

regulatory data. Actual leverage was higher for the largest bank holding companies and investment banks when off-balance sheet commitments, including credit derivative exposures, were included.

23. Pozsar (2008). Leverage will be the subject of a future FCIC staff report.
24. Federal Reserve Board of Governors, Commercial Bank Examination Manual, October 2009, § 2030.1, page 12.
25. At the end of 2007, deposits comprised 72% of liabilities at commercial banks and thrifts. Retail deposits have been backed by the Federal Deposit Insurance Corporation (FDIC) since the banking runs of the 1930s. Each depositor is guaranteed to receive the full amount of his or her deposit up to \$250,000 (increased during the current financial crisis from \$100,000), regardless of the solvency of a commercial bank or savings institution. The figures cited do not include deposits at credit unions which are insured by the National Credit Union Share Insurance Fund.
26. Note that thrifts owned by investment banks could access the Discount Window but those funds could not be used to support the parent company or any other subsidiary of the parent. The shadow banking system also did not have access to the lender-of-last-resort function of the Federal Home Loan Bank (FHLB) system, which issues federally guaranteed debt to purchase mortgages from savings and loan (thrift) institutions. During the second half of 2007, the FHLB system purchased \$235 billion in mortgages from the thrifts when the securitization market froze. See Ashcraft, Bech, and Frame (2008).

SEC/SRO Update

SEC & CFTC Jointly Address Emerging Regulatory Issues; SEC Charges Two Florida Residents for Unlawful Short Selling; SEC Proposes New Rules Designed to Minimize Market Disruption; Potential SEC Investigation of Moody's Investor Services; Penalties Reduced in Return for Cooperation in Recent Enforcement Actions

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SEC & CFTC Jointly Address Emerging Regulatory Issues

On May 11, Securities and Exchange Commission Chairman Mary Schapiro and Commodity Futures Trading Commission Chairman Gary Gensler announced the formation of the “Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues.”¹ The establishment of the Joint Committee was one of the 20 recommendations included in the harmonization report issued by the two agencies last year.² The Joint Committee will develop recommendations on emerging and ongoing regulatory issues relating to both agencies.

The first item on the Joint Committee’s agenda is conducting a review of the May 6 “2010 Flash Crash” market events and making recommenda-

tions related to market structure issues that may have contributed to the volatility, as well as disparate trading conventions and rules across various markets.³ During the 2010 Flash Crash, the Dow Jones Industrial Average had its second largest point swing of approximately 1,010 points, and the biggest one-day point decline, 998.5 points, on an intraday basis in its history.⁴ Other U.S. markets were subject to similar extremely high levels of volatility.⁵ According to the press release, “the staff of the SEC and CFTC will provide to the Committee on Monday [May 17] their joint preliminary findings regarding [May 6th’s] market events.”

The Committee’s charter provides for a broad scope of interest, including:

- Identifying of emerging regulatory risks;
- Assessing and quantifying of the impact of such risks and their implications for investors and market participants; and
- Furthering the SEC’s and CFTC’s efforts on regulatory harmonization.

Chairman Schapiro and Chairman Gensler will serve as cochairs of the Joint Committee. Members of the Joint Committee include, with additional members to join in coming days, Brooksley Born, Former Chair of the CFTC; Jack Brennan, Former Chief Executive Officer and Chairman, Vanguard; Robert Engle, the Michael Armellino Professor of Finance at the NYU Stern School of Business; Richard Ketchum, Chairman and Chief Executive Officer, FINRA; Maureen O’Hara, Professor of Management, Professor of Finance, Cornell University; Susan Phillips, Dean and Professor of Finance, The George Washington University School of Business; and David Ruder, former Chair of the SEC.

SEC Charges Two Florida Residents for Unlawful Short Selling

On May 11, the SEC charged two Boca Raton, Florida, residents whom the SEC alleged were “engaging in illegal short selling of securities in advance of participating in numerous secondary offerings to make illicit profits.”⁶

According to the press release, these actions mark the first enforcement actions brought by the SEC under Rule 105 of Regulation M against individuals with no securities industry background. Rule 105 seeks to prevent abusive short selling and market manipulation. Effective October 2007, the SEC amended Rule 105 to seek to prevent short selling ahead of offerings that could reduce the proceeds received by public companies and their shareholders by artificially depressing the market price shortly before the company prices its offering. The revised rule generally prohibits the purchase of offering shares by any person who sold short the same securities within five business days before the pricing of the offering.

In separate orders issued by the Commission, the first resident was charged with repeatedly violating Rule 105 over a period of more than two years for gains of \$636,123. The second resident was charged with similarly violating Rule 105 for gains of \$331,387. According to the orders, they each engaged in a strategy of participating in numerous secondary offerings of stock in public companies via multiple brokerage accounts in order to improve their access to initial public offerings underwritten by the same broker-dealers through which they participated in the secondary offerings.

In settling the SEC’s charges without admitting or denying the SEC’s findings, each party separately consented to cease and desist from violating Rule 105, and the parties agreed to pay a combined total of more than \$1.5 million.

SEC Proposes New Rules Designed to Minimize Market Disruption

On May 18, the SEC “announced that in response to the market disruption on May 6 (the date on which approximately 30 S&P 500 Index stocks fell at least 10% in a ten-minute period), the national securities exchanges and the Financial Industry Regulation Authority (FINRA) are filing proposed rules under which the exchanges would pause trading in certain individual stocks if the price moves 10% or more in a five-minute period.”⁷

Chairman Schapiro stated that the SEC continues “to believe that the market disruption of May 6 was exacerbated by disparate trading rules and conventions across the exchanges.” Accordingly, to avoid disparate trading rules going-forward, the exchanges are proposing the new rules in consultation with FINRA to provide for uniform market-wide standards for individual securities that experience a rapid price movement.⁸

The proposed rules will be available on the SEC’s Web site as well as the Web sites of each of the exchanges and FINRA. The SEC intends to promptly publish the proposed rules for a 10-day public comment period, and determine whether to approve them shortly thereafter. Following the comment period and SEC approval, the SEC intends to launch the new rules on a pilot basis through December 10, 2010.⁹

During the pilot period, the SEC staff will “consider ways to address the risks of market orders and their potential to contribute to sudden price moves, as well as to consider steps to deter or prohibit the use by market makers of ‘stub’ quotes, which are not intended to indicate actual trading interest.”¹⁰ In addition, the “SEC staff also will continue to work with the exchanges and FINRA to improve the process for breaking erroneous trades, by assuring speed and consistency across markets.”¹¹

Potential SEC Investigation of Moody’s Investor Services

On May 7, Moody’s Corp., the parent of credit rating agency Moody’s Investor Services, disclosed that the SEC sent the company a “Wells Notice”¹² (often construed as a sign that the SEC is considering legal action against a company). Moody’s disclosed that the SEC is “considering recommending that the [SEC] institute administrative and cease-and-desist proceedings against Moody’s Investor Services in connection with its initial June 2007 application to register as a nationally recognized statistical rating organization.”¹³

“The SEC has informed Moody’s that the recommendation it is considering is based on the theory that Moody’s Investor Services’ description of

its procedures and principles were rendered false and misleading as of the time the application was filed with the SEC in light of the Company’s finding that a rating committee policy had been violated.”¹⁴ Moody’s Investor Services “disagrees with the SEC that the violation of a company policy by a company employee renders the policy itself false and misleading and has submitted a response to the Wells Notice explaining why its initial application was accurate and why it believes an enforcement action is unwarranted.”¹⁵

The entire credit rating industry has come under scrutiny since the financial market problems began in part due to high ratings agencies placed on the credit-worthiness of securities and debt that eventually became worthless. The market for credit ratings is extremely tight with the top three firms controlling roughly 94% of the market. Moody’s Investor Service controls about 40% of the credit rating market, and its largest rival, Standard & Poor’s, also holds 40%. Third-ranked Fitch Ratings has about a 14% market share.

Penalties Reduced in Return for Cooperation in Recent Enforcement Actions

On April 19, the SEC announced that U.S. District Judge Jed S. Rakoff, for the Southern District of New York, issued an order approving a settlement with Schottenfeld Group, LLC in *SEC v. Galleon Management, LP, et al.*,¹⁶ an insider trading case the SEC filed on October 16, 2009.¹⁷ Separately, the SEC and Schottenfeld Group settled the action titled, *SEC v. Cuttillo et al.*,¹⁸ pending before U.S. District Judge Richard J. Sullivan, for the Southern District of New York.¹⁹

In each of the foregoing cases, the SEC submitted and the courts approved settlements that included a civil penalty representing 50% of the disgorgement amount, a discount from a one-time penalty, in recognition of Schottenfeld Group’s agreement to cooperate in the Commission’s investigation.²⁰ The penalties approved in each of the cases represents a departure from the SEC’s historic practices of securing a “one-time” penalty equal to the amount of disgorgement.

The settlement suggests a willingness on the part of the SEC to lessen disgorgement fees in insider trading cases in return for cooperation. However, as some practitioners have noted, the “cases do not articulate what the cooperation entailed (or promised for the future), or by what criteria the SEC determined that the appropriate discount level was 50%.”²¹

NOTES

1. SEC Press Rel. No. 2010-75 (May 11, 2010), available at <http://www.sec.gov/news/press/2010/2010-75.htm>. See also SEC Rel. No. 33-9123 (May 10, 2010), available at <http://www.sec.gov/rules/other/2010/33-9123.pdf> (notice of federal advisory committee establishment).
2. See *A Joint Report of the SEC and the CFTC on Harmonization of Regulation* (Oct. 16, 2009), available at <http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf>.
3. The SEC issued several press releases since May 6 on the topic of interagency regulation and coordination. e.g., SEC Press Rel. No. 2010-74 (May 10, 2010), available at <http://www.sec.gov/news/press/2010/2010-74.htm> (in which Chairman Schapiro states that she “had a constructive meeting with the leaders of six exchanges—the New York Stock Exchange, NASDAQ, BATS, Direct Edge, ISE, and CBOE—and the Financial Industry Regulatory Authority to discuss the causes of Thursday’s market events, the potential contributing factors, and possible market reforms.”); SEC Press Rel. No. 2010-73 (May 7, 2010), available at <http://www.sec.gov/news/press/2010/2010-73.htm> (in which the SEC and CFTC jointly stated, among other things, “[S]ince yesterday, we have been in regular contact with other financial regulators and our respective exchanges. We also have been in touch with our foreign counterparts around the world.”); and SEC Press Rel. No. 2010-72 (May 6, 2010), available at <http://www.sec.gov/news/press/2010/2010-72.htm> (in which the SEC and CFTC jointly stated, among other things, that they “are working closely with the other financial regulators, as well as the exchanges, to review the unusual trading activity that took place briefly this afternoon.”).
4. See “Dow’s Dizzying Drop Was Scary, Surreal—Traders (Reuters, May 6, 2010) available at <http://www.reuters.com/article/idUSN0613266120100507>.
5. Reuters, May 6, 2010.
6. SEC Press Rel. No. 2010-76 (May 11, 2010), available at <http://www.sec.gov/news/press/2010/2010-76.htm>. See also *In re Adams*, SEC Rel. No. 34-62072 (May 11, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-62072.pdf>; *In re Grabler*, SEC Rel. No. 34-62073 (May 11, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-62073.pdf>.
7. SEC Press Rel. No. 2010-80 (May 18, 2010), available at <http://www.sec.gov/news/press/2010/2010-80.htm>.
8. SEC Press Rel. No. 2010-80.
9. SEC Press Rel. No. 2010-80.
10. SEC Press Rel. No. 2010-80.
11. SEC Press Rel. No. 2010-80.
12. See Moody’s Corp. Form 10-Q for the quarter ended March 31, 2010, as filed with the SEC on May 7, 2010.
13. Moody’s Corp. Form 10-Q.
14. Moody’s Corp. Form 10-Q.
15. Moody’s Corp. Form 10-Q.
16. *SEC v. Galleon Management, LP, et al.*, 09-CV-8811 (S.D.N.Y.).
17. Litigation Release No. 21493 (April 20, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21493.htm>.
18. *SEC v. Cutillo et al.*, 09-CV-9208.
19. Litigation Release No. 21493.
20. Litigation Release No. 21493.
21. See <http://www.thecorporatecounsel.net/Blog/2010/04/goldman.html>; see also Wayne Carlin, Ted Levine, and Kevin Schwartz, “SEC Agrees to Reduce Penalties in Exchange for Cooperation,” April 22, 2010, available at <http://www.thecorporatecounsel.net/Blog/2010/04/goldman.html>.