

## Legal Updates & News

### Legal Updates

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#### I Heard It Through the Grapevine

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John Tudor, former pitcher for the St. Louis Cardinals, once said, “A rumor without a leg to stand on will get around some other way.” But when it comes to the securities markets, the SEC recently proclaimed that if a broker-dealer’s or investment advisor’s lax policies allow a rumor to “get around some other way,” the firm could pay through an enforcement action.

On July 13, 2008, the SEC announced its intention to conduct immediate examinations to determine whether entities’ supervisory and compliance controls are reasonably designed to prevent potentially manipulative conduct, such as the intentional creation or spreading of false information intended to affect securities prices. Chairman Cox said that “[t]he examinations . . . are aimed at ensuring that investors continue to get reliable, accurate information about public companies in the marketplace.” The examinations will be conducted by the SEC’s Office of Compliance Inspections and Examinations, FINRA, and NYSE Regulation, Inc.

This is not the first regulatory foray into the rumor mill. In March 2008, FINRA announced that it, NYSE Regulation, Inc., and the Options Regulatory Surveillance Authority would coordinate efforts to heighten the monitoring and investigation of trading activity of issuers that may be subject to credit market-related volatility. FINRA then warned that “intentionally spreading false rumors or engaging in collusive activity to impact the financial condition of an issuer will not be tolerated and will be vigorously and aggressively investigated.”

Firms preparing for an examination should review their supervisory and compliance controls over communications by firm personnel. Because manipulative activity such as spreading rumors typically requires dissemination to numerous third parties, firms should particularly focus on controls over representatives’ mass communications with outside personnel. Mass communications methods – such as fax, email, and instant messages – pose particular compliance risks and, thus, should be a compliance focus. In addition, regulators will favorably view comprehensive training on avoiding the spread of rumors.

Although currently focused on monitoring and examining firms, the increased regulatory interest could blossom into enforcement actions against firms as well. Numerous provisions of the securities laws and attendant regulations prohibit the circulation of false or misleading rumors. *See, e.g., NASD Rule 5120(e) / NYSE Rule 435(5); NASD Rule 2110 / NYSE Rule 476; Exchange Act §§ 9(a) and 10(b); Securities Act § 17(a); and IAA § 206.* Thus, to help keep an examination from becoming an enforcement matter, broker-dealers and investment advisors are well-advised to ensure tight internal controls and procedures in this area.

The SEC this year has already demonstrated its willingness to pursue enforcement on these issues. In April 2008, the SEC settled with Paul S. Berliner, a trader formerly associated with Schottenfeld Group, LLC, for alleged securities fraud and market manipulation. The SEC accused Mr. Berliner of spreading a false rumor about a lower takeover price for a company, which he disseminated through

instant messages to traders at brokerage firms and hedge funds. Mr. Berliner short-sold the company's stock and profited when, within 30 minutes of sending the false rumor, the company's share price fell significantly. Among other things, Mr. Berliner agreed to disgorgement of \$26,129, a third-tier civil penalty of \$130,000, and a permanent bar from associating with any broker-dealer. See *Litigation Release No. 20537 (April 24, 2008)*. On July 15, 2008, Chairman Cox also stated that other investigations have been underway for the past several months.

Rumors have a long history on Wall Street, and the SEC's recent announcement comes at a time of great uncertainty in the markets. Among other things, the recent demise of a large financial firm has popularly been blamed on false rumors. More recently, a multitude of rumors have circulated about established mortgage and financial companies, with each suffering falling share prices. In light of the increased regulatory focus on the spread of rumors, compliance officers should take steps to prevent the next legless rumor from finding wheels at their firms.