

Options backdating is to CLOs as financial restatements were to CFOs. And in both situations, it's not pretty. Those of us who are even semiconscious have noticed that the CLOs are taking the fall in the options cases. Why and how bad is it?

We all know that the SEC publicly stepped up its scrutiny of in-house counsel, whom it has come to regard as corporate "gatekeepers" or "sentries of the marketplace,"¹ and that since 2002 there has been a marked increase in civil enforcement actions and criminal prosecutions brought against in-house counsel. But the focus was usually elsewhere—the CEO, the COO, or the CFO.

Stock-option backdating cases are somewhat different.

In-house Counsel and Backdating: What Will They Criminalize Next?

BY JOHN K. VILLA

For the benefit of Rip Van Winkle, let's review backdating. Backdating an options grant is not, per se, illegal. It becomes problematic when a backdated option grant results in value to the recipient because the exercise price of the option is below the share price on the day it is granted, and is not properly accounted for as a compensation expense.² And it becomes a serious problem when the actor knew that it should have been disclosed and it was not. Many, however, were ignorant of this accounting rule. Not recognizing the necessity to reflect options-backdating on the financial statements, it was seen by many executives as a benign means of rewarding employees. Couple that with the relative obscurity of options-backdating as a risk factor until the

last several years, and we have a fairly widespread practice—and problem.

The genesis of the problems for most in-house counsel is their central involvement in the stock-options process. Options backdating cases have shown that in-house counsel often oversee the stock option process, prepare minutes of key board or committee meetings, and, of course, review the public filings.³ That leads to trouble when the options-backdating problem hits. Of the approximately 13 in-house counsel charged with civil and/or criminal violations of the securities laws since July of 2006,⁴ more than half have been charged with participating in unlawful stock-options backdating schemes.⁵ And, with the large number of investigations still underway, it is certain that this figure will increase sharply.⁶

So what are the allegations against in-house counsel? Why have some, but not all of this group, been charged criminally as well as civilly? Let's take a look at the cases, starting first with those in which only civil enforcement proceedings have been initiated, and continuing with those in which both civil and criminal actions have been initiated against in-house counsel. This review is based on the *allegations* in government pleadings, and they often give an advocate's view of the facts.

SEC Civil Enforcement Proceedings

Of the seven in-house counsel charged with illegal stock options backdating, three are *not*, at least as of yet, subject to criminal prosecution but only to civil enforcement proceedings. In each of these three cases, all of which involve the company's general counsel, the SEC's allegations are similar: The general counsel participated in, and benefited from, the backdating of stock-option grants, understood the accounting implications for grants that were "in-the-money," prepared false documentation to support the authorization of the grant by the board or the pertinent committee, and prepared and/or reviewed the public filings containing the false information.

For example, in the case of the general counsel of Apple, Inc.,⁷ the SEC alleges that she engaged in two backdating incidents: one, involving a grant of \$4.8 million options to the company's executive team, which included the general counsel,⁸ and the second, involving a grant of \$7.5 million options to the company's CEO, which together caused the company to underreport its expenses by \$40 million.⁹ According to the SEC, the general counsel "caused" the company to backdate the options to the



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executive team by suggesting in emails to the CEO and CFO that an earlier date be used when the closing price for the company's stock was lower,¹⁰ and, upon the CEO's approval of the earlier date, by preparing the false paperwork that was submitted to the board for its authorization of the grant.¹¹ As to the backdated options grant to the CEO, the SEC alleges that the general counsel provided a three-month listing of closing prices to the compensation committee, and suggested that it pick a grant date on which the closing price was low and which corresponded to a date that the committee telephoned its members either individually or jointly.¹² Upon selecting a grant date, the SEC alleges that the general counsel created fictitious board minutes for a meeting that never occurred, at which the board purportedly approved the options grant, and signed the minutes in her capacity as corporate secretary.¹⁵ The SEC also alleges that the general counsel reviewed and/or assisted in the preparation of the financial statements and public filings that contained false information concerning the options grants.¹⁴

With respect to her knowledge of any wrongdoing in her actions, the SEC alleges that the general counsel "understood" the accounting implications of an "in-the-money" grant, and "knew" that the company would have to record as a compensation expense any such option grant.¹⁵

In the case of the general counsel of Mercury Interactive,¹⁶ a computer software manufacturer, the SEC alleges that the general counsel participated in a fraudulent stock-option backdating scheme that spanned a period of eight years¹⁷ and involved 45 different option grants.¹⁸ While the CEO and CFO were said to be primarily responsible for selecting option dates that coincided with low closing prices for the company's stock, and

for signing the unanimous consents reflecting the board's authorization of the grants,¹⁹ the SEC alleges that the general counsel assisted in selecting the dates and prepared false documentation memorializing the backdated grants,²⁰ including falsified unanimous written consents and meeting minutes, false SEC forms reporting the grants, and false proxy statements and quarterly and annual reports.²¹ According to the SEC, the general counsel "knew, should have known or acted in reckless disregard of the fact,

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that their backdating was generating unreported compensation expense" for the company.²² In support of this allegation, the SEC references certain notes taken by the general counsel at one board meeting, which purportedly show that the CFO explained that the company was opposed to "in-the-money" grants of stock options because of the fact that such a grant would result in a compensation charge for the company.²³ In addition, the SEC alleges that in subsequent merger discussions, the general counsel explained the accounting effect of granting options to new employees at below the then-market value of the company's stock.²⁴

Finally, the SEC alleges that for a period of six years, a lawyer routinely backdated stock options, first while serving as the general counsel of a manufacturer of semiconductor equipment, and then while serving as the general counsel of another company—a manufacturer of internet-re-

lated networking products.²⁵ According to the SEC, the general counsel devised the backdating scheme at her first company, instructed employees on how to backdate the options upon her departure, implemented the same scheme at her second company where she was responsible for overseeing the stock options program,²⁶ and personally benefited from the backdating schemes at both companies.²⁷

At her first company, the SEC alleges that the general counsel directed the human resources department and stock administration employees to prepare the grant approval paperwork, and directed the process for selecting the backdated date which was based on historical information as to the lowest closing price for the company's stock in the preceding weeks.²⁸ At her second company, the SEC alleges that the general counsel used the same backdating procedure, created stock option committee meeting minutes that falsely stated that the committee had met on the backdated date reflecting the low closing price and had approved the option, and signed the minutes as a member of the committee.²⁹ At both companies, the SEC alleges, the general counsel reviewed the companies' financial statements, public filings, and registration statements that contained materially false representations as to the companies' financial condition.³⁰

As to her knowledge of engaging in wrongful conduct, the SEC alleges that the general counsel knew or was reckless in not knowing, not only that the documentation for the various grants contained false information as to the date on which the options were actually granted, but also that such false information resulted in the companies' failure to record the "in-the-money" grants as a compensation expense.³¹ In support of these allegations, the SEC alleges that the general counsel, when questioned

about whether using a prior date with a lower cost would prevent the company from passing the audit test that prohibited the setting of a date in the past in order to get a better price, acknowledged that she understood the issue, but allowed use of the backdated grant date without appropriately accounting for the “in-the-money” grant.³² In addition, the SEC alleges that the general counsel participated in conference calls and communications discussing the accounting rules relating to stock option grants, and wrote a memorandum in which she acknowledged that repricing stock options by selecting an earlier grant date when the price was lower would require the company to take “a charge to its P&L.”³³

All three of these civil enforcement actions remain pending, with each general counsel contesting the SEC’s charges.³⁴

Criminal Proceedings

In the remaining backdating cases,³⁵ the GCs of three public companies face *both* civil and criminal liability for their role in backdating schemes.

In the first federal stock-options backdating case filed against an in-house counsel, the government alleged that the former general counsel of Converse Technology, together with its CEO, orchestrated a decades-long backdating scheme that resulted in a personal profit of more than \$14 million after his exercise of the options and sale of the stock.³⁶ According to the civil complaint, the CEO directed and controlled the backdating scheme and was responsible for “cherry-picking” the grant dates by looking back at the company’s historical stock prices and choosing a date that corresponded with a low closing price. However, the general counsel, who also served as a director and as corporate secretary,³⁷ “played a critical role” in the scheme

by drafting, or directing his assistant to draft, the approval documents containing the false grant dates and by obtaining the compensation committee’s approval of the grants.³⁸ The complaint alleges that the general counsel, as liaison to the compensation committee, knew, or was reckless in not knowing, that no corporate action had taken place on the purported grant date because the compensation committee had neither signed nor received the approval documents on that date.³⁹ The complaint further alleges that the general counsel not only drafted the company’s stock option plan, which provided that no option could have an exercise price that was less than the fair market value of the company’s common stock on the date of the grant,⁴⁰ but also reviewed and signed the company’s public filings and other financial statements which falsely represented that all options had been granted at exercise prices equal to fair market value on the date of grant and that no compensation expense had been recognized by the company.⁴¹

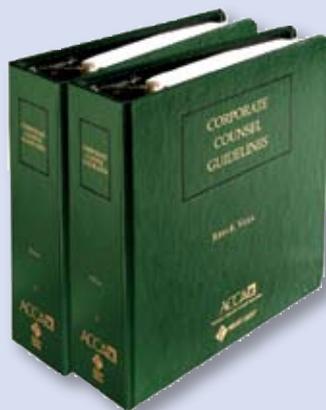
In November of 2006, the former GC of Converse Technology pled guilty to one count of conspiracy to

commit securities fraud, mail fraud, and wire fraud, admitting that he conspired to conceal the unlawful stock-options backdating scheme and approved false SEC filings and proxy statements.⁴² Subsequently, the general counsel settled the civil enforcement action, without admitting or denying the allegations of the SEC’s complaint.⁴³

In the next options backdating case in which an in-house counsel was charged both civilly and criminally, the government alleged that the former general counsel of a job website’s parent company, Monster Worldwide, Inc., participated in a scheme that spanned a seven-year period and resulted in the company’s overstatement of approximately \$340 million in income,⁴⁴ and the receipt of both financial and professional benefits by the general counsel.⁴⁵ According to the government, most of the stock option grants that were made between 1996 and 2003 were “in the money” grants because they were based on fictitious grant dates that had been selected by senior officers to coincide with the date of the lowest price

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for the company's common stock.⁴⁶ The complaint alleged that the GC was responsible for maintaining the options grant documentation, such as the unanimous written consents executed by the compensation committee in approving the grants, and knew, or was reckless in not knowing, that the consents were false because the purported grant date was not the actual grant date, and that the compensation committee had not authorized the option grant on the date set forth in the consents.⁴⁷ The complaint further alleged that in order to conceal the backdating, the general counsel sometimes discarded certain records that reflected the actual grant process.⁴⁸ In addition to participating in the backdating scheme, the government alleged that the general counsel participated in preparing and/or reviewing the company's periodic SEC filings and other financial statements which he knew, or was reckless in not knowing, contained materially false and misleading information as to the company's stock-option grants.⁴⁹

With respect to his knowledge of the accounting requirements for stock-option grants, the government alleged that the general counsel "understood" that backdating options to a date coinciding with a low stock price required the company to recognize a compensation expense in its financial records.⁵⁰ In support of this allegation, the government relied on an email sent by the general counsel to the human resources department in which he cautioned that, "[n]o written document should ever state lowest price over next 30 days" since the auditor would view that as backdating "and we'll have a charge to earning in the amount of the difference between price on day 30 and any lower price which is used."⁵¹ The government also relied on an email forwarded to the general counsel in which a finance department employee refused to ap-

prove a backdated grant where no compensation expense was recorded in the accounting for the grant.⁵²

On February 15, 2007, the former GC of Monster Worldwide pled guilty to one count of conspiracy to commit securities fraud, make false statements in SEC filings, make false statements to auditors, and falsifying corporate books and records, and to one substantive count of securities fraud.⁵³ One month later, a final judgment was entered against him in the SEC's civil enforcement action.⁵⁴

In the third backdating case involving parallel civil and criminal proceedings brought by the federal government,⁵⁵ the government has charged the former general counsel of McAfee, Inc.,⁵⁶ with fraudulently backdating stock options on two occasions: one, in connection with an option grant to himself, and the other, in connection with a option grant to the company's CEO.⁵⁷ The government alleges that after being awarded an option to purchase 20,000 shares on February 14, 2000, the GC secretly, and without authorization, accessed the company's computerized internal system for the stock options program and changed the option grant date to a later date on which the closing price of the stock was lower than that on February 14.⁵⁸ Afterwards, the government alleges that the general counsel filed an initial beneficial ownership form with the SEC, which reported the false exercise price and the false expiration date of the option.⁵⁹ With respect to a stock-option grant to the CEO, the government similarly alleges that, after approval of the grant by the compensation committee, the general counsel unilaterally changed the grant date to the next day when the closing price was lower, and then prepared the minutes of the compensation committee meeting which falsely stated the date when the committee

had approved the grant.⁶⁰ The government further alleges that the general counsel prepared and signed proxy statements that contained false and misleading information and omitted material facts concerning the option grants to himself and the CEO, as well as to certain other employees.⁶¹

McAfee's former general counsel was indicted on two counts of mail fraud, one count of wire fraud, three counts of making false SEC filings, and one count of falsifying corporate books and records.⁶² Both the civil and criminal actions remain pending.

What Does This Mean for In-house Counsel?

What meaningful conclusions can be drawn from this small sample of cases in light of the far larger number likely to be in the pipeline?

- Backdating of stock options coupled with underreporting compensation expense is almost surely not enough to prompt criminal or even SEC action against an inside lawyer. If that were so, there would presumably be hundreds of cases on file already.
- For an enforcement action, there must be some or all of the following aggravating factors:
 1. substantial personal financial gain from the backdating;
 2. falsified documents;
 3. repeated violations;
 4. material impact on the financial statements;
 5. responsibility for review of the securities filings and public statements; and
 6. demonstrable understanding that options-backdating rendered the financial statements materially misleading by understating compensation expense.

Is every one of these factors present in each of the cases brought? No, but the allegations in government pleadings make it appear that *most*

are present. Whether the evidence backs this up remains to be proven (although we doubt it).

How does in-house counsel meaningfully distinguish between the instances that have resulted in only civil actions from those where there are also criminal charges? The answer probably lies in the strength of the evidence supporting the government's allegations of knowledge-of-wrong-doing or scienter. It is one thing to allege that the general counsel knew or should have known (or was reckless in not knowing), and another to prove knowledge beyond a reasonable doubt. History will probably show that the cases that have resulted in criminal charges had much stronger evidence that the lawyer understood that he or she was involved in improperly and materially understating compensation expense. Ironically, those cases where the practice was open and notorious within the company are more likely to reflect lack of scienter because of ignorance of the rules than those where elaborate cover-ups were developed. ❏

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NOTES

1. First characterized as gatekeepers in 2004 by the then-Director of the SEC's Division of Enforcement, see Stephen M. Cutler, Director, Division of Enforcement, SEC, "The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program," speech before UCLA School of Law (September 20, 2004), available at www.sec.gov/news/speech/spch092004smc.htm, this view as to the role of in-house counsel was more recently echoed by the chairman of the SEC who emphasized that corporate counsel are "crucial gatekeepers responsible for safeguarding shareholders' interest[.]" See Christopher Cox, chairman, SEC, "Address to the 2007 Corporate Counsel Institute," (Georgetown Law Center, March 8, 2007), available at www.sec.gov/news/speech/2007/spch030807cc.htm.
2. When the share price on the backdated option grant is lower than the price on the date on which it is actually issued, the grant must be recorded as a compensation expense in company books and public filings. See David Hechler, "The Dating Game: Five GCs have already been implicated in stock option backdating problems," 8/2006 *Corp. Counsel* (Mag.) 18.
3. See David B. Bayless and Tammy Albarin, "Recent SEC Enforcement Actions Against In-house Lawyers: An Ominous Trend for the Legal Profession," 17 No. 3 *Andrews' Prof. Liab. Litig. Rep.* 13 (August 30, 2007) (noting that "[i]t is unusual for these types of actions to be the subject of an SEC enforcement action for securities fraud.").
4. This figure, which itself is significant, does not reflect counsel who have been charged with insider trading or other conduct that is not substantively related to the function of an in-house lawyer.
5. Even if not charged, a record number of in-house counsel have resigned or have been fired from their positions, and several have been named as defendants in shareholder derivative actions. See D.M. Osborne, "The Great Plague," 8 *Corp. Counsel* (Mag.) 16 (December, 2006) (noting that "[n]othing in memory has ever caused as many GCs to lose their jobs as quickly as stock options backdating[.]" and reporting that, as of the date of publication, at least seven chief legal officers are defendants in shareholder derivative actions).
6. See Pamela A. MacLean, "Lawyers Flying Blind on Options Penalties," 8/25/07 *N.Y.L.J.* 5 (col. 3) (noting that 220 companies have been subject to internal and federal investigations for stock-options backdating).
7. See Complaint, *SEC v. Nancy R. Heinen and Fred D. Anderson*, No. 07-2214-HRL (LLOYD) (N.D. Cal. filed April 24, 2007).
8. The SEC alleges that the general counsel exercised her backdated options and reaped profits of \$1.6 million. See *id.* at ¶¶31-32.
9. *Id.* at ¶ 1.
10. *Id.* at ¶¶16-18.
11. *Id.* at ¶¶19-20 (further alleging that the general counsel directed a lawyer in the legal department to prepare a unanimous written consent for the board members' signature, using the backdated date as the effective date when, in fact, no board action had taken place on that date).
12. *Id.* at ¶ 38.
13. *Id.* at ¶¶41-45 (also alleging that the general counsel caused the alteration of minutes of previously-held meetings and signed these altered minutes, thereby falsely attesting to their accuracy).
14. *Id.* at ¶¶24-28.
15. *Id.* at ¶ 29.
16. See Complaint, *SEC v. Mercury Interactive LLC (f/k/a/ Mercury Interactive, Inc.) et al.*, No. 07-2822 (RS) (N.D. Cal. filed May 31, 2007).
17. Before joining Mercury Interactive in 2000, the general counsel served as outside counsel for the coming between 1996 and 2000. See *id.* at ¶ 14.
18. *Id.* at ¶ 1.
19. *Id.* at ¶¶27-28.
20. *Id.* at ¶ ¶31, 36, 61-67, 75.
21. *Id.* at ¶¶36, 74, 79, 91,102, 112. Additionally, the SEC alleges that the general counsel unlawfully structured loans to overseas employees in order to enable those employees to exercise options prior to their vesting date, thereby minimizing the tax that some countries imposed on the company for the gain received upon the exercise of the option, and to avoid the variable accounting consequences that would otherwise be required for loans which were, in fact, non-recourse obligations. *Id.* at ¶¶131-144.
22. *Id.* at ¶ 41.
23. *Id.* at ¶ 42.
24. *Id.* at ¶ 43.
25. See Complaint, *SEC v. Lisa C. Berry*, No. C 07-4431 RMW (N.D. Cal. filed August 28, 2007).
26. *Id.* at ¶¶1, 33, 48.
27. *Id.* at ¶¶69-71.
28. *Id.* at ¶¶24-25.
29. *Id.* at ¶¶49-50, 56-60.
30. *Id.* at ¶¶36-40, 62-68. The SEC alleges that the general counsel caused her first company to overstate its net income for the years 1998-1999 by 47%, and caused her second company to overstate its income for 2003 by 22%. After restating its financial statements, the SEC alleges that the second company disclosed previously unreported compensation expenses amounting to almost \$900 million. See *SEC v. Lisa C. Berry*, No. C

- 07-4431 RMW (N.D. Cal.), Litigation Rel. No. 20257 (August 28, 2007).
31. Complaint, *SEC v. Lisa C. Berry*, No. C 07-4431 RMW, *supra*, at ¶¶35, 40, 61.
 32. *Id.* at ¶ 31.
 33. *Id.* at ¶ 33. The SEC also alleges the stock option plan at her first company specifically prohibited “in-the-money” grants, and, as general counsel, she signed registration statements that incorporated the stock option plan, as well as public filings that stated the company followed generally accepted accounting procedures (GAAP) with respect to the recording of stock option grants. *Id.* at ¶¶14-21.
 34. See Steven N. Machlinger and Kenneth f. Schacter, “Targeting GCs in Stock Options Backdating Actions,” 10/18/2007 N.Y.L.J. 24 (col. 5) (noting comments by the attorney for Apple’s former general counsel to the effect that her client had no responsibility for accounting and had no idea that the company operated in violation of the accounting rules); “Backdating: Are the Lawyers to Blame?,” 8/28/2007 *CFO Mag. For Senior Fin. Executives* 5 (reporting similar comments by the attorney for the former general counsel of KLA -Tencor and Jupiter).
 35. One state criminal action has been brought against a general counsel for unlawful stock-option backdating. See “Former Take-Two Official is Sentenced in Backdating Case,” 8/9/07 *N.Y. Times* C3 (reporting on the sentencing of the former general counsel of a computer software company in connection with the backdating of employee stock options: the former general counsel pleaded guilty to second-degree falsifying business records, a misdemeanor, and was sentenced to three years of probation).
 36. Complaint, *SEC v. Jacob (“Kobi”) Alexander, David Kreinberg, and William F. Sorin*, No. CV-063844 (GJ) (E.D.N.Y. filed August 9, 2006) at ¶ 7.
 37. *Id.* at ¶ 15 (the general counsel also served as a director of an affiliated company at which unlawful backdating also allegedly occurred).
 38. *Id.* at ¶¶34-41, 64-65.
 39. *Id.* at ¶¶43, 65.
 40. *Id.* at ¶¶19-28.
 41. *Id.* at ¶¶87-90, 92-101. It is also alleged that the general counsel made materially false and misleading statements to the company’s auditors in an effort to conceal the backdating scheme. See *id.* at ¶¶102-107.
 42. See United States Attorney’s Office, Eastern District of New York, Press Release (November 2, 2006) (“William F. Sorin, Former General Counsel of Comverse Technology Inc., Pleads Guilty to Securities Fraud Charge”).
 43. See *SEC v. Jacob (“Kobi”) Alexander, David Kreinberg, and William F. Sorin*, No. CV-063844 (GJ) (E.D.N.Y.), Litigation Rel. No. 19964 (January 10, 2007).
 44. See *SEC v. Myron F. Olesnyckyj*, No. 07 CV 1176 (HB) (S.D.N.Y.), Litigation Rel. No. 20004; Accounting and Auditing Enforcement Rel. No. 2558 (February 15, 2007); Office of the United States Attorney, Southern District of New York, Press Release (February 15, 2007) (Former General Counsel of Monster Pleads Guilty to Securities Fraud in Connection with Backdating of Stock Options).
 45. Complaint, *SEC v. Myron F. Olesnyckyj*, No. 07 CV 1176 (HB) (S.D.N.Y. filed February 15, 2007), at ¶¶55-57.
 46. *Id.* at ¶¶1, 14, 33-46.
 47. *Id.* at ¶¶29, 30.
 48. *Id.* at ¶¶31-32, 54.
 49. *Id.* at ¶¶58-81.
 50. *Id.* at ¶¶15, 48.
 51. *Id.* at ¶ 48.
 52. *Id.* at ¶ 53 (further alleging that the options were granted with the backdated date without taking a compensation expense).
 53. Office of the United States Attorney, Southern District of New York, Press Release, *supra*, n. 44.
 54. See *SEC v. Myron F. Olesnyckyj*, No. 07 CV 1176 (HB) (S.D.N.Y.), Litigation Rel. No. 20056; Accounting and Auditing Enforcement Rel. No. 2583 (March 27, 2007).
 55. *SEC v. Kent Roberts*, No. 07-CV-00407 (D. D.C.), Litigation Rel. No. 20020; Accounting and Auditing Rel. No. 2567 (February 28, 2007); Office of the United States Attorney, Northern District of California, Press Release (February 27, 2008) (Former McAfee General Counsel Indicted for Stock Options Backdating).
 56. The former general counsel also served as the company’s compliance officer with respect to SEC reporting rules, and was a founding member of the Ethics First Committee, which was responsible for investigating fraudulent conduct reported by employees. See Office of the United States Attorney, Northern District of California, Press Release, *supra*, n. 55..
 57. See *SEC v. Kent Roberts*, No. 07-CV-00407 (D. D.C.), Litigation Rel. No. 20020; Accounting and Auditing Rel. No. 2567 (February 28, 2007); Office of the United States Attorney, Northern District of California, Press Release, *supra*, n. 55.
 58. Complaint, *SEC v. Kent Roberts*, No. 07-CV-00407 (D. D.C. filed February 28, 2007), at ¶¶13-15.
 59. *Id.* at ¶ 16.
 60. *Id.* at ¶¶19-23.
 61. *Id.* at ¶¶25-37.
 62. Office of the United States Attorney, Northern District of California, Press Release, *supra*, n. 55.