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SEC Announces New Examinations Focusing on Stock Manipulation

The SEC took the unusual step yesterday of issuing a Sunday press release to announce that the agency will immediately begin conducting examinations aimed at preventing the "intentional spread of false information intended to manipulate securities prices." The SEC made this announcement at least partly in reaction to recent stock price declines experienced by several companies in the financial sector.

According to the release, the examinations will be conducted by OCIE (and simultaneously by the Financial Industry Regulatory Authority and New York Stock Exchange Regulation, Inc.) and will focus on supervisory and compliance controls by investment advisers and broker-dealers with respect to the prevention of market manipulation. In particular, examiners will look at whether supervisory and compliance controls are reasonably designed to "prevent the intentional creation or spreading of false information intended to affect securities prices, or other potentially manipulative conduct." The press release also notes that this undertaking will provide examiners the opportunity to double-check that advisers and broker-dealers "have appropriate training for their employees" and "sturdy controls in place to prevent intentionally false information from harming investors." A full copy of the press release can be found at: http://www.sec.gov/news/press/2008/2008-140.htm.

We expect OCIE will conduct inspections on this issue through "sweep examinations." In a sweep examination, the SEC staff typically looks at only one or a few targeted issues and may conduct the inspection through on-site visits or possibly only through document requests. With regard to investment adviser practices, we are not aware that asset managers typically have specific or detailed policies and procedures for addressing the intentional creation or spreading of false information intended to affect securities prices. In our experience, this issue is typically addressed with a brief statement in an adviser's policies and procedures on general trading restrictions or in policies and procedures addressing insider trading. Moreover, we are not aware of specific control procedures or "forensic tests" that the SEC expects asset managers to have in place to address this issue. As a result, the examinations may result in deficiency letters or the OCIE staff providing additional suggestions for improvement.

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In the meantime, we suggest that investment advisers consider taking the following steps:

1. Review policies and procedures to ensure that they address the prohibition on the intentional creation or spreading of false information intended to affect securities prices and other manipulative conduct. If not, consider updating the policies and procedures to specifically address this point.

2. Send employees a prompt reminder, either in an email or a memorandum, regarding the prohibition on the intentional creation or spreading of false information intended to affect securities prices and manipulative conduct generally.

3. Update the firm's compliance training program to add a segment that specifically addresses the prohibition on the intentional creation or spreading of false information intended to affect securities prices and manipulative conduct generally.

The SEC's Enforcement Division has also shown an interest in this area. The SEC recently brought a settled enforcement action against a trader formerly associated with a broker-dealer, Schottenfeld Group, LLC, alleging that the trader engaged in securities fraud and market manipulation in connection with a pending acquisition. More specifically, the SEC alleged that the trader disseminated a false rumor that the board of directors of the potential acquiring company was meeting to consider a revised proposal to acquire the target company at a price significantly lower than a previously announced acquisition price. The SEC further alleged that (1) the trader disseminated the false rumor through instant messages to a number of individuals, including those at brokerage firms and hedge funds; (2) heavy trading in the target company's stock ensued and the price of the stock plummeted in intraday trading; and (3) the trader profited from spreading the false rumor by short selling the target stock at the same time he was disseminating the false rumor and covered the short sales when the price of the target stock began to decline. *See* *SEC v. Paul S. Berliner*, Litigation Release No. 20537 (Apr. 24, 2008).

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