. The Rule has been covered in three previous *Alerts*: September 18, 2007 (initial Rule requirements); November 20, 2007 (interpretive guidance); and April 29, 2008 (effective date delay).

The proposed amendments respond to various comments submitted after the SEC and FINRA approved the initial version of Rule 2821. The FINRA filing addresses three key points. First, FINRA proposes to amend the rule so it applies only to *recommended* purchases and exchanges of deferred variable annuities and *recommended* initial subaccount allocations. The industry had objected to the requirement in the initial Rule that non-recommended transactions be subject to the new suitability and principal review obligations. Second, FINRA proposes to modify the beginning of the seven-business-day period for principal review. Under the proposal, the period would begin to run from the date the broker-dealer's office of supervisory jurisdiction receives a complete and correct copy of the application (rather than from the date of the customer's signature on the application). Third, FINRA proposes to add a "supplementary materials" section following the Rule to provide guidance on certain implementation issues, including the holding of funds during the principal review process and the use of insurance company suspense accounts.

The SEC has not yet issued a release setting forth the proposed changes. FINRA proposes that the effective date of the proposed Rule changes would be 120 days following the publication of a FINRA Regulatory Notice announcing SEC approval.

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## *Other Item of Note*

### ➤ **FINRA Shares Examination Priorities and Frequently Found Deficiencies**

FINRA issued a publication detailing its examination priorities and deficiencies frequently cited in its examination program. The list of examination priorities includes the following: (1) anti-money laundering, (2) protection of customer information, (3) supervision and supervisory controls, (4) sales of new or non-conventional products, (5) transaction reporting, (6) business continuity planning, (7) bank sweep programs, (8) agency lending disclosure and (9) the Order Audit Trail System. Many of these same topics are covered in the listing of frequently found deficiencies, which provides additional information on compliance requirements for each area. The other topics covered in the frequently found deficiencies section include the following: (a) changes in account name or designation, (b) time and price discretion, (c) net capital, (d) customer protection, and (e) operational effects of transaction processing on books and records, net capital and customer protection compliance.