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## **REPORT OF INVESTIGATION**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
OFFICE OF INSPECTOR GENERAL**

**Case No. OIG-522**

**Investigation of the Circumstances Surrounding the SEC's Proposed Settlements with Bank of America, Including a Review of the Court's Rejection of the SEC's First Proposed Settlement and an Analysis of the Impact of Bank of America's Status as a TARP Recipient**

**September 30, 2010**

## **REDACTION KEY**

LE = Law Enforcement/  
Interference with Enforcement Proceedings  
Protected by FOIA Exemption (b)(7)(A)

LEP = Law Enforcement Policy  
Protected by FOIA Exemption (b)(2)

DP = Deliberative Process Privilege  
Protected by FOIA Exemption (b)(5)

AC = Attorney-Client Privilege  
Protected by FOIA Exemption (b)(5)

WP = Attorney Work-Product Privilege  
Protected by FOIA Exemption (b)(5)

PII = Personal Identifying Information  
Protected by FOIA Exemptions (b)(6) & (b)(7)(C)

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#### **Introduction and Background**

On August 6, 2009, the Honorable Elijah E. Cummings, Member of Congress, U.S. House of Representatives (D-Maryland), sent a letter to the Securities and Exchange Commission ("SEC" or the "Commission") Office of Inspector General ("OIG") and to the Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") regarding the SEC's proposed \$33 million settlement with Bank of America ("BofA"), for false and misleading statements made in connection with its merger with Merrill Lynch & Co. ("Merrill"), filed in U.S. federal court on August 3, 2009. August 6, 2009 letter from the Honorable Elijah E. Cummings to SIGTARP and OIG, attached hereto as Exhibit 1. Specifically, Congressman Cummings referenced an attached August 4, 2009 *Washington Post* article that raised the following conflict of interest issues that could potentially arise from SEC Division of Enforcement ("Enforcement") actions against entities who, like BofA, were in receipt of Troubled Asset Relief Program ("TARP") funds:

- (1) the enforcement action may harm the firm's viability, and threaten systemic risk to the financial industry;
- (2) the fines levied would essentially be paid with taxpayer funds;
- (3) the fines would harm the shareholder investment in the firm, when the shareholder is the U.S. taxpayer; and
- (4) the role played by Federal Reserve or Treasury officials in the actions upon which fines were issued may have been significant to the occurrence of the violation but cannot be investigated by the SEC.

*Id.* Congressman Cummings asked the OIG and SIGTARP, respectively, to "investigate the extent to which the enumerated scenarios above existed in the case of *SEC v. Bank of America*, as well as the potential for future instances of the above conflicts . . . ." *Id.* at p.

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2. In response to Congressman Cummings, this office opened an official investigation on August 6, 2009 and, on August 20, 2009, the OIG and SIGTARP responded to Congressman Cummings by letter, stating that because SIGTARP and the SEC were still jointly investigating the circumstances of BofA's merger with Merrill, "independence questions could arise if SIGTARP were to lead or participate in a review of [the] SEC's settlement with Bank of America. . . . Accordingly, the [SEC OIG] will conduct the investigation outlined in your request." August 20, 2009 letter from SIGTARP and the OIG to the Honorable Elijah E. Cummings, attached hereto as Exhibit 2.

To stabilize the financial system and encourage banks to resume lending in the wake of the recent global financial crisis, Congress enacted the Emergency Economic Stabilization Act of 2008 ("EESA"). EESA established the TARP, which provided the United States Department of the Treasury with the power to purchase hundreds of billions of dollars in illiquid assets from banks and other financial institutions and to take other measures to bolster lending and unfreeze the credit markets. EESA also established SIGTARP to conduct, supervise and coordinate audits and investigations of the purchase, management and sale of assets under TARP.

TARP recipients included BofA. In September 2008, as a major financial institution - Lehman Brothers - was collapsing, Merrill looked to be acquired by a commercial bank. On September 15, 2008, BofA and Merrill signed a merger agreement, and on November 3, 2008, BofA and Merrill filed a definitive joint proxy statement soliciting the votes of shareholders for approval of the merger transaction. The merger agreement stated that, except as set forth in its disclosure schedule, Merrill could not pay discretionary bonuses to its employees or executives without BofA's consent. However, there was no disclosure of the contents of the disclosure schedule in the merger agreement or elsewhere in the proxy statement. BofA did not disclose to its shareholders that it had agreed to allow Merrill to pay up to \$5.8 billion in discretionary bonuses. BofA also did not disclose that it was aware, prior to the December 5, 2008 vote on the merger, that Merrill had net losses of \$7 billion in October and November 2008. On January 16, 2009, after the merger had been approved, BofA reported that Merrill had sustained a net loss of \$15.3 billion and that BofA had obtained \$20 billion in TARP funds to assist in the acquisition. On the next trading day, BofA's stock price fell by nearly 30 percent.

After Merrill's losses were disclosed, several state and federal law enforcement agencies – including the SEC, the Department of Justice, the New York Attorney General ("NYAG") and SIGTARP – investigated the circumstances of the merger. On July 30, 2009, the Commission authorized Enforcement to file an action against BofA for failure to disclose the agreement authorizing Merrill to pay up to \$5.8 billion in discretionary year-end bonuses. At the same time, the Commission also approved the general terms of Enforcement's recommended settlement with BofA. On August 3, 2009, the SEC formally reached a proposed settlement with BofA, the terms of which were: (1) entry of a final judgment permanently enjoining the company from violating Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act"); and (2) a civil monetary penalty against the company in the amount of \$33 million.

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Subsequent to opening its investigation, the OIG learned that the Honorable Jed S. Rakoff, United States District Judge for the Southern District of New York, rejected the Commission's proposed settlement with BofA on September 14, 2009. Shortly after Judge Rakoff rejected the settlement, Senior Counsel from the United States Senate Committee on Banking, Housing and Urban Affairs contacted the Inspector General and asked if the OIG's investigation of this matter would include the circumstances surrounding the decision by Judge Rakoff to reject the settlement, including analysis of whether Enforcement had vigorously and appropriately enforced the securities laws in its investigation of BofA that led to the settlement rejected by Judge Rakoff. Based upon this discussion, the OIG expanded the scope of its investigation to analyze the circumstances surrounding the settlement rejected by Judge Rakoff.

On February 4, 2010, the SEC and BofA submitted a revised proposed settlement, which Judge Rakoff ultimately approved on February 22, 2010. The second settlement included a civil monetary penalty of \$150 million, specific remedial undertakings that BofA was required to implement and maintain for three years, and a Statement of Facts prepared by the Enforcement staff and agreed to by BofA describing the details behind the SEC's allegations. Pursuant to subsequent conversations with the Congressional officials, the OIG further expanded its investigation to include an analysis of the circumstances surrounding the revised settlement to determine whether the charging decisions in each instance were made appropriately.

### **Scope of Investigation**

In its investigation of the circumstances surrounding the two BofA settlements and potential conflicts of interest, the OIG obtained and reviewed over 500,000 e-mails and numerous supporting attachments from over 15 employees in five different offices and divisions within the SEC. The OIG also reviewed numerous supporting materials including, but not limited to: (1) drafts and final versions of internal memoranda to the Commission recommending an enforcement action against BofA; (2) pleadings filed and judicial orders issued in the BofA litigation; (3) drafts and final versions of internal policy memoranda, including an internal policy memorandum to the Commission establishing an Enforcement policy for seeking civil penalties against TARP recipients; (4) the transcript of Judge Rakoff's August 10, 2009 hearing on whether he should approve the SEC's first proposed settlement with BofA; and (5) numerous press articles about both SEC settlements with BofA. In addition, the OIG also took on-the-record, under-oath testimony from the following 18 SEC employees:

- (1) CF Supv 1 Division of Corporation Finance ("Corporation Finance" or "Corp Fin") on April 27, 2010, excerpted portions of which are attached hereto as Exhibit 3;
- (2) Paula Dubberly, Deputy Director for Policy and Capital Markets, Corporation Finance on April 28, 2010, excerpted portions of which are attached hereto as Exhibit 4;



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- (3) CF Atty 1  
Corporation Finance May 6, 2010;
- (4) CF Atty 2  
Corporation Finance on May 7, 2010, excerpted portions of which are attached hereto as Exhibit 5;
- (5) Richard Levine, Associate General Counsel for Legal Policy, Office of General Counsel on May 24, 2010, excerpted portions of which are attached hereto as Exhibit 6;
- (6) IM Supv 1  
Management on May 25, 2010;
- (7) ENF Supv 2  
Enforcement on May 25, 2010, excerpted portions of which are attached hereto as Exhibit 7;
- (8) ENF Supv 1  
New York Regional Office (“NYRO”), Enforcement on June 2, 2010, excerpted portions of which are attached hereto as Exhibit 8;
- (9) ENF Supv 5  
NYRO, Enforcement on June 2, 2010, excerpted portions of which are attached hereto as Exhibit 9;
- (10) ENF Atty 4  
, Enforcement on June 3, 2010, excerpted portions of which are attached hereto as Exhibit 10;
- (11) ENF Atty 3  
NYRO, Enforcement on July 1, 2010, excerpted portions of which are attached hereto as Exhibit 11;
- (12) ENF Atty 2  
NYRO, Enforcement on July 1, 2010, excerpted portions of which are attached hereto as Exhibit 12;
- (13) David Rosenfeld, Associate Regional Director, NYRO, Enforcement on July 1, 2010, excerpted portions of which are attached hereto as Exhibit 13;
- (14) George Canellos, Regional Director, NYRO on July 2, 2010, excerpted portions of which are attached hereto as Exhibit 14;
- (15) ENF Atty 1  
NYRO, Enforcement on July 15, 2010, excerpted portions of which are attached hereto as Exhibit 15;

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- (16) ENF Supv 4 [REDACTED], NYRO, Enforcement on July 29, 2010, excerpted portions of which are attached hereto as Exhibit 16;
- (17) ENF Supv 3 [REDACTED] NYRO, Enforcement on July 30, 2010, excerpted portions of which are attached hereto as Exhibit 17; and
- (18) Robert Khuzami, Director, Enforcement on August 13, 2010, excerpted portions of which are attached hereto as Exhibit 18.

In addition to the above, the OIG took the under-oath testimony of a former BofA employee on March 9, 2010. The OIG also took the under-oath testimony of Neil Barofsky, Special Inspector General for the Troubled Asset Relief Program, on August 4, 2010, excerpted portions of which have been deemed confidential (*See* Exhibit 19). Finally, the OIG submitted written questions to the NYAG, and received written responses on August 13, 2010, which are attached hereto as Exhibit 20.

### **Relevant Regulations and Rules**

The SEC's Enforcement staff is obligated to continuously and diligently investigate instances of securities fraud, as set forth in the Commission's *Canon of Ethics* (the "Canon") and the *Standards of Ethical Conduct for Employees of the Executive Branch* ("Standards of Ethical Conduct") in the Code of Federal Regulations. The "Policy" provision of the Canon recognizes that "[i]t is characteristic of the administrative process that the Members of the Commission and their place in public opinion are affected by the advice and conduct of the staff, particularly the professional and executive employees." 17 C.F.R. § 200.51. Thus, "[i]t shall be the policy of the Commission to require that employees bear in mind the principles specified in the Canons." *Id.* The "Preamble" of the Canon sets forth the serious duty placed upon members of the Commission and its staff, as follows:

Members of the Securities and Exchange Commission are entrusted by various enactments of the Congress with powers and duties of great social and economic significance to the American people. It is their task to regulate varied aspects of the American economy, within the limits prescribed by Congress, to insure that our private enterprise system serves the welfare of all citizens. Their success in this endeavor is a bulwark against possible abuses and injustice which, if left unchecked, might jeopardize the strength of our economic institutions.

17 C.F.R. § 200.53. The Canon provides further that: "In administering the law, members of this Commission should vigorously enforce compliance with the law by all persons affected thereby. . . . In the exercise of their judicial functions, **members shall ...**

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**impartially determine the rights of all persons under the law.** 17 C.F.R. § 200.55 (emphasis added). Similarly, the Standards of Ethical Conduct state that: “Employees shall act impartially and not give preferential treatment to any private organization or individual.” 5 C.F.R. § 2635.101. Finally, the Canon requires the maintenance of independence and the rejection of any impressions of influence: “A member should not, by his conduct, permit the impression to prevail that any person can improperly influence him, that any person unduly enjoys his favor or **that he is affected in any way by the rank, position, prestige, or affluence of any person.**” 17 C.F.R. § 200.61 (emphasis added).

### Executive Summary

On August 6, 2009, the Honorable Elijah E. Cummings, Member of Congress, U.S. House of Representatives (D-Maryland) requested that the SEC OIG and SIGTARP investigate possible conflict of interest issues that may have arisen from the SEC’s Enforcement action against BofA, which had culminated in a \$33 million proposed settlement, for false and misleading statements made in connection with its merger with Merrill. Congressman Cummings identified the fact that BofA was in receipt of TARP funds and sought an investigation of whether the following conflict of interest issues arose in connection with the SEC investigation of BofA and, if so, their impact on the investigation:

- (1) the enforcement action may harm the firm’s viability, and threaten systemic risk to the financial industry;
- (2) the fines levied would essentially be paid with taxpayer funds;
- (3) the fines would harm the shareholder investment in the firm, when the shareholder is the U.S. taxpayer; and
- (4) the role played by Federal Reserve or Treasury officials in the actions upon which fines were issued may have been significant to the occurrence of the violation but cannot be investigated by the SEC.

That same day, the OIG opened an official investigation.

On September 14, 2009, the OIG learned that the Honorable Jed S. Rakoff, United States District Judge for the Southern District of New York, rejected the Commission’s proposed settlement with BofA. Shortly after the Court rejected the settlement, Senior Counsel from the United States Senate Committee on Banking, Housing and Urban Affairs contacted the Inspector General and asked if the OIG’s investigation of this matter would include the circumstances surrounding the decision by the Court to reject the settlement, including an analysis of whether Enforcement had vigorously and appropriately enforced the securities laws in its investigation of BofA. Based upon this discussion, the OIG expanded the scope of its investigation to analyze the circumstances surrounding the settlement.

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On February 4, 2010, the SEC and BofA submitted a revised proposed settlement, which Judge Rakoff approved on February 22, 2010. The second settlement included a civil monetary penalty of \$150 million, specific remedial undertakings that BofA was required to maintain for three years, and a mutually agreed-upon Statement of Facts, describing the details behind the SEC's allegations. Pursuant to subsequent conversations with Congressional officials, the OIG further expanded its investigation to include an analysis of the circumstances surrounding the revised settlement to determine whether the charging decisions in each instance were made appropriately.

The OIG investigation analyzed the SEC Enforcement actions against BofA, including the first proposed settlement and its rejection by the Court; the second proposed settlement and its acceptance by the Court; and the role, if any, BofA's status as a TARP recipient played in the SEC's investigation, charging decisions and settlement discussions.

Overall, the OIG found that despite the Court's rejection of the SEC's first proposed settlement with BofA, the evidence did not show that SEC staff failed to diligently and zealously investigate potential securities law violations. The Enforcement attorneys who worked on both proposed settlements ably operated under considerable time constraints to investigate and bring actions against BofA for violations of securities laws in connection with the Merrill merger. The OIG's investigation chronicles the decisions made by both Enforcement teams for "lessons learned" and informational purposes and describes how the second Enforcement team's strategic determinations and clear understanding of the statutory basis for individual liability led to a settlement accepted by the Court.

The OIG also did not find evidence of the improper conflicts of interest that formed the basis of the August 6, 2009 Congressional letter to the OIG and SIGTARP requesting this investigation. The OIG did find that, when deciding whether to impose a civil penalty against TARP recipients, Enforcement's policy is to consider the TARP status of a proposed defendant or respondent as one of many factors to be considered. Additionally, the OIG found that BofA's status as a TARP recipient had an impact on the favorable settlement the staff first recommended to the Commission.

In summary, the OIG found that in or around January 2009, the SEC New York Regional Office Enforcement staff began its investigation of the circumstances surrounding BofA's approximately \$50 billion acquisition of Merrill on January 1, 2009. The Enforcement staff began investigating allegedly false and misleading statements made by BofA in a November 3, 2008 joint proxy statement filed in connection with the merger. The initial investigation involved a disclosure schedule detailing an agreement to pay up to \$5.8 billion – nearly 12% of the total consideration to be exchanged in the merger – in discretionary year-end bonuses to Merrill executives for 2008. The disclosure schedule was omitted from the proxy statement and its contents not disclosed before the shareholders' vote on the merger on December 5, 2008. The staff also began investigating an alleged failure by BofA to disclose, prior to the December 5, 2008 shareholder meeting, extraordinary fourth quarter losses that Merrill sustained in October

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and November 2008. We found that the decision was made to bring an action solely on the issue of BofA's failure to disclose the agreement to pay the year-end bonuses to company executives, at least partially, on the staff's perceived need to bring the Enforcement case against BofA quickly. The OIG found the Enforcement staff felt pressure to bring a case against BofA promptly because of the internal interest in the case and its high-profile nature. There was also initial skepticism on the part of senior Enforcement officials with regard to the viability of an action regarding the failure to disclose the extraordinary fourth quarter losses.

On August 3, 2009, the SEC announced in a press release that it had "charged Bank of America Corporation for misleading investors about billions of dollars in bonuses that were being paid to Merrill Lynch & Co. executives at the time of its acquisition of the firm." Also according to the press release, "Bank of America agreed to settle the SEC's charges and pay a penalty of \$33 million." The press release noted that "as Merrill was on the brink of bankruptcy and posting record losses, Bank of America agreed to allow Merrill to pay its executives billions of dollars in bonuses. Shareholders were not told about this agreement at the time they voted on the merger." The press release stated further that the settlement was "subject to court approval."

The OIG investigation found that as the SEC and BofA negotiated settlement terms, attorneys representing BofA raised the issue of potential collateral consequences were it to agree to a settlement that included an injunction against future violations of the antifraud provisions of the federal securities laws. The potential collateral consequences for BofA included losing its status as a Well-Known Seasoned Issuer ("WKSI") and its safe harbor for forward-looking statements. WKSI status allows an issuer to use advantageous procedures in the registration and offering of securities, including allowing the issuer to file an automatic shelf registration statement with the SEC. The safe harbor provisions of Section 27A(c) of the Securities Act of 1933 ("Securities Act") and Section 21E(c) of the Exchange Act afford limited protection from liability or penalty for certain issuers who make forward-looking statements that turn out to be false, provided that certain statutory criteria are met.

The Commission has the power to waive certain collateral consequences of an antifraud injunction, including the statutory disqualification from WKSI status and from the safe harbor for forward-looking statements. Prior to entry of the first proposed settlement, BofA requested that the Commission grant it waivers from both WKSI and safe harbor disqualification. The waiver most important to BofA involved its status as a WKSI filer. However, the alleged violation of the proxy solicitation rules was directly related to BofA's own disclosures, according to the <sup>CF Supv 1</sup> [REDACTED] in Corporation Finance who was tasked with deciding WKSI waiver requests, and therefore, BofA did not meet the "traditional criteria" for granting a WKSI waiver.

Initially, Corporation Finance officials took the position that under the SEC's standard criteria, BofA should not receive a WKSI waiver. Corporation Finance also objected to the fact that the proposed settlement was conditioned on the granting of the WKSI waiver, noting that the previous Commission had been "strongly against being

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presented with contingent settlement offers.” Corporation Finance also explained its own opposition to conditioning settlements on granting waivers in that the waiver becomes a bargaining chip that can be negotiated away and thus, the impact of the collateral consequences of the antifraud provision may be eroded.

The OIG investigation found that up until the morning of the July 30, 2009 Closed Commission Meeting that was to consider the proposed settlement, it appeared that Corporation Finance would continue to deny BofA's request for the WKSI waiver. However, at a meeting with BofA and Enforcement that morning, BofA officials convinced Corporation Finance to alter its view of BofA's WKSI waiver request. In this meeting, BofA argued that the dire state of the financial markets made it critical that it be able to raise money quickly. Corporation Finance noted that although BofA did not meet the “traditional criteria” for a WKSI waiver, it decided not to oppose the waiver because of “deference given to the fact that BofA was a TARP recipient” and because “it would not be in the interest of the market or investors to prevent them from getting to the market as quickly as their competitors.”

Thus, the OIG found that the traditional criteria for determining WKSI waiver requests were not applied to BofA. Corporation Finance agreed to recommend that BofA receive a conditional WKSI waiver based upon its TARP status, and the related concern that in the economic environment denying BofA a WKSI waiver could have had an adverse impact on BofA and the entire market. The OIG found this departure from general SEC practice noteworthy, although BofA never actually received the waiver because the Court rejected the proposed settlement.

After the SEC filed the proposed settled action in the U.S. District Court for the Southern District of New York, the Honorable Jed S. Rakoff, United States District Judge, held a hearing during which the SEC and BofA presented arguments supporting the proposed settlement. On September 14, 2009, the Court issued a Memorandum Order rejecting the SEC's proposed settlement with BofA, stating,

the parties' submissions, when carefully read, leave the distinct impression that the proposed Consent Judgment was a contrivance designed to provide the S.E.C. with the facade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry – all at the expense of the sole alleged victims, the shareholders. Even under the most deferential review, this proposed Consent Judgment cannot remotely be called fair. Nor is the proposed Consent Judgment reasonable.

Judge Rakoff further opined in his Memorandum Order that the SEC's normal policy was to bring actions against individuals who are responsible for securities law violations as well as the responsible issuers. The OIG investigation found that Enforcement looked at this issue after Judge Rakoff rejected the proposed settlement. In putting together a list of cases where individuals were not named but corporations were

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required to pay a civil penalty, the SEC found DP, WP, LE

DP, WP, LE

According

to the research performed, DP, WP, LE

DP, WP, LE

The OIG investigation found that the BofA case, however, differed from the other cases where individuals were not named – notably because there was no rule change or other intervening event that made a case against individuals more difficult. Further, the OIG found that when considering whether to name individuals in its first proposed settled action against BofA, members of the Enforcement team were unaware that individuals could directly violate Exchange Act Section 14(a) and Exchange Act Rule 14a-9, and as a result, the team was left to consider whether the individuals in this case could be sued successfully under Exchange Act Section 10(b) and Exchange Act Rule 10b – as either direct violators or as aiders and abettors. The team then considered whether the individuals in the case possessed the requisite intent for a successful 10(b)/10b-5 case when a 14(a)/14a-9 case potentially could have been made with a lower showing of intent (“negligence” as opposed to “scienter”).

With Section 10(b)/Rule 10b-5 the only avenue available, the team decided that the evidentiary hurdle, and resulting litigation risk, were simply too high to pursue individuals. The misperception of this higher evidentiary hurdle may have been a reason that the OIG found no evidence of any substantive or significant analysis of the question of whether to charge individuals in connection with the first proposed settlement on the BofA case until after the proposed settlement was filed with the Court.

In contrast to the approach of the first Enforcement team, the second Enforcement team revisited the issue of the appropriateness of naming individuals and engaged in a very substantive and thorough analysis of whether a viable legal theory existed for pursuing individuals. The second team did not appear confused about whether individuals could be charged as direct violators of Exchange Act Section 14(a) and Exchange Act Rule 14a-9, acknowledging that the SEC has historically charged individuals for direct violations of these statutes. Even after this substantive analysis, however, the second Enforcement team concluded that there were insufficient legal and factual bases to charge individuals.

In addition, after the Court rejected the SEC's first proposed settlement, the second Enforcement team conducted extensive discovery, added a new claim to strengthen its litigation position and focused at great length on developing the facts necessary to file a second case alleging a failure by Merrill to disclose the fourth quarter losses. In January 2010, the Commission filed the fourth quarter losses action as a related case to the bonuses action charging Bank of America with violating Section 14(a) and Rule 14a-9 by failing to disclose, prior to the December 5 shareholder meeting, the “extraordinary losses” that Merrill sustained in October and November 2008. This additional case was critical to the second proposed settlement with BofA because it

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created (along with the Court's rejection of the first proposed settlement) the leverage necessary to demand a larger civil monetary penalty from BofA and enhanced the prospect for a Fair Fund distribution to injured investors.

A second issue that Judge Rakoff identified was that the SEC sought the standard "obey-the-law" injunction in which a defendant neither admits nor denies the SEC's allegations of wrongdoing. According to Judge Rakoff, the SEC's "obey-the-law" injunction was an ineffective remedy because BofA maintained that it violated no federal securities laws by issuing the joint proxy statement with Merrill. Because the company believed it engaged in lawful conduct the first time, according to Judge Rakoff, the Court would be unable to hold BofA in contempt for engaging in similar conduct in the future.

The OIG investigation found that "obey-the-law" injunctions, in which a defendant neither admits nor denies wrongdoing, were often sought by Enforcement for settled actions in federal court. DP, LE

DP, LE

DP, LE The second Enforcement team worked with Corporation Finance to craft remedial measures that would provide a level of prophylactic relief against future misconduct that an injunction could not. These measures, known as "undertakings," were designed to remedy the alleged underlying violations and to create safeguards in the areas where BofA was deficient to avoid a recurrence of the problem. In addition, these undertakings had the additional effect of allowing the proposed settlement to proceed without triggering the WKSI provisions that were a source of considerable discussion during the Commission's approval of the first proposed settlement.

A third major concern expressed by Judge Rakoff in his September 14, 2009 Memorandum Order was the recommended civil penalty of \$33 million against only the company. According to Judge Rakoff, the \$33 million was a "trivial penalty for a false statement that materially infected a multi-billion-dollar merger and thus, would be imposed not on the individuals putatively responsible, but on the shareholders, thus further victimizing the victims."

The OIG investigated the methodology that Enforcement used to arrive at the original \$33 million figure and found that members of the first BofA investigative team relied substantially on case precedent in arriving at the \$33 million civil penalty figure that the Court rejected. We note that the Division's own Enforcement Manual provides, "If the Division agrees to make a specific enforcement recommendation to the Commission, the staff should consider the settlement terms of other similar cases to identify prior precedent involving similar alleged misconduct." In contrast, the OIG found that the second Enforcement team was not as constrained by precedent, and used leverage provided by adding the fourth quarter losses action and the Court's rejection of the first proposed settlement to reach a substantially higher penalty figure of \$150 million.



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The OIG investigation also found that at the time that the SEC began investigating issues related to the merger between BofA and Merrill, several other law enforcement agencies were conducting related investigations. These law enforcement agencies included the United States Attorney's Offices for the Southern District of New York and the Western District of North Carolina, the NYAG and SIGTARP.

The United States Attorney's Offices and the SEC made significant efforts to coordinate their investigations. Attempts between the SEC and the NYAG to coordinate the BofA investigation were less successful. In contrast to the collaborative relationship between the SEC and the United States Attorney's Office for the Southern District of New York, the OIG investigation found that there has historically been tension in the relationship between the SEC and the NYAG. SEC attorneys expressed that the NYAG has had a history of undermining the SEC in order to upstage them, such as by racing to file charges before the SEC in cases in which they have agreed to work together and by making statements to the press about ongoing investigations.

Prior to investigating the merger between Merrill and BofA, the SEC and the NYAG had been coordinating an investigation involving Merrill. However, according to SEC attorneys, once the NYAG learned that the SEC was coordinating its investigation with the United States Attorney's Office for the Southern District of New York, the NYAG would no longer coordinate with the SEC and "cut [them] off" from their investigation. SEC lawyers expressed the view that, although the NYAG provided some cooperation with the SEC during the BofA investigation, the NYAG failed to cooperate fully. According to SEC attorneys, the NYAG refused to share information and to provide certain witness transcripts requested by the SEC prior to the SEC's first and second proposed settlements. The NYAG explained why certain transcripts were not provided to the SEC in connection with the BofA investigation, noting that they were "concerned about the impact partial disclosure could have on [their] litigation . . . [as well as] on [their] ongoing investigations of other individuals."

The NYAG's refusal to produce witness transcripts to the SEC meant that the SEC did not obtain testimony for certain witnesses. Because the Court had limited the number of depositions that the SEC could take, the SEC could not always remedy the NYAG's refusal to produce transcripts by deposing the same witness. Consequently, in making its charging decisions, there were certain witnesses whose testimony the SEC was not able to obtain, requiring the staff to rely instead on attorney proffers that were considered "not as good as a transcript." There also were concerns expressed about the SEC not sharing information with the NYAG. The NYAG stated that the "office requested copies of certain investigative materials from the SEC," but "did not receive investigative materials from the SEC in this case." A staff attorney on the investigation denied that the SEC did anything to precipitate the type of treatment it received from the NYAG, stating the SEC made significant efforts to cooperate with the NYAG. However, SEC staffers did acknowledge that they did not "discuss the facts that [they] had uncovered" with the NYAG and their distrust of the NYAG kept them from speaking to the NYAG "in confidence about [their] investigative plans."

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The OIG's investigation also found that SIGTARP was closely aligned with the NYAG and, therefore, was limited in the information it could share with the SEC. As a result, SEC attorneys on the BofA investigation did express some frustration about SIGTARP's decision not to share information among law enforcement agencies and, furthermore, the OIG's investigation found that concerns over SIGTARP sharing SEC investigative findings with the NYAG also kept the SEC from coordinating more fully with SIGTARP.

In or around January 2010, the Director of Enforcement and the Regional Director of NYRO communicated with the NYAG about a potential global settlement in which the SEC and the NYAG would jointly announce a settlement with BofA. However, according to an SEC trial attorney, the NYAG rejected the idea of a global settlement largely because the SEC's settlement did not include a charge against individuals.

On February 4, 2010, the SEC and BofA submitted a revised proposed settlement, which the Court ultimately approved on February 22, 2010. The second settlement included a civil monetary penalty of \$150 million, specific remedial undertakings that BofA was required to maintain for three years, and a Fair Fund distribution to harmed "legacy" BofA shareholders. The SEC's settlement did not include any charges against individuals. On February 4, 2010, the NYAG and SIGTARP also announced that the NYAG had filed charges against BofA and two of its executives, "Kenneth Lewis and Joe Price for violations of the Martin Act, the Executive Law and common law . . . [following] a year-long investigation."

The SEC attorneys involved in the investigation asserted that if the NYAG had cooperated fully and produced all of the requested transcripts, the SEC still would not have charged individuals at BofA. The SEC attorneys expressed that they were able to ascertain what evidence the NYAG had developed and did not feel that the NYAG was in possession of facts that would have led the SEC to charge individuals. However, the OIG found that greater coordination and collaboration among law enforcement agencies would have more efficiently utilized governmental resources and sped up the investigation by reducing duplication of witness interviews and other investigative efforts.

The OIG did not find that any SEC employee engaged in improper conduct during the BofA investigation and two proposed settlements. The OIG is, however, making recommendations in two areas. First, with respect to the WKSI waiver process, the OIG is recommending that the Division of Corporation Finance: (1) create clear criteria for making waiver determinations; (2) disseminate the guidance both internally and externally; and (3) in cases where the waiver decision departs from the stated criteria, articulate in a written decision or order the rationale for its departure.

Second, to improve coordination issues identified in the OIG's investigation, the OIG is making additional recommendations that the Division of Enforcement: (1) continue the efforts undertaken by NYRO's Regional Director to increase cooperation and coordination among law enforcement agencies; (2) as part of these efforts, review the level of coordination and cooperation on current investigations and assess where

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improved coordination would conserve government resources; (3) in the early planning stages of investigations, assess whether other law enforcement agencies are already participating in, or should be made aware of, the subject investigation; and (4) encourage staff, where appropriate, to establish and maintain effective communication with those who are assisting in investigations and to inform supervisory personnel when they are not receiving cooperation.

## **Results of the Investigation**

### **I. ENFORCEMENT INVESTIGATION OF THE BofA/MERRILL MERGER AND FIRST SETTLEMENT**

In or around January 2009, NYRO Enforcement staff began its investigation of the circumstances surrounding BofA's approximately \$50 billion acquisition of Merrill on January 1, 2009. At the time of this investigation and resulting first settlement, the NYRO Enforcement team consisted of: (1) [REDACTED] ENF Atty 1 (2) [REDACTED] ENF Supv 3 (3) [REDACTED] ENF Supv 4 and (4) Associate Regional Director David Rosenfeld ("first team"). According to [REDACTED] ENF Supv 4 the investigation of the merger:

[S]prang out of [an] earlier investigation that we'd opened previously, which was titled "In the matter of the Merrill Lynch Subprime Portfolio." That was triggered by an announcement, I believe, in October of 2007 . . . The Bank of America piece of that larger matter I think began in earnest for us the end of January. A lot of us, we were aware of the merger, we were cognizant of the merger when it was announced[.] [The] specific issues that we wound up investigating – we first started looking into sometime in January, probably the latter part of January, the 16th.

[REDACTED] ENF Supv 4 Testimony Tr. at pgs. 18-20.<sup>1</sup> NYRO Enforcement staff began investigating, among other things, allegedly false and misleading statements made by BofA in a November 3, 2008 joint proxy statement filed in connection with the merger. See Commission Action Memorandum titled *In the Matter of Merrill Lynch & Co., Inc. Subprime Mortgage Portfolio (NY-7842)*, dated July 20, 2009, attached hereto as Exhibit 21, at p. 1 ("Summary" Section). According to Enforcement staff, BofA and Merrill had agreed not to pay year-end performance bonuses or other discretionary incentive

<sup>1</sup> In addition to NYRO Enforcement, several other law enforcement agencies conducted investigations of BofA and its January 2009 acquisition of Merrill, including the U.S. Attorney's Office for the Southern District of New York, U.S. Attorney's Office for the Western District of North Carolina, SIGTARP and the NYAG. The investigative relationship between NYRO Enforcement staff and other investigatory agencies, specifically SIGTARP and the NYAG, during the BofA investigation will be discussed later in this report.

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compensation to its executives prior to the closing of the merger without BofA's consent. *Id.* However, the staff alleged that the exact opposite had occurred as BofA had agreed that, notwithstanding this provision of the merger agreement, Merrill could pay up to \$5.8 billion – nearly 12% of the total consideration to be exchanged in the merger – in discretionary year-end bonuses to Merrill executives for 2008. *Id.* The staff alleged further that the disclosure schedule detailing this bonus agreement was omitted from the proxy statement and its contents were never disclosed before the shareholders' vote on the merger on December 5, 2008. *Id.*

Enforcement staff also began investigating an alleged failure by BofA to disclose, prior to a December 5, 2008 shareholder meeting, extraordinary losses that Merrill sustained in October and November 2008 – BofA's fourth quarter and, at the time of the first settlement, were “continuing to investigate issues arising from Merrill's large losses in the fourth quarter of 2008 . . . .” *Id.* at p. 2. However, as will be discussed below, a decision was made to bring an action solely against BofA and, initially, only on the issue of BofA's failure to disclose an agreement allowing Merrill to grant significant year-end bonuses to company executives. On July 30, 2009, the Commission approved Enforcement's recommended settlement with BofA, subject to certain unique conditions to be discussed later in this report. On August 3, 2009, the SEC reached a proposed settlement with BofA, the terms of which were: (1) an injunction against the company from violating Section 14(a) of the Exchange Act and Exchange Act Rule 14a-9 thereunder; and (2) a civil monetary penalty against the company in the amount of \$33 million. *See generally* August 3, 2009 SEC Press Release titled *SEC Charges Bank of America for Failing to Disclose Merrill Bonus Payments*, attached hereto as Exhibit 22.

#### **A. NYRO Enforcement Staff Felt They Needed to Bring the BofA Case Quickly**

The OIG has found that, throughout the course of its investigation leading up to the first proposed settlement with BofA, NYRO Enforcement staff felt that the case against BofA needed to be brought quickly. This was a factor in the staff's ultimate decision to bring a settled action against BofA solely for its failure to disclose an agreement allowing Merrill to grant year-end executive bonuses. NYRO Enforcement staff universally acknowledged the need to bring the case quickly; for example, [REDACTED] ENF Atty 1 stated, “I think [Enforcement Director] Rob Khuzami was very much interested in the case. The Chairman was interested in the case.” ENF Atty 1 Testimony Tr. at p. 36. [REDACTED] ENF Atty 1 then stated that, “Rob [Khuzami] was very much interested in moving this along, making sure we have the evidence.” *Id.* at p. 38. Consistent with [REDACTED] ENF Atty 1 understanding, Khuzami acknowledged to the OIG that “there would be a value to have the SEC bring an action like [this] against Bank of America.” Khuzami Testimony Tr. at p. 111.

In an e-mail from [REDACTED] ENF Supv 3 to [REDACTED] ENF Supv 4 dated May 7, 2009, [REDACTED] ENF Supv 3 attempted to coordinate schedules with the attorneys from the Southern District of New York for witness testimony, and stated, “I told the [Southern District] that we would prefer [May] 13th [for testimony] due to internal pressures here to get this wrapped up asap.” May 7,

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2009 e-mail from ENF Supv 3 to ENF Supv 4 attached hereto as Exhibit 23. During her testimony, ENF Supv 3 described the need to bring the BofA case quickly in the following exchange:

Q: And the source of the pressure, was it from the immediate supervision or was it from higher up . . .

A: Yes. From the pressures above, all above. Everyone wants to make sure that they're doing what we are asked to do and do our job. And I think there [were] also a lot of problems that cases were dragging on too long. We just need to get the work done.

ENF Supv 3 Testimony Tr. at p. 24. ENF Supv 4 felt similarly, stating his belief that outside interest in the case also was a factor:

[T]here was a lot of interest in the country at large in this merger, and I think the [C]hairman was getting letters from Congressman Kucinich and a lot of folks were weighing in regularly. And I think it was communicated to us that we should act with all dispatch to determine whether there's a case here. And if so, to bring it as expeditious[ly] as possible. That's generally how we operate and generally what folks up the chain wanted. I think all the public attention that the merger was getting certainly heightened [the need to bring the case quickly].

ENF Supv 4 Testimony Tr. at p. 63. Although NYRO Enforcement staff felt that, due to the high-profile nature of the case and the level of public interest surrounding it, it was important to bring the matter quickly, the staff also realized that it was important that it be brought correctly. According to ENF Atty 1:

Q: To you, your sense of the office, this is a high priority matter?

A: Yes. The answer is yes. This was both an investigative phase and a litigation phase. The message that I walked away with was **this was a very important case and had to be very well handled and very well thought out and done in the best possible way.**

ENF Atty 1 Testimony Tr. at p. 37 (emphasis added).

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The OIG has found that Enforcement staff's perceived need to bring the case quickly was a factor in Enforcement's ultimate decision to bring only the bonus disclosure portion of the case for settlement in August 2009. As this report will discuss, NYRO Enforcement's focus on bringing its case quickly may also have affected the staff's research of relevant case law leading up to the first proposed settlement with BofA, which ultimately was rejected by Judge Rakoff.

**B. NYRO Enforcement Staff Decided to Charge the Company, but Not Individuals**

Following its investigation of BofA, NYRO Enforcement staff decided to charge only BofA with violating Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder. According to the staff's July 20, 2009 Action Memorandum to the Commission:



Exhibit 21 at p. 8. The staff's Action Memorandum made no mention, however, of whether individuals could or should have been charged with the same violations of Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder. Instead, the entire discussion regarding charging individuals, which was relegated to a footnote, focused solely on whether individuals should have been charged with violations of Exchange Act Section 10(b) and Exchange Act Rule 10b-5 thereunder:



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DP, AC, WP, LE

*Id.* at p. 7, n. 5. When asked why the Action Memorandum made no mention of charging individuals under Exchange Act Section 14(a), <sup>ENF Supv</sup><sub>3</sub> assumed it was an oversight:

Q: That's fine. I was just curious about Footnote 5, discussing whether not to charge individuals, and refers to Section 10[(b)] of the [Exchange Act] . . . saying

DP, AC, WP, LE  
DP, AC, WP, LE

A: Right.

Q: And I guess I'm curious about 14[(a)] and 14 [a-9] and the possibility of charging individual[s]. Is that something that was considered –

A: It was –

Q: – in this memo?

A: It was definitely considered. It was obviously not stated Footnote 5, but I can't tell you why.

Q: Okay.

A: I don't know if it was just an oversight, which I assume it was. I don't think it was anything more.

<sup>ENF Supv</sup><sub>3</sub> Testimony Tr. at p. 77.

Other witnesses responded similarly that Exchange Act Section 14(a) and Exchange Act Rule 14a-9 were considered when determining whether to charge individuals in the case. The OIG, however, after a thorough review of all relevant documents and e-mails, has found no evidence that any research was performed, or memorandum written, on the issue prior to Enforcement staff's recommendation to the Commission on July 30, 2009. There is no indication in the documentary record that substantive research was performed on this issue prior to the first proposed settlement. There is substantial evidence that research on this issue was performed after the proposed settlement was held up by Judge Rakoff, and while NYRO Enforcement staff was working on a submission to the judge in support of the first proposed settlement. It is certainly possible and perhaps even likely that the focus on bringing the case quickly contributed to the fact that this research was not done sooner.

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Overall, when considering whether to charge individuals with violations of Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder, the OIG has found that NYRO Enforcement staff, while claiming to have considered the issue, provided no discussion of it in its Action Memorandum to the Commission. Enforcement staff chose instead to discuss in a footnote whether an action should have been brought against individuals under Exchange Act Section 10(b) and Exchange Act Rule 10b-5 thereunder, and concluded that the DP, AC, LE <sup>2</sup>

The OIG also found that certain members of NYRO Enforcement's first team believed at the time of the first proposed settlement that only issuers could violate Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder when, in fact, this was not the case. As will be discussed in greater detail below, this confusion may have caused the team to restrict its analysis to Exchange Act Section 10(b), which requires actual knowledge (or, at a minimum, recklessness) as opposed to Exchange Act Section 14(a), which requires simple negligence. This, along with other factors discussed previously, could explain not only the absence of an Exchange Act Section 14(a) discussion in the Action Memorandum to the Commission regarding potential individual liability, but also NYRO Enforcement staff's apparent difficulty with charging individuals in the first proposed settlement.

### **C. Enforcement Decided to Bring Only One of the Potential Claims Against BofA**

During the course of its investigation leading up to the first settlement, NYRO Enforcement staff focused on the failure of BofA to disclose in a joint proxy with Merrill that, under the merger agreement, Merrill could pay nearly \$6 billion in discretionary, year-end bonuses to executives for 2008. Enforcement staff considered this omission, when coupled with other proxy language creating the opposite impression for shareholders, to be materially misleading in violation of Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder. As the staff explained in their July 20, 2009 Action Memorandum to the Commission:

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Exhibit 21 at p. 2.

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<sup>2</sup> Enforcement concluded similarly that the scienter standard for an aiding-and-abetting case against individuals under Exchange Act Section 10(b) and Exchange Act Rule 10b-5 also was not met in this case.



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Although Enforcement staff ultimately brought two settled actions against BofA – one for the alleged failure of the company to disclose its authorization for Merrill to pay several billion dollars in year-end bonuses, and the other for the alleged failure of the company to disclose significant fourth quarter losses by Merrill – Enforcement decided not to bring the fourth quarter losses portion of the case as part of the first proposed settlement with BofA. When asked about this issue, the senior staff of Enforcement, who made the decision to bring the bonus action only, determined that the bonus action was the only one that was ready to be brought. Specifically, ENF Supv 4 stated the following:

In light of the fourth quarter losses suffered by Merrill, those issues were involved. Issues from the Fed, there were a lot more witnesses, there was information that we were having trouble getting at that's relevant. **It was clear that that was going to take a while to get to the bottom of. And frankly, [we] didn't know where that was going to lead us.** And there was a public interest in identifying the violation of law sooner rather than later and [it] got to the point where we thought there was a case here.

ENF Supv 4 Testimony Tr. at pg. 62 (emphasis added). Similarly, Director Khuzami felt that bringing the bonus portion first was necessary because he wasn't sure whether there would be another case to bring. In a June 28, 2009 e-mail from Khuzami to SEC Chairman Mary Schapiro, Khuzami stated:



June 28, 2009 e-mail from Khuzami to Chairman Schapiro, attached hereto as Exhibit 24 (emphasis added). When asked specifically about the decision to bring the bonus case before the fourth quarter losses case, Khuzami reiterated his skepticism at the time about bringing the second case, as evidenced by the following exchange:

Q: Okay. And was there also just generally the thinking that your staff had worked through the bonus case; it was poised to bring it; and it would be good to get that out, get that out in front, whether by an action or a settlement, because there would be a value to have the SEC bring an action like [this] against Bank of America?

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A: Yeah. Although for exactly the reason that you say, this may have been the only Bank of America [case]. At that point we're thinking this may be the only part of the case that's viable. And so, you know, bringing it then may have been bringing the Bank of America case, because that's all there was going to be to it. So in other words it was just, as you say, speculative as to whether or not we'd get there on the other piece. So why would you hold it off for something that may never come to pass, I guess.

Khuzami Testimony Tr. at p. 111.

The OIG has found that in deciding how to proceed with its first action against BofA, Enforcement determined that it was necessary to bring the bonus case first, followed by the fourth quarter losses case. This decision was made by senior Enforcement officials who did not feel that the investigation into Merrill's alleged fourth quarter losses was far enough along and who were skeptical – as expressed by ENF Supv 4 and Khuzami above – as to whether Enforcement could have brought a second case at all. Furthermore, as discussed earlier, the focus on bringing the case quickly likely was a contributing factor as well.

## **II. ENFORCEMENT'S FIRST PROPOSED SETTLEMENT AND THE COURT'S OPINION**

On August 3, 2009, the SEC announced that it had “charged Bank of America Corporation for misleading investors about billions of dollars in bonuses that were being paid to Merrill Lynch & Co. executives at the time of its acquisition of the firm.” Exhibit 22 at p. 1. Also according to the press release, “Bank of America agreed to settle the SEC's charges and pay a penalty of \$33 million.” *Id.* According to Rosenfeld, “As Merrill was on the brink of bankruptcy and posting record losses, Bank of America agreed to allow Merrill to pay its executives billions of dollars in bonuses. Shareholders were not told about this agreement at the time they voted on the merger.” *Id.* Moreover, the press release stated:

In settling the SEC's charges without admitting or denying the allegations, Bank of America consented to the entry of a judgment that permanently enjoins Bank of America from violating the proxy solicitation rules – Section 14(a) of the Exchange Act of 1934 and Rule 14a-9 – and orders Bank of America to pay the financial penalty.

*Id.* at p. 2. The press release stated further that the settlement was “subject to court approval.” *Id.*

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After the SEC filed the proposed settled action in the U.S. District Court for the Southern District of New York, the Honorable Jed S. Rakoff, United States District Judge, held a hearing during which the SEC and BofA presented arguments supporting the proposed settlement.<sup>3</sup> *See generally* Transcript of August 10, 2009 hearing before the Honorable Jed S. Rakoff, U.S.D.J., attached hereto as Exhibit 25. At the conclusion of the hearing, Judge Rakoff informed the parties that he was not prepared to rule on whether he would accept the proposed settlement, stating:

I would be less than candid if I didn't express my continued misgivings about this settlement at this stage . . . When this settlement first came to me it seemed to be lacking, for lack of a better word, in transparency. . . . [A]nd even after hearing the very helpful and candid responses from counsel today I am concerned that we have not yet ferreted out all that the court needs to know. When all is said and done, no court can make an informed decision in any matter of attorneys without knowing the facts, without knowing the truth. . . . I need to know more before I can approve this settlement.

*Id.* at p. 47. Judge Rakoff then set a briefing schedule for the parties to make submissions on the issue of why he should approve the proposed settlement, and informed the parties that "after I have reviewed all that I will either take action or convene another hearing, whichever is required." *Id.* at p. 48. On September 14, 2009, Judge Rakoff issued a Memorandum Order rejecting the SEC's proposed settlement with BofA. *See generally* September 14, 2009 Memorandum Order from the Honorable Jed S. Rakoff, U.S.D.J., attached hereto as Exhibit 26. In rejecting the proposed settlement, Judge Rakoff stated:

Overall, indeed, the parties' submissions, when carefully read, leave the distinct impression that the proposed Consent Judgment was a contrivance designed to provide the S.E.C. with the façade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry – all at the expense of the sole alleged victims, the shareholders. Even under the most deferential review, this proposed Consent Judgment cannot remotely be called fair. Nor is the proposed Consent Judgment reasonable.

*Id.* at p. 8. Judge Rakoff then concluded:

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<sup>3</sup> Appearing on behalf of the SEC were Associate Regional Director Rosenfeld, <sup>ENF Supv 3</sup> and <sup>ENF Atty 1</sup> Appearing on behalf of BofA were Lewis J. Liman, Esq. and Shawn J. Chen, Esq. of Cleary, Gottlieb, Steen & Hamilton, LLP.

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The proposed Consent Judgment in this case suggests a rather cynical relationship between the parties: the S.E.C. gets to claim that it is exposing wrongdoing on the part of the Bank of America in a high-profile merger; the Bank's management gets to claim that they have been coerced into an onerous settlement by overzealous regulators. And all this is done at the expense, not only of the shareholders, but also of the truth. . . . Accordingly, the Court, having hereby disapproved the Consent Judgment, directs the parties to file with the Court, no later than one week from [September 14, 2009], a jointly proposed Case Management Plan that will have this case ready to be tried on February 1, 2010.

*Id.* at pgs. 11-12. Detailed immediately below are the major points of Judge Rakoff's September 14, 2009 Memorandum Order rejecting the proposed settlement, as well as an analysis of how each point relates to charging decisions made in NYRO Enforcement's investigation of BofA.

**A. The Court's Order Raised Questions About the Fairness of the Settlement and Whether Enforcement Departed from its Usual Policy**

In his Memorandum Order rejecting the first proposed settlement reached between the SEC and BofA, Judge Rakoff expressed his belief that it was "not fair, first and foremost, because it does not comport with the most elementary notions of justice and morality, in that it proposes that the shareholders who were the victims of the Bank's alleged misconduct now pay the penalty for that misconduct." *Id.* at p. 4. Judge Rakoff explained in his Memorandum Order why he did not agree with the SEC's argument that a civil penalty is justified because it allows shareholders to better assess the quality and performance of management:

[The SEC's argument] makes no sense when applied to the facts here: for the notion that Bank of America shareholders, having been lied to blatantly in connection with the multi-billion-dollar purchase of a huge, nearly-bankrupt company, need to lose another \$33 million of their money in order to "better assess the quality and performance of management" is absurd.

*Id.*

Judge Rakoff also noted in his Memorandum Order that the SEC conceded in its court submissions that "its normal policy in such situations is to go after the company executives who were responsible for the lie, rather than innocent shareholders." In response to the SEC's assertion that BofA's lawyers (rather than company executives) made the relevant decisions concerning the disclosure of the Merrill bonuses, Judge Rakoff asked why the SEC was not seeking penalties from the attorneys: "But if that is

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the case, why are the penalties not then sought from the lawyers? And why, in any event, does that justify imposing penalties on the victims of the lie, the shareholders?" *Id.* at pgs. 4-5.

The Memorandum Order raised a question about whether Enforcement should have departed from its usual practice of seeking to charge individuals as well as companies responsible for corporate wrongdoing. The Court's decision also raised the question of whether NYRO Enforcement staff sufficiently analyzed whether individuals should have been charged in the SEC's first proposed settlement with BofA. This report will address below each of the Court's concerns about why individuals were not named in the SEC's first proposed settlement.

**1. By Not Naming Individuals in the First Proposed Settlement, the SEC Departed from its Normal Policy**

As Judge Rakoff opined in his September 14, 2009 Memorandum Order rejecting the SEC's proposed settlement with BofA, the SEC's normal policy is to bring actions against individuals who are responsible for securities law violations as well as the responsible issuers. In this particular case, NYRO Enforcement staff decided not to charge individuals based, at least in part, on a determination that "the integral role of counsel on the disclosure matter at issue is evidence of good faith and makes it unlikely that the Commission could establish the requisite scienter for a Section 10(b) charge [under the Exchange Act]." *See* Exhibit 21 at p. 7, n. 5. As will be discussed below, the determination not to charge individuals may have been different had the possibility of individual liability under Exchange Act Section 14(a) been thoroughly considered and researched but, in any case, the decision not to proceed against individuals was a departure from standard SEC practice.

The OIG investigation found that a former Counsel to the Director and Deputy Director of Enforcement looked at this issue after Judge Rakoff rejected the proposed settlement. In putting together a list of cases where individuals were not named but corporations were required to pay a civil penalty, the front office found

WP, AC, DP, LE  
WP, AC, DP, LE  
WP, AC, DP, LE  
ENF Supv 7  
to Robert  
Khuzami *et al.* and attached document titled *Corporate Penalty Cases*  
WP, AC, DP, LE  
WP, AC, DP, LE  
According to the research performed,  
WP, AC, DP, LE  
WP, AC, DP, LE  
In other words, these cases  
WP, AC, DP, LE  
WP, AC, DP, LE

The BofA case, however, differed from the other cases where individuals were not named because there was no rule change or other intervening event that made a case

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against individuals more difficult. Thus, using Enforcement's own analysis conducted after the settlement was rejected, there seemed to be no basis under existing precedent not to thoroughly consider charging individuals in the BofA case. The OIG has found, rather, that the lack of a comprehensive analysis by the NYRO Enforcement team prior to the first proposed settlement being presented to the Commission, may have been related to the staff's failure to recognize until after the first proposed settlement was filed that an action could be brought against individuals for direct violations of Exchange Act Section 14(a).

## **2. NYRO Enforcement Initially Analyzed Potential Individual Liability Unaware that Exchange Act Section 14(a) Applied**

As stated earlier, NYRO Enforcement's July 20, 2009 Action Memorandum to the Commission recommending the first proposed settlement with BofA made no mention of Exchange Act Section 14(a) in its discussion of why individuals were not charged. Apart from the question of why there was not a more comprehensive discussion of potential individual liability in the Action Memorandum generally, a key question is why wasn't potential individual liability under Exchange Act Section 14(a) discussed – particularly given the lower standard of intent compared to Exchange Act Section 10(b) (“negligence” vs. “scienter”)? The NYRO Enforcement first team asserted unanimously in OIG testimony that the issue was considered, yet none could explain its absence from the Action Memorandum – other than one witness assuming that it was “just an oversight.” <sup>ENF Supv 3</sup> Testimony Tr. at p. 77. The answer may be that more than one member of the NYRO Enforcement team believed that Exchange Act Section 14(a) actions could be brought only against issuers.

After the first proposed settlement with BofA was filed, Judge Rakoff held a hearing on August 10, 2009 to entertain arguments on why the proposed settlement should be approved. *See generally* Transcript of August 10, 2009 hearing attached hereto as Exhibit 25. In apparent preparation for the hearing, Rosenfeld prepared an outline titled *BoA Questions*. Included in this document was the following:

Given the egregious violation, why have no individuals been charged?

- Can't discuss the specifics of any particular charging decision.
- We need to charge based on what the evidence supports and the legal standards applicable to a particular statutory or regulatory provision.

-  WP, DP, LE

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- [REDACTED]
- (paragraph 12 of the complaint: lawyers drafted the documents).

August 9, 2009 e-mail from Rosenfeld and attached outline of BofA questions, attached hereto as Exhibit 28, at pgs. 6-7 (emphasis added). Following the hearing, on August 12, 2009, Rosenfeld discussed via e-mail with others at the SEC how best to respond to a New York Times reporter wanting to do a story on whether the SEC went easy on BofA by not charging individuals. During this e-mail discussion, Rosenfeld stated:

I think it would be worth talking to him off the record. A few things that could be brought out:

\*\*\*\*\*

3. On not charging individuals: there was considerable discussion of this issue at the court hearing. What we said was that lawyers drafted the documents . . . I also told the court that under those circumstances it would be difficult to sustain scienter based fraud charges, against individuals or by extension against the company. The sections that we charged (Section 14(a) and Rule 14a-9) are negligence based, **but they can only be directly violated by the company; individuals cannot be charged as primary violators.** . . . Because we disclosed all this in open court, I would feel comfortable walking the reporter through the analysis.

August 12, 2009 e-mail from Rosenfeld to [REDACTED] attached hereto as Exhibit 29, at p. 1 (emphasis added).<sup>4</sup>

On August 18, 2009 (over two weeks after the first proposed settled action was filed), the first team members were finalizing their brief, which was due to Judge Rakoff in less than a week. Exhibit 25 at p. 48 (Judge Rakoff sets August 24, 2009 as the due date for the parties' first submissions to the Court). In an e-mail to [REDACTED] [REDACTED] stated, "Here is the current draft of the BofA submission. There are two items that I still need to plug in: [REDACTED]"

<sup>4</sup> After reviewing the transcript of Judge Rakoff's August 10, 2009 hearing, the OIG has found no mention by Rosenfeld, or anyone else present at the hearing, that only BofA could directly violate Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder. Rosenfeld mentioned only Exchange Act Section 10(b) when discussing the difficulties in making a prima facie fraud case against BofA individuals. It appears, therefore, that although Rosenfeld clearly believed this to be true at the time of the hearing, he was mistaken about actually mentioning this to Judge Rakoff.

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...” August 18, 2009 e-mail from ENF Atty 1 to ENF Supv 3 attached hereto as Exhibit 30. ENF Supv 3 then responded, “[T]here is a 6<sup>th</sup> [C]ircuit case charging outside auditors with 14(a) charges. WP, DP, LE

WP, DP, LE” *Id.* The very next day, ENF Supv 3 e-mailed ENF Atty 1 two cases supporting the correct proposition that Exchange Act Section 14(a) charges can be brought against individuals, “You might have already tracked this down but it looks like the [C]ommission has charged individuals with violations of Section 14(a) in the not so distant [past] – I saw other cases but only saved these to demonstrate the point.” August 19, 2009 e-mail from ENF Supv 3 to ENF Atty 1 and attached cases, attached hereto as Exhibit 31.

When asked about these e-mails and the fact that some on the Enforcement team had an incorrect understanding of individual liability under Exchange Act Section 14(a), ENF Supv 3 responded that she had begun looking at the issue of individual liability under Section 14(a) while preparing a brief in support of the proposed settlement:

Q: And then I see Exhibit 12, [it] looks like you had looked into the issue and had determined that[.] WP, DP, LE  
WP, DP, LE

A: So, I think, in fact, but it's certainly after the case is brought.

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Q: Because the decision [came down] from the judge and then you looked at this and said, “Wait a minute, this isn't right” –

A: WP, DP, LE  
WP, DP, LE -- and I've forgotten this 14[(a)]. It could be, but I hope it wasn't in the final brief. I know that it was in the brief, obviously, at the time this was circulated.

ENF Supv 3 Testimony Tr. at pgs. 85-86. ENF Supv 3 stated also that, “I think that in the end, WP, DP, LE  
WP, DP, LE

ENF Supv 3 wasn't the only one who realized that this was not a correct understanding of the law. On August 26, 2009, over three weeks after the first proposed settled action was filed, an e-mail discussion took place between ENF Atty 2 of NYRO



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Enforcement and [ENF Supv 3] during which [ENF Atty 2] stated, [WP, DP, LE]  
[WP, DP, LE]  
[WP] [ENF Atty 2] also stated, "Section 14(a) [WP, DP, LE]  
[WP, DP, LE]  
[WP, DP, LE] Next, after some back-and-forth with [ENF Supv 3] [ENF Atty 2] concluded  
with [WP, DP, LE]  
[WP, DP, LE] When asked about the purpose for this  
discussion, [ENF Atty 2] stated in the following exchange:

Q: You say at the top e-mail on [August 26, 2009],  
[DP, WP, LE]

A: [DP, WP, LE]

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A: I thought I heard him say that . . . [DP, WP, LE]  
[DP, WP, LE]

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A: But in any event, I would say it's [DP, WP, LE]  
[DP, WP, LE]

[ENF Atty 2] Testimony Tr. at pgs. 21-23.

When asked whether the proposition that only issuers can be charged as direct violators of Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder is a correct statement of the law, current NYRO Regional Director George Canellos explained his view in the following exchange:

Q: One thing that I wanted to ask you about, we've looked at a lot of e-mails and particularly a lot of e-mails involved before the first settlement was rejected by Judge Rakoff, which you know you weren't involved in that whole part. But what we found was there was some kind of internal discussion and disagreement. There were some

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initial e-mails that we found which seemed to indicate that some of the folks on the original Bank of America team in connection with the first matter did not necessarily believe that you could bring a 14a-9 claim against an individual directly, that you had to do it as an aider and abettor?

A: Yes.

Q: Is that correct, and over time it seems like it was clarified that you could bring a 14a-9 claim against an individual directly, although then of course you have to have the factual predicate for it. Is that your recollection?

A: Well, you know, if I got to play appellate court, my answer is you can bring a 14a-9 against an individual, but I agree with you, I remember very distinctly that at least I believe that David Rosenfeld had articulated before Judge Rakoff a view that you couldn't charge individuals except as aiders and abettors, and I'm not positive that that's wrong and I'm not positive that that's right. But the rule says cast into liability those who, quote, solicit a proxy. So the question is the issuer here is Bank of America, it's obviously soliciting a proxy from its shareholders, but at the same time there are people behind it and Ken Lewis signed the proxy and the board of directors has to approve the proxy, and so while I'm not sure there is a great deal of precedent that completely answers the question, **there's certainly a pretty well-founded argument that the people who have put their names in some sense, any imprimatur on the proxy could be charged on a negligence theory under 14a-9.**

Q: And the SEC has charged individuals under 14a-9 as a direct violator in other cases?

A: Yes, the SEC has charged individuals.

Canellos Testimony Tr. at pgs. 24-26 (emphasis added). Finally, Richard Levine, Associate General Counsel for Legal Policy, Office of General Counsel, and an expert in

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reviewing and opining on Enforcement recommendations,<sup>5</sup> was asked directly about whether, as a matter of law, a Section 14(a) and Rule 14(a)(9) case could be brought against the individuals in the BofA case in the following exchange:

Q: Could you bring a 14[(a)] or 14a-9 case against the individuals?

A: You can, yes.

Q: And in that case, you wouldn't have the scienter requirement?

A: That's right.

Q: Are there -- are there situations that you're aware of where the SEC has done that, brought a 14[(a)] or 14a-9 case against the individuals?

A: I'm pretty sure we have. I'm not sure I can remember any specific cases.

Q: And you don't remember any discussion in the Bank of America matter about bringing a 14[(a)] or 14[a-9] case against individuals?

A: I don't think I remember any, no.

Levine Testimony Tr. at p. 24.

Accordingly, the OIG has found evidence that when considering whether to name individuals in its first proposed settled action against BofA, members of the NYRO Enforcement team were unaware that individuals could directly violate Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder. As a result, the team was left to consider whether the individuals in this case could be sued successfully under Exchange Act Section 10(b) and Exchange Act Rule 10b-5 thereunder – as either direct violators or as aiders and abettors. The team then considered whether the individuals in the case possessed the requisite intent for a successful 10(b)/10b-5 case when a 14(a)/14a-9 case

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<sup>5</sup> Levine has considerable expertise in reviewing and opining on Enforcement recommendations to the Commission, having worked in the Office of General Counsel for over 25 years and having served as Assistant General Counsel for Enforcement from 1997 until his recent promotion to Associate General Counsel in May 2010. Levine Testimony Tr. at pgs. 6-10. For approximately 13 years as Assistant General Counsel at the SEC, Levine was responsible for “reviewing all the Enforcement recommendations that get sent to the Commission [and] reviewing those for legal sufficiency to make sure that [cases are] legally supportable [and] well grounded in the facts . . . .” *Id.* at pgs. 8-9. By his estimation, his office would typically receive and review “more than 2,000 memos a year [including drafts and final versions].” *Id.* at p. 9.

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potentially could have been made with a lower showing of intent (“negligence” as opposed to “scienter”). With Section 10(b)/Rule 10b-5 the only avenue available, the team decided that the evidentiary hurdle, and resulting litigation risk, were simply too high to pursue individuals. The misperception of this higher evidentiary hurdle may have been a reason that we found no evidence of any substantive or significant analysis of the question of whether to charge individuals in connection with the first proposed settlement on the BofA case.

As discussed earlier in this report, NYRO Enforcement team perceived the need to bring the BofA case quickly. This focus on bringing the BofA case quickly may have factored into the team’s analysis of whether an action could have been brought against individuals. <sup>DP, WP, LE</sup> NYRO witnesses, including <sup>ENF Atty 2</sup> and <sup>ENF Supv</sup> and Canellos, testified that individuals could directly violate Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder. <sup>DP, WP, LE</sup> this issue was not addressed in the first Action Memorandum to the Commission, and the OIG has seen no evidence that the issue was researched until after the proposed settlement recommendation was approved by the Commission and filed with the Court. Specifically, <sup>ENF Supv</sup> testified that the team’s failure to do this research earlier was a source of frustration:

A: And I hadn’t done [the research] because I wasn’t involved in the [process] – as I ordinarily would be – it’s kind of like, this is what we are doing. So, I know that I found it was frustrating.

Q: Yeah.

A: And in fact, well – I don’t know. I think they’re ultimately – obviously, there were no charges brought against individuals . . . So, it was fine, but I remember being frustrated [when] I went back and did that research.

Q: Because that’s something that you thought was uncovered earlier in the process?

A: Well, because I know that at times, there [were] some discussions. <sup>DP, WP, LE</sup>

<sup>DP, WP, LE</sup>

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A: There were questions, why aren’t you charging individuals? . . . We tried to figure out – we had all

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sorts of theories going in and none of those panned out certainly. So, I was so [very] frustrated that I heard that maybe it wouldn't be appropriate to bring [charges] when I saw that, in fact, that we had [in the past] . . . I think that what we did was ultimately the right thing, but I know I was frustrated.

Q: The fact that you found those cases?

A: Right.

ENF Supv  
3 Testimony Tr. at pgs. 81-83.

From the testimonial and other evidence obtained in this investigation, it appears that NYRO Enforcement's first team neither researched completely nor analyzed correctly, the issue of who can be sued and under what statute and rule. Instead of a complete analysis of whether individuals should have been sued in the case and, if so, under what legal theory(ies), the July 20, 2009 Action Memorandum

DP, WP, LE

DP, WP, LE

See Exhibit 21 at p. 7, n.5.

Thus, a central part of the first case was not analyzed as thoroughly as it could have been, and the OIG has found that more time and attention spent on researching this aspect of the case might have proven helpful to Enforcement staff in its decision whether to charge individuals in the BofA case, just as a more thorough discussion of the issue in the Action Memorandum might have proven helpful to the Commission in its consideration of the proposed settlement. It appears, therefore, that there was a two-fold reason why the Exchange Act Section 14(a)/Exchange Act Rule 14a-9 analysis was not performed properly; namely, a focus on bringing the case quickly coupled with a misunderstanding of the applicable law. The end result was an evidentiary hurdle (scienter under Exchange Act Section 10(b)/Exchange Act Rule 10b-5) that was too high to meet.

As this report will discuss, after the Court rejected the first proposed settlement, the attorneys working on the litigation and second proposed settlement with BofA (the "second team") revisited the issue of the appropriateness of naming individuals. The second team engaged in a very substantive and thorough analysis of whether a viable legal theory existed for pursuing individuals. Moreover, this analysis was performed with the understanding that Exchange Act Section 14(a) applied to individuals as well as issuers. The second team reached the decision not to name individuals only after performing this more thorough analysis.

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**B. The Proposed Settlement Would Have Imposed an Injunction Against BofA While the Company Continued to Deny Wrongdoing**

A second issue that Judge Rakoff identified was that the SEC sought the standard “obey-the-law” injunction in which the defendant neither admits nor denies the SEC’s allegations of wrongdoing. As Judge Rakoff explained in his September 14, 2009 Memorandum Order:

[S]ince the Bank contends that it never made any false or misleading statements in the past, the Court at this point lacks a factual predicate for imposing such relief. To be sure, the Bank’s initial position was that it neither admitted nor denied the allegations, and such a position, when coupled with proof by the S.E.C. that the alleged violations have occurred, may often be sufficient to support certain forms of injunctive relief. But here the further submissions of the Bank make clear its position that the proxy statement in issue was totally in accordance with the law: meaning that, notwithstanding the injunctive relief here sought by the S.E.C., the Bank would feel free to issue exactly the same kind of proxy statement in the future. Under these circumstances, the broad but vague injunctive relief here sought would be a pointless exercise, since the sanction of contempt may only be imposed for violation of a particularized provision known and reasonably understood by the contemnor, all of which would be lacking here.

Exhibit 26 at pgs. 10-11. According to Judge Rakoff, the SEC’s “obey-the-law” injunction was an ineffective remedy because BofA maintained that it violated no federal securities laws by issuing the joint proxy statement with Merrill. Because the company believed it engaged in lawful conduct the first time, according to Judge Rakoff, the Court would be unable to hold BofA in contempt for engaging in similar conduct in the future.

“Obey-the-law” injunctions in which a defendant neither admits nor denies wrongdoing are often sought by Enforcement for settled actions in federal court. For example, the SEC’s Enforcement Manual provides that, when making a specific recommendation to the Commission that an action be settled against a cooperating individual or company, “the cooperating individual or company agrees to resolve the matter without admitting or denying the alleged violations.” *See United States Securities and Exchange Commission Division of Enforcement’s Enforcement Manual*, Office of Chief Counsel, January 13, 2010 (revised March 3, 2010), excerpted portions of which are attached hereto as Exhibit 33, at p. 132. DP, LE, WP [REDACTED] and the stance taken by Judge Rakoff in his September 14, 2009 Memorandum Order questioned the appropriateness of this remedy in every case. DP, LE, WP [REDACTED]

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DP, WP, LE

NYRO Regional Director Canellos –

DP, WP, LE

DP, WP, LE

[T]his is an issue that's **of the view and I think** and I am

DP, WP, LE

DP, WP, LE

DP, WP, LE

Canellos Testimony Tr. at pgs. 62-63 (emphasis added). To Canellos and others within Enforcement,

DP, WP, LE

DP, WP, LE

DP, WP, LE

Canellos also expressed the view that

DP, WP, LE

DP, WP, LE

Overall, the OIG has found that, as was the case with Judge Rakoff's concerns about victims being forced to pay for the wrongdoing of others, his concerns with the standard "obey-the-law" injunction sought by the SEC in its first proposed settlement with BofA resulted in a changed focus by Enforcement and others at the SEC who responded to these concerns. The result was a second settlement that, among other things, provided relief to shareholders in the form of a series of measures that BofA was required to take to enhance shareholder protection while improving corporate governance and responsibility.

### C. The Court Found the Proposed Penalty Amount Too Low

A third major concern expressed by Judge Rakoff in his September 14, 2009 Memorandum Order was over the recommended civil penalty of \$33 million against BofA only. According to Judge Rakoff:

Finally, the proposed Consent Judgment is inadequate. The injunctive relief, as noted, is pointless. The fine, if looked at from the standpoint of the violation, **is also inadequate,**

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**in that \$33 million is a trivial penalty for a false statement that materially infected a multi-billion-dollar merger.** But since the fine is imposed, not on the individuals putatively responsible, but on the shareholders, **it is worse than pointless: it further victimizes the victims.**

Exhibit 26 at p. 11 (emphasis added). As explained earlier, Judge Rakoff was concerned that if he approved the first proposed settlement, shareholders would be victimized a second time. However, he also was bothered by the amount of the penalty, which he thought was “trivial” considering the size of the merger and resulting fraud. *Id.* Although his September 14, 2009 Memorandum Order made no mention of what the court estimated the correct amount should have been, the second SEC settlement that Judge Rakoff approved secured nearly five times the amount originally sought. *See generally* February 4, 2010 SEC Litigation Release titled *Bank of America Agrees to Pay \$150 Million to Settle SEC Charges*, attached hereto as Exhibit 34. The facts and circumstances surrounding the second settlement, including how the SEC arrived at its increased penalty amount, will be discussed later in this report.

Although reasonable minds can differ over the civil penalty that should have been sought originally, in light of the Court's determination that the amount proposed was “trivial,” the OIG investigated the methodology that NYRO Enforcement used to arrive at the original \$33 million figure. The OIG has found that, although NYRO Enforcement claimed to have used a variety of factors to determine the appropriate civil penalty, its strong reliance on precedent was a major factor in determining the final civil penalty amount.

When asked how the first team arrived at the \$33 million civil penalty, witnesses unanimously pointed to precedent as the starting point, looking for prior cases with facts comparable to the BofA case. For example, as ENF Atty 1 explained in the following exchange:

- Q: Did you work on a penalty analysis at all, the penalty analysis to get to \$33 million?
- A: There was. I can't remember how much I did of it. I can tell you what the key features of it were. **The most important thing was a precedent, which we felt was something [we] needed to have, to have a footing on.** We looked – I think everybody in the team, everybody looked at the penalty factors. And some of those factors were not particularly applicable.

ENF Atty 1 Testimony Tr. at p. 71 (emphasis added). ENF Supv 3 made a similar observation in the following exchange:



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Q: [D]o you recall how the civil penalty amount [was] arrived at in discussions you may have had about it?

A: I remember looking at the cases comparable. There's a database. And for cases not involving fraud, certainly, in the past, the SEC had not gotten very large settlement civil penalty amounts. And particularly, we were coming off of the prior Commission [who] did not [look] favorably upon instituting civil penalties against public corporations because it was viewed as harming the shareholders twice; right? They were the victim of the initial, whatever it was in this case. There were proxy violations and they weren't told the full information and then they're being forced to pay the civil penalty. So, I remember looking at the comparable case database. And looking at the variety of cases . . . the largest civil penalty was Wachovia. That was \$37 million. . . . So, we thought large – that's the sweet spot. That's where we need to go.

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Q: Were there any other factors that you considered in addition to the Wachovia case in terms of –

A: Well, the case comparables, **that's where you always begin.**

ENF Supv 3 Testimony Tr. at pgs. 34-36 (emphasis added). Rosenfeld agreed:

So it's difficult to find a lot of precedent that was directly on point. The Wachovia case was the one that was closest. It involved another financial institution. It involved the context of a merger or a takeover direct fee, I forget which one it was.

Q: What was the number in Wachovia?

A: 37 million [dollars].

Q: In addition to a conversation with Rob [Khuzami], was it kind of generally understood that the way the Commission would look at settlement numbers or

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penalty amounts was also dependent upon prior cases?

A: Yes, very much so.

Q: It wasn't something Rob came up with?

A: No, we had started looking at that before Rob had said anything about that. That's the way we do it. **That's the first thing you look to is what have you done in other cases.** But I was just pointing out that when I had the conversations with Rob and asked him what his thinking was, the first thing he said was okay, what had we done in other cases. So we tried to find whatever we could. The Wachovia case was the closest one on point.

Rosenfeld Testimony Tr. at pgs. 33-34 (emphasis added).<sup>6</sup> Finally, the first team's view that precedent is the starting point for civil penalties itself was supported by the Division's own Enforcement Manual, which provides, "If the Division agrees to make a specific enforcement recommendation to the Commission, **the staff should consider the settlement terms of other similar cases to identify prior precedent involving similar alleged misconduct . . .**" Exhibit 33 at p. 132 (emphasis added).

While other factors were considered, Commission precedent was the starting point, and was the single largest factor in determining the civil penalty amount.<sup>7</sup> Once the NYRO Enforcement team found the single case that was closest factually to BofA, the team determined "that's the sweet spot. That's where we need to go." ENF Supv 3 Testimony Tr. at p. 35. Accordingly, the OIG has found no evidence that the team's reliance on precedent was either arbitrary or capricious. Rather, it appeared to be a by-product largely of the way that Enforcement weighed penalty factors generally, as evidenced by the Division's own Enforcement Manual.

For reasons this report will discuss, the OIG has found that the second team was not as constrained by precedent, and used leverage provided by adding an additional charge and by virtue of the Court's rejection of the first proposed settlement to reach a resolution more acceptable to the Court. Before addressing the issue of Judge Rakoff's

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<sup>6</sup> See also August 9, 2009 e-mail from Rosenfeld and attached document titled *Outline of BoA*, attached hereto as Exhibit 28, at p. 1 ("In determining the proper amount of a penalty, **we look first and foremost to precedent**") (emphasis added).

<sup>7</sup> According to ENF Supv 4 the penalty factors considered by the first team in addition to precedent were, "the benefits to the company, the harm to current shareholders, the harm to prior shareholders . . . what impact the penalty would have on the company [and] the degree of cooperation." ENF Supv 4 Testimony Tr. at p. 46.

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treatment of the second settlement, however, this report will discuss immediately below another critical issue – the possible collateral consequences that BofA faced if an antifraud injunction had been imposed, including the potential loss of its status as a “Well-Known Seasoned Issuer.”

### **III. THE FIRST PROPOSED SETTLEMENT HIGHLIGHTED FLAWS IN THE SEC'S PROCESS FOR GRANTING WAIVERS**

#### **A. BofA Raised the Issue of Collateral Consequences of an Antifraud Injunction During Settlement Negotiations**

As the SEC and BofA negotiated settlement terms, attorneys representing BofA raised the issue of potential collateral consequences were it to agree to a settlement that included an injunction against future violations of the antifraud provisions of the federal securities laws. Rosenfeld Testimony Tr. at pgs. 40-41. The potential collateral consequences for BofA included losing its WKSI status and its safe harbor for forward-looking statements. *See* Supplemental Memorandum Re Bank of America Corporation to the Commission from NYRO, dated July 28, 2009, attached hereto as Exhibit 35 (“July 28, 2009 Supplemental Memorandum”) at pgs. 1-4.

WKSI status allows an issuer to use advantageous procedures in the registration and offering of securities, including allowing the issuer to file an automatic shelf registration statement with the SEC.<sup>8</sup> Rosenfeld Testimony Tr. at p. 39. The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act afford limited protection from liability or penalty for certain issuers who make forward-looking statements that turn out to be false, provided that certain statutory criteria are met. *See generally* Allan Horwich, *Cleaning the Murky Safe Harbor for Forward-Looking Statements: An Inquiry into Whether Actual Knowledge of Falsity Precludes the Meaningful Cautionary Statement Defense*, *Journal of Corporation Law*, Vol. 35, 2010, attached hereto as Exhibit 36, at pgs. 520 *et seq.*

An “ineligible issuer” cannot take advantage of WKSI securities procedures. The definition of “ineligible issuer” includes any issuer who has had an antifraud injunction entered against it within the last three years. 17 C.F.R. § 230.405. The first proposed settlement between BofA and the SEC included the entry of an injunction against future

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<sup>8</sup> “There are two significant advantages of using an automatic shelf registration statement, as opposed to a regular non-WKSI Form S-3 shelf registration statement. First, as the name indicates, a Form S-3ASR registration statement becomes effective automatically upon filing, without review by the SEC. Accordingly, after filing a Form S-3ASR with a ‘universal’ prospectus, an issuer can, promptly thereafter, file a prospectus supplement indicating the amount, and describing the features, of the securities that it wishes to ‘take off the shelf,’ and then commence to sell those securities immediately upon the [sic] filing the prospectus supplement. Second, as a WKSI, the issuer is not required to register a specified dollar amount of securities at the time of filing the Form S-3ASR; and it may postpone the payment of the filing fee until the time of filing the prospectus supplement for each shelf take-down (called ‘pay as you go’).” *See* Peter Flagel *et al.*, *Effects of Loss of WKSI Status on Automatic Shelf Registration Statements*, Client Advisory, Carter Ledyard & Milburn LLP (February 4, 2009), attached hereto as Exhibit 37, at p. 1. *See also* <http://www.clm.com/publication.cfm/ID/223>.

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violations of Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder, which are antifraud provisions. Exhibit 35 at p. 1. Therefore, upon entry of the injunction, BofA would be deemed an “ineligible issuer” and statutorily disqualified from taking advantage of WSKI procedures. *Id.*

Similarly, the safe harbor for forward-looking statements is not available to any issuer who has had an antifraud injunction entered against it “during the 3-year period preceding the date on which the statement was first made.” Section 27A(b)(1)(A)(ii) of the Securities Act; Section 21E(b)(1)(A)(ii) of the Exchange Act. Upon entry of the injunction, BofA would also be disqualified from the safe harbor for forward-looking statements provisions of the Securities Act and the Exchange Act. Exhibit 35 at p. 3.

The Commission has the power to waive certain collateral consequences of an antifraud injunction. *Id.* at pgs. 1, 3. With regard to BofA’s WSKI status, Securities Act Rule 405 provides that even if an issuer meets the definition of “ineligible issuer,” the Commission may waive the statutory disqualification from WSKI status where the Commission “determines, upon a showing of good cause, that it is not necessary under the circumstances that the issuer be considered an ineligible issuer.” 17 C.F.R. § 230.405. Corporation Finance has delegated authority to grant or deny requests for waivers of “ineligible issuer” status for the Commission. Exhibit 35 at p. 1. The Commission also has the statutory authority to waive disqualification from the safe harbor for forward-looking statement provisions of the securities laws. Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act. While the Commission has not delegated its authority to grant waivers from disqualification from the safe harbor for forward-looking statements, the Commission considers recommendations made by Enforcement when making its waiver determinations. ENF Atty 4 Testimony Tr. at p. 17.

#### **B. Under SEC Practice, WSKI and Safe Harbor Waiver Requests Were Denied When the Fraud at Issue Was Related to the Issuer’s Own Disclosures**

According to current SEC practice, “the same criteria [are] used for granting the WSKI and forward-looking statements waiver requests. . . .” Exhibit 35 at p. 4. Thus, the WSKI and safe harbor waivers “generally are granted or denied in tandem.” E-mail from CF Atty 2 to ENF Supv 3 *et al.*, dated July 10, 2009, attached hereto as Exhibit 38.

The SEC’s general practice was to deny WSKI and safe harbor waiver requests where the antifraud violations were related to the issuer’s own disclosures.<sup>9</sup> Exhibit 35 at pgs. 3-4. In a memorandum to the Commission, the SEC’s Office of General Counsel described the Commission’s practice and its purpose:

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<sup>9</sup> Corporation Finance also had a practice of granting WSKI waiver requests where “an agreement in principle between the Division of Enforcement and the proposed defendant was entered into prior to December 1, 2005.” Exhibit 35 at p. 3. This criterion was inapplicable to the case at issue.

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DP, AC, WP, LE



See Memorandum to the Commission from Office of General Counsel, Re *In the Matter of Merrill Lynch & Co. (NY-7842)*, dated July 29, 2009, attached hereto as Exhibit 39, at p. 2.

### C. Corporation Finance Initially Opposed Granting BofA's Waiver Requests

Prior to entry of the first proposed settlement, BofA requested that the Commission grant it various regulatory waivers and exemptions, including waivers from the WKSI and safe harbor disqualifications.<sup>10</sup> Exhibit 35 at p. 1. The waiver most important to BofA involved its status as a WKSI filer.<sup>ENF Atty 1</sup> Testimony Tr. at pgs. 63-64. According to an Enforcement<sup>PII</sup> on the case, the "safe harbor proposal wasn't so much of an issue. It was really a tag-along to WKSI." *Id.* at p. 77. In its WKSI waiver application, BofA made several arguments why it should receive a waiver, none of which addressed the criteria applied by Corporation Finance. BofA's arguments included the following:

- (1) BofA "has a strong record of compliance with the securities laws and has fully cooperated with the staff in its investigation";
- (2) "this matter does not involve intentional or willful misconduct";
- (3) "the violation at issue relates to an extraordinary merger and not a routine securities issuance in the regular course of business";
- (4) "a disqualification in this case . . . would discourage other companies from settling cases";
- (5) "designating Bank of America as an ineligible issuer would undermine the policy

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<sup>10</sup> BofA had additional waiver and exemption requests. Exhibit 35 at pgs. 4-7. BofA "requested a waiver from the Rule 602(b)(4) and 602(c)(2) automatic disqualification provisions of Regulation E, 17 C.F.R. § 230.602 [ , which] provides an exemption from registration under the Securities Act . . . for securities issued by certain small business investment companies and business development companies." *Id.* at p. 4. BofA also requested an exemption from Section 9(a) of the Investment Company Act of 1940, which would have automatically disqualified BofA and its affiliated companies from "serving or acting in specified capacities for certain registered investment companies" upon entry of the injunction. *Id.* at pgs. 5-7. The Division of Investment Management recommended that the Commission grant the requested waivers and exemptions. *Id.* at p. 7.

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objectives of the 2005 securities offering reform amendments because Bank of America would lose the ability to access the public markets on an immediate basis, thereby increasing its cost of capital”; (6) “[d]isqualifying Bank of America would be unduly and disproportionately severe since it would impose a substantial penalty not contemplated under the terms of the Final Judgment since Bank of America relies on securities offerings, often at a moment’s notice, as its primary funding source in addition to deposits . . . the loss of WKSI status would have significant negative consequences on Bank of America and its shareholders”; and (7) “[d]isqualification would be fundamentally inconsistent with bank regulators and other governmental bodies’ efforts to stabilize the financial markets at a time of severe ongoing challenges to the economy.”

Exhibit 35 at p. 2.

In this case, the alleged violation of the proxy solicitation rules was related to BofA’s own disclosures. *Id.* at p. 3. Therefore, according to the [redacted] CF Supv 1 [redacted] who was tasked with deciding WKSI waiver requests for Corporation Finance, BofA did not meet the “traditional criteria” for granting a WKSI waiver. [redacted] CF Supv 1 [redacted] Testimony Tr. at pgs. 103-104, 112-114.

In support of its safe harbor waiver request, BofA made arguments similar to those made in pursuit of the WKSI waiver. For example, BofA argued that:

(1) “[t]here is no connection between the alleged misconduct and the integrity of forward-looking statements made by it or any of its affiliates;” (2) BofA “has a strong record of compliance with the securities laws and fully cooperated with the staff’s investigation into this matter;” (3) “[t]he disqualifications are not necessary given the nature of the conduct, which involved no intentional or willful misconduct by [BofA], occurred in the context of an ‘extraordinary merger during a time of unprecedented market conditions, and related to a merger proxy vote rather than a typical securities issuance or in the regular course of [BofA’s] or any of its affiliates’ businesses;” and (4) BofA “and its affiliates are ‘established and reputable entities’ within the financial industry.”

Exhibit 35 at p. 4. Just as with the WKSI waiver request, application of the Commission’s traditional criteria for safe harbor waiver applications would have resulted in the denial of BofA’s request. *Id.*

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BofA's arguments in support of its waiver requests may not have addressed the criteria used by the Commission and its operating divisions in making waiver determinations because the Commission has not disseminated the criteria to the public, as this report will discuss below. <sup>CF Supv 1</sup> Testimony Tr. at pgs. 112-113.

On July 6, 2009, the Office of Chief Counsel in Enforcement circulated a draft action memorandum to the SEC's operating divisions for comment. E-mail from <sup>ENF Atty 4</sup> to <sup>PII</sup> *et al.*, dated July 6, 2009, attaching an undated draft Action Memorandum Re Bank of America Corporation to the Commission from NYRO, attached hereto as Exhibit 40, ("July 6, 2009 Draft Action Memorandum"). In the July 6, 2009 Draft Action Memorandum, the Enforcement staff recommended that the Commission <sup>WP, AC, DP, LE</sup>

<sup>WP, AC, DP, LE</sup>

On July 10, 2009, <sup>CF Atty 2</sup> in Corporation Finance's <sup>PII</sup> commented on the July 6, 2009 Draft Action Memorandum. Exhibit 38. <sup>CF Atty 2</sup> stated that it would be <sup>WP, DP, AC, LE</sup>

<sup>DP, WP, AC, LE</sup>

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On July 13, 2009, the Office of General Counsel also commented on Enforcement's July 6, 2009 Draft Action Memorandum. E-mail from Richard Levine to ENF Supv 3, dated July 13, 2009, attached hereto as Exhibit 40. In the e-mail, Richard Levine, then an Assistant General Counsel, stated that the Office of General Counsel DP, WP, AC, LE

DP, WP, AC, LE

Exhibit 40.

**D. Despite Corporation Finance's Objections, Enforcement Recommended that the Commission Accept a Settlement with BofA that was Contingent upon Regulatory Waivers**

After receiving comments regarding the July 6, 2009 Draft Memorandum, the Enforcement staff separated the recommendations regarding BofA's request for regulatory waivers and exemptions into a separate Supplemental Memorandum. E-mail from ENF Supv 3 to Levine *et al.*, dated July 24, 2009 (attaching July 24, 2009 Draft Supplemental Memorandum), attached hereto as Exhibit 41. On July 24, 2009, ENF Supv 3 circulated a draft version of the Supplemental Memorandum with a cover e-mail stating that "the WSKI and Safe-Harbor Waiver issues are still unresolved" and that the team "anticipate[s] revising the memo as soon as a final determination is reached on Monday," July 27, 2009. *Id.* The cover page of the attached July 24, 2009 Draft Supplemental Memorandum stated that the recommendation was for the Commission to deny BofA's WSKI waiver request, yet grant the company's safe harbor waiver request. July 24, 2009 Draft Supplemental Memorandum (Exhibit 41) at p. i. The document also stated in bold type that both of the recommendations were "Subject to Further Review." *Id.*

On July 27, 2009, Corporation Finance submitted extensive comments to Enforcement in response to the July 24, 2009 Draft Supplemental Memorandum. E-mail from CF Supv 1 to ENF Supv 3 *et al.*, dated July 27, 2009, attached hereto as Exhibit 41. Specifically, Corporation Finance stated that it found the July 24, 2009 Draft Supplemental Memorandum unclear as to whether Enforcement was recommending that the Commission grant or decline the WSKI waiver and "unclear as to whether the



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proposed settlement [was] conditioned on the granting of waivers.” *Id.* at pgs. 1-2. Corporation Finance also pointed out that Enforcement staff had not rebutted BofA’s arguments in support of a waiver. *Id.* at pgs. 2-3. Notably, Corporation Finance took issue with Enforcement’s statements that BofA’s “senior management did not knowingly cause the materially misleading statements in the proxy statement” and that disqualification would be “unduly severe” to BofA. *Id.* at pgs. 2-3. Corporation Finance explained its view as follows:

The fact that in-house counsel for [BofA] was involved in the decision not to disclose is evidence that [BofA]’s senior management was involved. Also, it’s our understanding that Enforcement’s decision not to recommend scienter-based fraud violations was made in the context of settlement only. Finally, it seems inconsistent to say disqualification would be disproportionately and unduly severe while at the same time Enforcement views the conduct as egregious enough to warrant a \$33 million monetary penalty.

*Id.* at pgs. 2-3.

In response to Corporation Finance’s comments on the July 24, 2009 Draft Supplemental Memorandum, ENF Supv 4 e-mailed Rosenfeld, ENF Supv 3 and ENF Atty 1 that the comments were “odd . . . in that they ignore what we’ve told them about our posture: that we are ultimately agnostic and will not oppose either course of action.” E-mail from ENF Supv 4 to ENF Supv 3 dated July 27, 2009, attached hereto as Exhibit 42. ENF Supv 4 testified that he was “agnostic on the merits as to whether, in fact, it was appropriate to grant the WKSI waiver.” ENF Supv 4 Testimony Tr. at p. 71. He stated, “We didn’t weigh in internally with the Commission or with the folks in the division saying we think you should grant it for the following reasons.” *Id.* at p. 72. ENF Supv 4 and ENF Atty 1 testified that if the settlement with BofA fell through, they were prepared to litigate. ENF Supv 4 Testimony Tr. at p. 110; ENF Atty 1 Testimony Tr. at p. 69. However, ENF Supv 4 explained that they did not want the deal to break down because of the WKSI waiver:

Would it have made us happy [if] we didn’t have [a] settlement [because of the] WKSI issue? No. You know, to the extent we thought it was a good settlement on the Enforcement side, the injunction and the penalty and wanted to see it get presented to the Commission and approved by the Commission? Yes. To the extent the whole WKSI thing became an obstacle to that, that decreased our level of happiness, for lack of a better term. . . . [W]e didn’t want the deal to break down.

ENF Supv 4 Testimony Tr. at pgs. 72-73.

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In contrast to ENF Supv 4 "agnosticism," Rosenfeld was very concerned about the WKSI waiver and feared BofA would not enter into a settlement without it. In a June 26, 2009 e-mail to ENF Atty 1 ENF Supv 3 described Rosenfeld's state of mind by stating, "I stopped off in ENF Supv 4 office to let him know about the WKSI issue. He wasn't concerned but then David [Rosenfeld] came in and was **extremely worried that it could be a potential dealbreaker.**" E-mail from ENF Supv 3 to ENF Atty 1, dated June 26, 2009, attached hereto as Exhibit 43 (emphasis added).

Rosenfeld testified that he recalled that the WKSI waiver was an important issue, stating "I don't recall a specific time line but I do remember it as being a very, very important issue." Rosenfeld Testimony Tr. at p. 38. He explained that for BofA "it was an issue primarily from a straight economic standpoint. They were concerned if they did not have a WKSI waiver they would be at a competitive disadvantage in going to the market." *Id.* at pgs. 40-41. ENF Supv 3 had a similar recollection of why the WKSI waiver was important to BofA: "I think they had to issue a new security to get an infusion of cash. So, at this point in time, it was very critical to the company to be able to access the capital markets. So David [Rosenfeld] recognized that it would be an issue to Bank of America." ENF Supv 3 Testimony Tr. at p. 41.

The WKSI waiver issue was of such importance to BofA that the settlement became contingent on BofA's receipt of the waiver. ENF Supv 3 discussed the contingency in the following July 23, 2009 e-mail to ENF Supv 4 (copying ENF Atty 1

In the very first paragraph [of the Draft Supplemental Memorandum], we state that [BofA] has indicated that its offer of settlement is contingent on the grant of the requested regulatory waivers. **I realize there is sensitivity surrounding this point**, but Robin Bergen [from BofA] told IM Supv 1 [from the Division of Investment Management] today that there would be no settlement if Corp Fin didn't grant the WKSI. The sentence is bolded and in brackets.

July 24, 2009 e-mail from ENF Supv 3 to ENF Supv 4 (emphasis added) (e-mail chain includes the July 23, 2009 e-mail from ENF Supv 3 to ENF Supv 4 attached hereto as Exhibit 68, at p. 2.

ENF Supv 3 testified that late in the settlement process, BofA "communicated [that a WKSI waiver was] a deal breaker."<sup>11</sup> ENF Supv 3 Testimony Tr. at pgs. 46, 50. Similar to

<sup>11</sup> On July 7, 2009, ENF Supv 3 sent an e-mail describing BofA's position to Rosenfeld and ENF Supv 4 "I just had a call with Robin Bergen – primarily relating to the status of BofA's 9(c) waiver request . . . Robin mentioned that people at the highest levels of BofA are most focused on the [WKSI] issue – 'since that is potentially a deal breaker.'" E-mail from ENF Supv 3 to Rosenfeld dated July 7, 2009, attached hereto as Exhibit 44. As discussed above, approximately two weeks later, BofA informed an SEC official that "there would be no settlement if Corp Fin didn't grant the WKSI." Exhibit 68 at p. 2.

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ENF Supv 3 recollection, the Regional Director of NYRO, George Canellos, testified, "I think it was clear that [BofA] was not going to do a settlement without a waiver of any disabilities that they would have under WKSI. It was very important for them to remain WKSI . . . ." <sup>12</sup> Canellos Testimony Tr. at pgs. 61-62.

On the morning of July 30, 2009, only hours before the Commission was scheduled to vote on whether to accept Enforcement's proposed settlement, Rosenfeld and the Director of Enforcement, Robert Khuzami, met with BofA and high level officials from Corporation Finance where BofA sought to persuade Corporation Finance to grant a WKSI waiver. At the meeting, BofA made a "presentation that was again focused entirely on the business necessity of obtaining this waiver." Rosenfeld Testimony Tr. at p. 44. BofA was willing to settle on the SEC's terms as long as they got the WKSI waiver. *Id.* at p. 43.

### 1. The Commission and Corporation Finance Disfavored Contingent Settlement Recommendations

The issue of whether the BofA settlement was contingent on the WKSI waiver was an important one because the Enforcement staff was aware that the previous Commission had been "strongly against being presented with contingent settlement offers." E-mail from ENF Atty 4 to Rosenfeld *et al.*, dated July 9, 2009, attached hereto as Exhibit 45. ENF Atty 4 in Enforcement's Office of Chief Counsel, commented on a draft of the BofA Action Memorandum as follows:

Is Bank of America's offer contingent upon the granting of the waivers? If so, this should be noted in the memo (and you should be prepared to answer questions about this from the Commission – the previous Commission was strongly against being presented with contingent settlement offers, but this Commission has not yet faced the issue).

*Id.* <sup>13</sup>

ENF Atty 4 further described the Commission's view of contingent settlements in testimony as follows:

The previous Commission had made very clear to us that they did not want to consider offers that were contingent

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<sup>12</sup> ENF Supv 4 recalled that the WKSI waiver "might be a deal breaker, but did not recall BofA threatening to "pull the settlement." ENF Supv 4 Testimony Tr. at pgs. 70, 78. However, he testified that he was not "involved directly" in the WKSI discussions. *Id.*

<sup>13</sup> On July 23, 2009, ENF Supv 3 circulated a draft that described BofA's settlement offer as contingent on a WKSI waiver. Exhibit 68 at p. 2. In the draft and in her e-mail, ENF Supv 8 highlighted the contingency issue and stated in her e-mail, "I realize that there is sensitivity surrounding this point." *Id.*

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upon the granting of a waiver. In other words, they didn't want a company to come forward and say, "Here's our offer of settlement. Oh, but we're going to withdraw it if you don't grant XYZ waiver for us." . . . I know that they expressed frustration if a waiver was connected to an offer of settlement. . . . They did not like contingent settlement offers.

ENF Atty 4 Testimony Tr. at pgs. 19-24.

Not only did the Commission historically disfavor contingent settlements, Corporation Finance was strongly against them as well. CF Supv 1 Corporation Finance's PII, explained in the following exchange why Enforcement settlements are not supposed to be contingent upon regulatory waivers:

A: The reason for that is it cannot be a condition. . . . Because . . . when the WKSI waivers were put into the rule itself . . . the whole idea is that they [can't] be negotiated out, okay? They [weren't] to be . . . a [chip] that you use to settle. Either you violated it, or you haven't violated it. . . . And you either got the requirement or you don't. You didn't want it to become a bargaining tool. Otherwise, what's the point of having a waiver? We might as well just take that provision out of there. . . . We didn't want to get in the middle of being that bargaining thing. So, we decided that, you know, look, it's either – there are two criteria that you're going to . . . [meet to] get the waiver.

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Q: So you didn't want companies to be able to negotiate away this –

A: No. . . . And we didn't want it to be eroded.

CF Supv 1 Testimony Tr. at pgs. 108-109.

Then-Associate Director Dubberly also described how allowing Enforcement to use WKSI waivers as a bargaining chip in settlements could erode the integrity of the WKSI waiver determination in the following exchange:

A: [W]e're never going to win. . . . Enforcement is just never going to care about it as much as Corp Fin does, so if it becomes part of the Enforcement

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negotiating process, it will always be given up. You'll always give the waiver because they're not going to care as much as we do. It's just conceptually not something they are going to worry about like we do.

Q: Corp Fin didn't want the WKSI waiver to turn into something that could be negotiated away by Enforcement in a settlement?

A: [T]hat's been something we have been worried about throughout the WKSI waiver process.

Dubberly Testimony Tr. at p. 51.

## 2. The Contingency of the Settlement Was Not Disclosed in the Action Memorandum to the Commission

Despite ENF Atty 4 telling Rosenfeld and the rest of the Enforcement team that any contingency in the proposed settlement with BofA should have been included in the Action Memorandum to the Commission, neither the final Action Memorandum nor the final Supplemental Memorandum disclosed that the settlement was contingent upon the WKSI waiver. See July 20, 2009 Action Memorandum (Exhibit 21); July 28, 2009 Supplemental Action Memorandum (Exhibit 35).

After the Enforcement staff received ENF Atty 4 comment, a subsequent draft of the Supplemental Memorandum did describe the settlement as contingent. See E-mail from ENF Supv 4 to ENF Supv 6 dated July 27, 2009, attached hereto as Exhibit 47. However, during the process of editing the action memorandum for the Commission, Rosenfeld deleted that information. *Id.* His deletion of that information caused ENF Supv 6 some concern as she expressed in the following July 27, 2009 e-mail exchange:

ENF Supv 3

Did I tell you the memo no longer states that the offer is contingent on the waivers – I'm a bit concerned about that.

ENF Supv 4

[responding one minute later]:

Yes, I saw that David made that deletion.

*Id.*

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In testimony, ENF Supv 3 explained why she believed that the contingency of the settlement should have been disclosed to the Commission in the Supplemental Memorandum:

A: Well, I think that – if I was understanding [what] Bank of America's position was [then] we didn't have a settlement unless they got the WKSI. My thought was that everyone should know about that, that the Commission certainly should know about that when reading the authorization, the memo was directed towards them. My experience here is that we just make sure they are aware of all of the relevant facts. And in my mind, that was a relevant fact.

Q: And why did you feel that was relevant?

A: Well, because I had been told that ordinarily, we don't make recommendations that are contingent on any – have any contingencies.

ENF Supv 3 Testimony Tr. at pgs. 63-64. ENF Supv 3 did not recall further discussion with ENF Supv 4 about the deletion issue and did not recall him raising the issue with Rosenfeld. ENF Supv 3 explained that "I raised it to my supervisor and I don't think I [said] anything beyond that." *Id.* at p. 64. ENF Supv 4 did not recall taking any action in response to ENF Supv 3 e-mail. ENF Supv 4 Testimony Tr. at pgs. 88-89.

Although disclosure of the contingent nature of the settlement was not made in the Action Memorandum, the Commission was clearly apprised of the conditional nature of the settlement DP, AC, LE

DP, AC, LE

DP, AC, LE

Verbal disclosure of a crucial and controversial point DP, AC, LE is, however, not necessarily a substitute for fulsome disclosure in the requisite Action Memorandum.

**E. After Meeting with BofA on the Morning of the Commission Meeting, Corporation Finance Decided to no Longer Oppose BofA's Request for a WKSI Waiver**

Up until the morning of the July 30, 2009 Closed Commission Meeting, it appeared that Corporation Finance would continue to deny BofA's request for the WKSI waiver. Rosenfeld stated that members of Enforcement had "had a number of conversations with the folks in [C]orporation [F]inance, CF Supv 1 CF Atty 2

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CF Atty 3 and at some point Brian Breheny, who was the deputy there . . . [and] [t]hey were very negative on the possibility of granting a WKSI waiver. . . . [T]hey were unwilling to budge off of this.” Rosenfeld Testimony Tr. at pgs. 42-44. A few days before the Commission meeting, ENF Supv 3 expressed the belief that BofA would not receive the requested waivers. In an e-mail to the Office of General Counsel, Corporation Finance and others, ENF Supv 3 wrote that “We’ve reached out to Bank of America’s counsel and communicated to them that the WKSI and safe-harbor waiver requests will almost certainly be denied. They are supposed to let us know by tomorrow morning whether they plan on withdrawing their settlement offer.” E-mail from ENF Supv 3 to CF Supv 1 et al., dated July 27, 2009, attached hereto as Exhibit 48.

The final version of the Supplemental Memorandum that was circulated to the Commissioners stated on the cover page that the recommendation was to “Deny Bank of America’s requests” for the WKSI and safe harbor for forward-looking statements waivers and grant BofA’s other requests for regulatory relief. Exhibit 35 at p. i. However, only hours before the Closed Commission Meeting, Khuzami, Rosenfeld, and head officials from Corporation Finance – including Tom Kim, Chief Counsel, and Brian Breheny, then-Deputy Director for Legal and Regulatory Policy – met with representatives of BofA, including the former General Counsel of the SEC Giovanni Prezioso. E-mail from ENF Supv 3 to ENF Atty 1 dated July 29, 2009, attached hereto as Exhibit 49.

At a meeting with BofA and Enforcement on the morning of the July 30, 2009 Closed Commission Meeting, Corporation Finance altered its view of BofA’s WKSI waiver request. Rosenfeld Testimony Tr. at pgs. 45-46. According to Enforcement attorneys, BofA convinced Corporation Finance of the potentially devastating impact of losing its WKSI status. ENF Supv 3 Testimony Tr. at pgs. 53-54; ENF Atty 1 Testimony Tr. at pgs. 86-87. Enforcement Director Khuzami recalled that at the morning meeting, BofA argued that the dire state of the financial markets made it critical that it be able to raise money quickly:

But at the meeting the point that Bank of America made [was] . . . given the circumstances of the need to [raise] financing at that point in time, because they were under financial stress as they put it, the ability go in quickly was particularly important at that time. And so it’s a combination of would [we] be at [a] disadvantage to our competitors, and in light of the financial strain in general, it’s a particularly inopportune time to deny us that status.

Khuzami Testimony Tr. at pgs. 112-113.

Rosenfeld recalled in the following quote that after the meeting with BofA, Corporation Finance agreed to grant BofA a conditional WKSI waiver that the Commission could revoke under certain circumstances:

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Subsequent to that meeting, the Division of Corporation Finance decided that they might be able to live with some form of a WKSI waiver. They completely just changed their minds on it and in the conversations we had with them, Tom [Kim] said he was convinced by some of their arguments about competitiveness. There was still some considerable consternation on their [part] and some worry about this. And so they tried to craft a modified WKSI waiver which would allow them basically to call back the waiver if certain things happened. So it was kind of like being on probation.

Rosenfeld Testimony Tr. at pgs. 45-46.

Consequently, Enforcement

DP, AC, LE

DP, AC, LE

DP, AC, LE

See Minutes of July 30, 2009 Closed Commission Meeting, attached hereto as Exhibit 46, at pgs. 8-9.

### **1. Corporation Finance Considered BofA's TARP Status in Making Its Final WKSI Recommendation**

The modified recommendation regarding BofA was the first time Corporation Finance did not oppose outright the grant of a WKSI waiver where the company did not meet the traditional criteria for the waiver. <sup>CF Supv 1</sup> Testimony Tr. at p. 116. Members of Corporation Finance explained that BofA's status as a TARP recipient played a part in the Division's decision not to oppose the WKSI waiver. <sup>CF Supv 1</sup> stated that although BofA did not meet the "traditional criteria" for a WKSI waiver, the Division "reluctantly [thought] that we . . . would throw it to the Commission and not oppose the WKSI waiver . . . because of the fact that the company needed to go into the market . . . they needed to raise an enormous amount of money" and "pay back" TARP. *Id.* at pgs. 112-113.

<sup>CF Atty 2</sup> had a similar recollection that Corporation Finance's ultimate decision not to oppose the grant of a WKSI waiver was, at least in part, based on BofA's status as a TARP recipient:

My understanding was that – that there was some deference given to the fact that the company was a TARP recipient and that it was, you know, the difficult financial times, and that we didn't want to interfere with their ability to compete with other banks; that it would not be in the interest of the market or investors to prevent them from getting to the market as quickly as their competitors. . . . Enforcement may have been trying to convince us that it was appropriate



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to grant it for the reasons relating to the TARP money – and the economic situation, financial, that there should be a way to get outside boundaries of those two narrow exceptions . . . .

CF Atty 2 Testimony Tr. at pgs. 42-43, 53-54.

CF Atty 2 was not convinced by BofA's financial distress arguments, but believed that she was in the minority. *Id.* at p. 47. She explained that she felt DP, LE

DP, LE

A: I didn't want DP, LE

Q: Because you felt DP, LE

A: Yeah. DP, LE

Q: Right, and you DP, LE

A:

*Id.* at pgs. 46-47.

In Section VIII below, the OIG thoroughly analyzed the issue of whether conflicts of interest identified by Congressman Cummings relating to BofA's status as a TARP recipient arose in connection with the SEC's Enforcement action and found that Corporation Finance's decision to recommend a WKSI waiver to BofA notwithstanding that BofA did not meet the criteria traditionally applied by Corporation Finance for a WKSI waiver, was an example of the SEC considering a TARP firm's viability and the potential systemic risk to the financial industry in connection with the SEC's Enforcement action against BofA.

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## 2. Corporation Finance May Have Been Concerned the Commission Would Grant BofA a WKSI Waiver Even if Corporation Finance Opposed It

In addition to the arguments BofA made at the July 30, 2009 meeting about its need to raise capital quickly, Corporation Finance's decision not to oppose BofA's request for a WKSI waiver may have been influenced by concern that if they did not relent, the Commission would grant BofA the waiver without imposing any conditions. The Commission took such action in a matter decided under the previous Chairman. In the case of *In the Matter of Tenet Healthcare Corp.*, LA-2658 (April 19, 2007), the company did not meet the traditional criteria for either WKSI or safe harbor waivers, yet the Commission granted the company the requested safe harbor waiver and "[d]irected [Corporation Finance] to grant the [WKSI] waiver." <sup>CF Supv 1</sup> Testimony Tr. at p. 107; Letter from <sup>CF Supv 1</sup> to Jay P. Lefkowitz, re *In the Matter of Tenet Healthcare Corp.*, LA-2658, granting relief from WKSI disqualification (April 19, 2007) and Securities Act Release No. 8792, order granting relief from safe harbor disqualification, attached hereto as Exhibit 50.

As witnesses from Corporation Finance testified, after delegating the authority to make WKSI waiver determinations to Corporation Finance, the Commission "went over our heads before [Corporation Finance] had a chance to deny" the company's waiver request. <sup>CF Atty 2</sup> Testimony Tr. at p. 53; <sup>CF Supv 1</sup> Testimony Tr. at p. 107. Members of Corporation Finance were "not happy about it." <sup>CF Supv 1</sup> Testimony Tr. at p. 107.

Dubberly stated that Corporation Finance was concerned that if the Commission overruled Corporation Finance and granted WKSI waivers without regard to the traditional and objective criteria that Corporation Finance followed, the WKSI waiver process would become arbitrary:

[The Commission was] pushing to try to have us grant [waivers] more often, and we were nervous it was going to turn into some sort of, you know, we're just picking and choosing. You know, we had this bright line. . . . You want something that's objective so it's not sort of at the whim, and "whim" is too strong a word, but you know, you don't want it to be just loosey-goosey, for lack of a better way of describing it. . . . [I]t's a big deal to be a WKSI, and you should be a good company if you've got it. You don't get it if you get charged with one of these or you agree to it. That was in the rule and we should only carve out the rule, you know, if there is really good reason. By now, it wasn't in black and white. It wasn't really clear what the Commission wanted to do with WKSI waivers.

Dubberly Testimony Tr. at pgs. 49-50.



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DP, AC, WP, LE

The recommended clawback would allow the Commission to terminate BofA's WKSJ waiver if Corporation Finance had reason to believe that BofA's filings were not reliable. *Id.* In response to questions from the Commissioners, Corporation Finance staff

DP, AC, WP, LE

The Commissioners expressed

DP, AC, LE

Specifically, Rosenfeld recalled the following:

DP, AC, LE

Rosenfeld Testimony Tr. at p. 47. ENF Supv 4 recalled that

DP, AC, LE

DP, AC, LE

ENF Supv 4

Testimony Tr. at p. 97.

DP, AC, WP, LE

OGC Supv

emphasized the view of the

Office of General Counsel that it

DP, AC, WP, LE

In a memorandum to the

Commission OGC Supv explained that,

DP, AC, WP, LE

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DP, AC, WP

Exhibit 39 at p. 3.

At the end of the Closed Meeting, the Commissioners approved the recommended civil injunctive action against BofA by a vote of DP, AC, LE Exhibit 46 at p. 10. The Commissioners also granted Enforcement's request for standby authority to grant BofA a conditional WKSI waiver by a vote of DP, AC, LE DP, AC, LE *Id.* In an e-mail to PII NYRO Enforcement staff, ENF Atty 2 described the results of the Closed Meeting as follows: "The staff's recommendation for [a] settled enforcement action against BofA for proxy fraud . . . was approved by executive session (the sensitive aspect: the controversial request for an exemption from the 'widely held' issuer disqualification – a deal breaker) was approved DP, AC, WP, LE See E-mail from ENF Atty 2 to ENF Supv 6 et al., dated August 3, 2009, re "Gleanings from 7/30 Closed SEC Meeting," attached hereto as Exhibit 51; ENF Atty 2 Testimony Tr. at pgs. 13-16.

Although the Commission voted to approve the grant of a conditional WKSI waiver, BofA neither needed nor received the waiver because an antifraud injunction was never entered. Judge Rakoff rejected the first proposed settlement, and the second settlement did not include an injunction, as described below.

### G. Recommendations for Improved Commission Waiver Practice

Notwithstanding that the waiver issue became moot in this case, the OIG investigation uncovered potential concerns about the clarity and consistency of the Commission's waiver practice. The OIG found that the Commission has not clearly stated what criteria should be applied in making waiver determinations and has not apprised the public of how waiver determinations are made in a policy statement nor articulated its reasoning in its written waiver determinations. See generally Exhibit 50 and Exhibit 69.

The OIG found that the traditional criteria for determining WKSI waiver requests were not applied to BofA. In this case, BofA clearly did not meet the SEC's traditional criteria as BofA's alleged fraud was related to its own disclosures. Nonetheless, Corporation Finance agreed to recommend that BofA receive a conditional WKSI waiver based upon a new concern that in this economic environment denying BofA a WKSI waiver could have an adverse impact on BofA and the entire market. We found that BofA was not the first issuer to receive waivers when they did not meet the traditional criteria. We found that the Commission had previously granted an issuer a safe harbor waiver and directed Corporation Finance to grant the issuer a WKSI waiver where the company did not meet the traditional criteria for waiver. In addition, we found that the SEC's general policy was to deny or grant WKSI and safe harbor waivers in tandem. Yet, in this case, the Commission acted in an inconsistent manner as it related to its prior

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practice, by agreeing to grant BofA a WKSI waiver while denying it a safe harbor waiver. We further found that these decisions to depart from the general practice were made with regard to the particular factual circumstances of a specific company, rather than due to an overall reconsideration of the policy. Moreover, we have not found written documentation explaining why the Commission departed from the SEC's general policy in these particular cases.

The Office of General Counsel has repeatedly encouraged the Commission to establish waiver criteria and to apply it consistently. Exhibit 39. While the Commission has flexibility in making waiver determinations, its discretion is reviewable. *Id.* The OIG understands that federal courts may find waiver decisions to be arbitrary and capricious where the agency fails to describe the criteria it uses in making waiver determinations and to explain how the criteria applied to the applicant. *See generally* Exhibit 39 and Exhibit 69 at pgs. 3-4. This may also occur in situations where the decision is inconsistent with prior determinations and the agency does not explain its rationale for the departure. *Id.* The OIG recommends, therefore, that Corporation Finance: (1) create clear criteria for making waiver determinations; (2) disseminate the guidance both internally and externally; and (3) in cases where the waiver decision departs from the stated criteria, articulate in a written decision or order the rationale for its departure.

#### **IV. ENFORCEMENT REACHED SECOND SETTLEMENT WITH BOFA**

After the Court rejected the SEC's first proposed settlement with BofA on September 14, 2009, the NYRO Enforcement staff immediately started preparing for trial while simultaneously continuing settlement talks with BofA. In preparation for trial, a new NYRO Enforcement team was assembled, consisting of ENF Atty 3 [REDACTED] ENF Supv 1 [REDACTED] ENF Supv 5 [REDACTED] and NYRO Regional Director Canellos. ENF Atty 1 [REDACTED] from the first team, was also on the second team. ENF Supv 1 [REDACTED] Testimony Tr. at pgs. 18-19. The second team's work on the case continued from the date of Judge Rakoff's Memorandum Opinion until a second proposed settlement was reached with BofA on February 4, 2010. The second proposed settlement consisted of two sets of charges filed against BofA in federal court for violations of Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder: the first being the previously-filed charge that BofA failed to disclose in its joint proxy statement with Merrill an agreement allowing Merrill to grant nearly \$6 billion in year-end bonuses to company executives; and the second being the later charge of "failing to disclose the extraordinary losses that Merrill sustained in October and November 2008," which was filed January 12, 2010. *See generally* February 4, 2010 Litigation Release titled *Bank of America Agrees to Pay \$150 Million to Settle SEC Charges*, attached hereto as Exhibit 34. As was the case with the first proposed settlement, the SEC did not charge any corporate officers with misconduct.

The second proposed settlement was approved by Judge Rakoff on February 22, 2010, and consisted of: (1) a civil monetary penalty of \$150 million with a distribution plan to be proposed at a later date; (2) seven remedial undertakings that BofA was

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required to implement and maintain for a period of three years; and (3) a Statement of Facts describing the details behind the allegations in the actions based on the discovery record. *Id.* at pgs. 1-2.

**A. The Second Team Worked Both to Litigate and Settle the Case**

**1. The Second Team Conducted Extensive Discovery and Added a New Charge Under Exchange Act Section 14(a)**

In the aftermath of Judge Rakoff's rejection of the SEC's first proposed settlement, NYRO Enforcement was required to assemble a second team in short order – a team that included litigators as well as investigators. A September 23, 2009 e-mail from ENF Supv 5 to a NYRO staff member communicated the urgency of the situation:

NYRO Staff ENF Supv 1 and I just got assigned to Bank of America. You may have heard, Judge Rakoff rejected the settlement and ordered the case to trial March 1, with expedited discovery commencing immediately. We need to take 20 to 30 depositions. This case is being watched by the Chairman's office. We need an RQ to fund all depositions (many of which will be video depositions). We need at least \$50k funding now. [How] much can you get[?] I need a general litigation expenses RQ for this case ASAP. Your help is much appreciated.

September 23, 2009 e-mail from ENF Supv 5 to NYRO Staff attached hereto as Exhibit 52.

To prepare for litigation in case the matter could not be settled, the second team engaged in extensive discovery, including deposing a significant number of witnesses in a short period of time, as the following excerpt from the staff's January 28, 2010 Action Memorandum to the Commission states:

DP, AC, WP, LE



January 28, 2010 Action Memorandum (attachments not included) titled *In the Matter of Merrill Lynch & Co., Inc. Subprime Mortgage Portfolio (NY-7842)*, attached hereto as Exhibit 53, at p. 3. While preparing for trial, the second team decided to add a new

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charge to the existing Exchange Section 14(a)/Exchange Act Rule 14a-9 charge against BofA. The new charge – that BofA violated Exchange Act Rule 14a-3 – was based on the theory that BofA's failure to file all required information as part of its joint proxy statement with Merrill violated the Rule. As Canellos stated in an e-mail to the members of both teams, Khuzami and Deputy Director of Enforcement Lorin Reisner:

Please give some thought to whether we ought to be adding to the [BofA] complaint a charge under Rule 14a-3. A charge under Rule 14a-3 would be essentially predicated on the allegation that B of A failed to discharge affirmative disclosure duties created by SEC regulations governing proxy solicitation. . . . If this analysis is correct, [BofA]/Merrill was required to file all information in the disclosure schedule unless the information was immaterial or disclosed in the merger agreement itself. . . . If we are going to a jury with this case, I am hard pressed to think why we would not add a count under Rule 14a-3 and give ourselves the opportunity to establish liability under such a lenient and uncomplicated standard.

October 19, 2009 e-mail from ENF Atty 3 to Canellos *et al.*, (chain includes October 18, 2009 e-mail from Canellos quoted above), attached hereto as Exhibit 54, at pgs. 2-3. Canellos similarly testified that he made the decision to add this new charge because:

When I became involved in the case actively it was close to the deadline for amendment of the existing complaint as of right, and we were in a contested litigation and the only charge that was included in the original complaint, which was [contemplated] to be a settled action, was a charge under Rule 14a-9 of the 1934 Securities Exchange Act, which proscribes deceptive conduct making misrepresentations or making misleading statements in connection with a proxy. And I felt that from a litigation standpoint a charge under Rule 14a-3, which is a very similar charge, would be well-founded in the law and put us in a better litigation position.

Canellos Testimony Tr. at pgs. 15-16.

On October 19, 2009, the second team received Commission authorization, through expedited action, to amend the existing complaint against BofA to include a charge for violating Exchange Act Rule 14a-3. Later that day, the staff filed the amended complaint. *See generally* October 19, 2009 e-mail from Reisner to Sr Adv *et al.*, and attached October 19, 2009 Action Memorandum and signed Amended SEC Complaint, attached hereto as Exhibit 55.



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## 2. The Second Team Brought a Second Case Based on Failure to Disclose Fourth Quarter Losses Suffered by Merrill

After amending the complaint to add the Exchange Act Rule 14a-3 charge against BofA, the second team brought a second case against BofA for its alleged failure to disclose significant fourth quarter losses suffered by Merrill. In its January 28, 2010 Action Memorandum to the Commission, Enforcement staff described the new "Q4 Losses Action" as follows:



Exhibit 53 at pgs. 3-4. As discussed earlier in this report, Khuzami once was skeptical whether a second case would be brought at all. However, as Canellos explained to the OIG, this became a critical issue, and Canellos stressed to the team the need to develop the facts to bring any and all potential cases together:

My concern, however, was that the laws of res judicata might require us . . . to bring any and all claims that we have relating to proxy disclosure in this case or suffer preclusion of ever being able to bring them again. So that you know in a litigated context we don't have the leash any longer to separately investigate this in a separate investigation. If we're ever going to bring other claims related to this proxy we may need to bring them now. . . . And so I very much wanted people to accelerate and fold into the discovery in this case scrutiny of that issue.

Q: So they kind of ramped up their investigation on the losses issue after that discussion?

A: I don't know about ramping it up. I don't know to what extent there had been much investigation about it before. But we all when we were talking about strategy for discovery, it was very important

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to focus on this issue because it might present the basis for amendment of the complaint. And I was saying this is it, don't start thinking we're going to be bringing a case a year from now. If it's meritorious it should be brought now.

Q: So an investigation was conducted and eventually I guess the first thought was to amend the complaint, but then as a procedural matter you weren't able to amend the complaint so a separate action was brought with Judge Rakoff in . . . a related case?

A: Correct.

Canellos Testimony Tr. at pgs. 47-49.

On December 18, 2009, Canellos (by phone) and others (including Khuzami and representatives from Corporation Finance) met with Chairman Schapiro about settlement issues, including adding the charge of BofA's failure to disclose Merrill's losses, <sup>DP, AC</sup> [REDACTED] <sup>DP, AC</sup> [REDACTED] December 19, 2009 e-mail from <sup>ENF Supv 5</sup> [REDACTED] to <sup>ENF Supv</sup> [REDACTED] *et al.*, (chain includes December 18, 2009 e-mail from Canellos to members of both BofA teams discussing the Chairman's meeting), attached hereto as Exhibit 56, at p. 2. As will be discussed below, this additional charge, which ultimately was filed as a second case due to procedural issues, was critical to the second proposed settlement with BofA because it created (along with Judge Rakoff's rejection of the first proposed settlement) the leverage necessary to demand a larger civil monetary penalty from BofA and enhanced the prospect for a Fair Fund distribution to injured investors.

### **3. The Second Team Focused Intently On Charging Individuals**

A critical difference of the second team's approach to the BofA settlement from that of the first team was the amount of attention paid to the issue of charging individuals. As discussed earlier in this report, a central theme of Judge Rakoff's September 14, 2009 Memorandum Opinion was his concern with the SEC's decision not to charge individuals in its first proposed settlement. Although at the end of the day the second team decided – as did the first team – not to charge individuals, the second team made great efforts look closely at individuals to determine if charges could be brought. For example, <sup>ENF Supv 1</sup> [REDACTED] wrote an e-mail on October 31, 2009 expressing his belief th

[T]he theme of our case has got to be that the company's negligence is rooted in [L]ewis' (and possibly others') decision to completely remove himself from the disclosure process and to delegate everything to counsel. . . . For these reasons, I am in favor of amending [the complaint] to name at least him. I don't see how our case is internally consistent otherwise.

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November 1, 2009 e-mail from ENF Supv 5 to Canellos *et al.*, (chain contains October 31, 2009 e-mail from ENF Supv 1 to others on BofA team from which the above quote was taken), attached hereto as Exhibit 57, at p. 3. ENF Supv 1 who ultimately concluded that individuals should not be charged in this case, testified to the OIG that although he changed his view as he learned more about the case, he first went through a process "several times in the case" whereby ideas were "banter[ed] back and forth." ENF Supv 1 Testimony Tr. at p. 27. ENF Supv 1 also testified that "there was consideration given to both perspectives" when making the final decision on the issue and described in the following exchange the discussions about charging individuals:

Q: Was there considerable discussion of this issue whether to charge Mr. Lewis individually?

A: We discussed this to death, repeatedly, over and over, amongst the trial team as well as with the Chairman's office.

Q: What was the Chairman's office's perspective on this?

A: I believe at a point in time the Chairman DP, AC, WP, LE

DP, AC, WP, LE

*Id.* at pgs. 33, 36-37. As Canellos explained to the BofA team in his December 18, 2009 e-mail recounting the Chairman's settlement meeting, DP, AC, WP, LE

DP, AC, WP, LE

DP, AC, WP, LE

Exhibit 56 at p. 2.

ENF Supv 1 assessment of the degree of consideration given to charging individuals was supported by Canellos in both testimony and e-mails. For example, in Exhibit 56 immediately above, Canellos wrote to the team about his conference call with the Chairman, DP, AC, WP, LE

DP, AC, WP, LE

*Id.* at p. 2. Canellos also testified in the following exchange:

Q: So is it fair to say from the time you were involved in the Bank of America case after Judge Rakoff had rejected them for a settlement, that you certainly wanted the team to explore every possible avenue to potentially bring a claim against individuals?

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A: Yes.

Q: And the team did explore it, there was a lot of discussion and back and forth and brainstorming to try to come up with an appropriate charge, but that you and the others determined that there simply wasn't a factual and legal basis to bring a claim against individuals?

A: That's correct.

Q:



A: That's correct.

Canellos Testimony Tr. at pgs. 26-27. Khuzami also spoke to the thoroughness of the second team's analysis of whether to charge individuals in the following exchange:

Q: Okay. And so is it fair to say that this was something that was discussed, in terms of the possibility of bringing an action against individuals, and it got a full airing and discussion, and it was determined not to go forward with?

A: There was a great deal of debate about whether or not we could charge individuals.

Q: Okay. And so the timeframe you're talking [about] is after the first settlement was rejected?

A: Yes.

Q: Okay. And so you feel comfortable that within that timeframe every effort was made to see if the case could be brought against individuals, there was a great deal of analysis, and the conclusion that the SEC [reached] to charge individuals was the correct one?

A: Yes.

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Q: And you participated in that on some level?

A: Yes.

Khuzami Testimony Tr. at pgs. 116-117.

Finally, the second team did not appear confused about whether individuals could be charged as direct violators of Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder. Specifically, <sup>ENF Supv</sup> testified that, when considering whether to charge former BofA CEO Ken Lewis, he was considering charging him with direct violations of Section 14(a)/Rule 14a-9. <sup>ENF Supv 1</sup> Testimony Tr. at pgs. 27-28. <sup>ENF Atty 3</sup> testified about a case where she “had a settled matter with an individual . . . who was charged with [Exchange Act Section] 14(a) and [Exchange Act Rule] 14a-9 directly.” See <sup>ENF Atty 3</sup> Testimony Tr. at pgs. 35-39. Similarly, Canellos responded in the affirmative when asked whether the SEC has charged individuals for direct violations of these statutes. See Canellos Testimony Tr. at p. 26.

The OIG has found that, after Judge Rakoff rejected the SEC’s first proposed settlement, the second NYRO Enforcement team performed a large amount of discovery, added a new claim to strengthen its litigation position, focused on developing the facts necessary to file a second case alleging a failure by Merrill to disclose “extraordinary” fourth quarter losses, and thoroughly considered the issue whether to charge individuals. In order to re-settle the matter, the second team also made efforts to devise remedial relief that went beyond the standard “obey-the-law” injunction in which the defendant neither admits nor denies SEC allegations of wrongdoing, seek a meaningful civil monetary penalty from BofA, and craft a settlement that would address Judge Rakoff’s concerns about the first proposed settlement. This report will discuss below the terms and conditions of the second BofA settlement and the extent to which Judge Rakoff’s concerns were addressed thereby.

## **V. THE SECOND SETTLEMENT AND THE COURT’S SECOND OPINION**

As stated earlier, the SEC reached its second proposed settlement with BofA on February 4, 2010, and Judge Rakoff approved it on February 22, 2010. According to the SEC’s February 4, 2010 litigation release, BofA agreed to pay a civil monetary penalty of \$150 million and implement and maintain the following remedial undertakings for a period of three years:

- Retain an independent auditor to perform an audit of the Bank’s internal disclosure controls, similar to an audit of financial reporting controls currently required by the federal securities laws.
- Have its Chief Executive and Chief Financial Officers certify that they have reviewed all annual and merger proxy statements.

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- Retain disclosure counsel who will report to, and advise, the Board's Audit Committee on the Bank's disclosures, including current and periodic filings and proxy statements.
- Adopt a "super-independence" standard for all members of the Board's Compensation Committee that prohibits them from accepting other compensation from the Bank.
- Maintain a consultant to the Compensation Committee that would also meet super-independence criteria.
- Provide shareholders with an annual non-binding "say on pay" with respect to executive compensation.
- Implement and maintain incentive compensation principles and procedures and prominently publish them on Bank of America's Web site.

Exhibit 34 at p. 1.<sup>14</sup> The terms of the second settlement were reached after continued talks between Enforcement and BofA, which occurred against the backdrop of quickly-approaching trial dates for both actions ("Undisclosed Bonuses" and "Undisclosed Fourth Quarter Losses"), and required a coordinated effort between Enforcement and Corporation Finance. *See, e.g.*, December 11, 2009 e-mail from Canellos to Khuzami and L. Reisner attaching draft of [*BofA*] *Proposed Undertakings*, attached hereto as Exhibit 58 ("Rob, [a]ttached is a document that lists the potential undertakings that have emerged from brainstorming among ourselves, with corp fin, and with [*BofA*]. . . . I have gone over the whole list of corporate finance, and it reflects their best thinking on potential undertakings as well").

**A. The Proposed Settlement Would Have Imposed an Injunction on BofA While the Company Continued to Deny Any Wrongdoing**

On February 22, 2010, Judge Rakoff issued his Opinion and Order in which he "reluctantly" granted the parties' motion seeking approval of the second Consent Judgment. February 22, 2010 Opinion and Order of the Honorable Jed S. Rakoff, U.S.D.J., attached hereto as Exhibit 59 at p. 2. As Judge Rakoff explained, after considering carefully whether the second proposed settlement was "fair, reasonable, adequate, and in the public interest," his decision to approve the settlement "reluctantly" stemmed from his continued dissatisfaction with certain elements of the proposed settlement, namely, the amount of the proposed civil monetary penalty and who ultimately would be responsible for paying it – victimized shareholders. *Id.* at pgs. 8, 11.

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<sup>14</sup> The SEC's second settlement with BofA also included "a Statement of Facts describing the details behind the allegations in the actions based on the discovery record," as well as a distribution plan that the "Commission [would] propose at a later date." Exhibit 34 at pgs. 1-2.

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The first issue Judge Rakoff addressed was the remedial undertakings proposed by the SEC. As discussed previously, one of the problems Judge Rakoff expressed about the first proposed settlement was the standard “obey-the-law” injunction in which the defendant neither admits nor denies the SEC’s allegations. According to Judge Rakoff in his September 14, 2009 Memorandum Opinion, “since the Bank contends that it never made any false or misleading statements in the past, the Court at this point lacks a factual predicate for imposing such relief.” Exhibit 26 at p. 10. After Judge Rakoff’s rejection, the second team worked with Corporation Finance in an attempt to craft remedial measures that would satisfy the Judge while providing a level of prophylactic relief against future misconduct that the rejected injunction could not. Canellos explained in the following exchange:

Q: Just generally tell me what were these undertakings, what was the idea behind having these undertakings?

A: We wanted to come up with undertakings that served as remedies for the underlying alleged violation and essentially that created safeguard[s] that, A, improved the areas that we thought were deficient and within Bank of America that explained how this disclosure failure took place, and also impose safeguards to avoid a recurrence of the problem.

Q: So if the purpose of these undertakings, is it fair to say both because this was something that Judge Rakoff would approve of and this would assist in Judge Rakoff approving the second settlement, but also because they were effective measures in providing remedial relief and ensuring that things don’t reoccur?

A: Yes.

Canellos Testimony Tr. at pgs. 34-35. In addition to the stated purpose for these undertakings, they had the additional effect of allowing the proposed settlement to proceed without triggering the WKSI provisions that were a source of considerable discussion during the Commission’s approval of the first proposed settlement. Canellos addressed this point under questioning in his testimony:

Q: [The WKSI waiver] was somewhat of a sticking point and in the end there were several meetings and then Corporation Finance agreed not to oppose the WKSI waiver, and of course it kind of became moot because the judge rejected [the] settlement?

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A: Right.

Q: But in the second settlement the injunctions were taken out?

A: Right.

Q: Which obviated the issue with WKSI waivers. I guess I was just wondering was that part of the thinking in terms of getting the [injunctive] relief out? I know you had concerns generally about the [injunctive] relief, I know the judge had concerns about the injunctive relief. So what was the thinking when the second settlement was put together to take out the injunctive relief part?

A: I think it was clear that B of A was not going to do a settlement without a waiver of any disabilities that they would have under WKSI. It was very important for them to remain WKSI, and in connection with the first settlement Corp Fin was supportive of a waiver of any collateral consequences that the "obey-the-law" injunction would have had on their WKSI status, and the Commission ultimately approved that. The second settlement was going to be no different. There's two ways that you can ensure that B of A's WKSI status is not adversely affected. One way is to impose an "obey-the-law" injunction but then have the Commission waive the collateral effect of that. Another way is to just not seek the obey-the-law injunction . . . .

*Id.* at pgs. 61-62.

Judge Rakoff accepted the proposed remedial measures, and offered the following assessment of their potential effectiveness in his Opinion and Order:

No one can quarrel that these remedial steps are helpful, so far as they go, and may help to render less likely the kind of piecemeal and mincing approach to public disclosure that led to the Bank's problems in the instant cases. Given that the apparent working assumption of the Bank's decision-makers and lawyers involved in the underlying events at issue here was not to disclose information if a rationale



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could be found for not doing so, the proposed remedial steps should help foster a healthier attitude of “when in doubt, disclose.”

Exhibit 59 at p. 9. The other significant aspects of the second proposed settlement are discussed immediately below.

### **B. The Court Again Expressed Concern that the Proposed Penalty Amount Was Too Low**

The next issue raised by Judge Rakoff in his February 22, 2010 Opinion and Order was a concern he raised in his September 14, 2009 Memorandum Opinion; namely, that “[t]he fine, if looked at from the standpoint of the violation, is also inadequate, in that \$33 million is a trivial penalty for a false statement that materially infected a multi-billion-dollar merger.” Exhibit 26 at p. 11. After the first proposed settlement was rejected, the second team undertook a settlement process that differed from the first by: (1) bringing a second case – BofA’s alleged failure to disclose extraordinary fourth quarter losses by Merrill – that would allow Enforcement to seek a larger civil penalty; and (2) using additional leverage gained from Judge Rakoff’s first rejection in negotiating the larger civil penalty.

With respect to the first aspect, the second team had the [REDACTED] DP, AC, LE [REDACTED] (as was the case with the first proposed settlement) in deciding to bring the second case against BofA. In an e-mail during which he recounted [REDACTED] DP, AC, LE [REDACTED] (in which he participated by phone), Canellos stated that [REDACTED] DP, AC, LE [REDACTED]. Canellos stated further that [REDACTED] DP, AC, WP, LE [REDACTED]. *Id.* Canellos then added, “As for the \$\$ of the settlement, there was [REDACTED] DP, AC, WP, LE [REDACTED].” [REDACTED] DP, AC, WP, LE [REDACTED]

The second team recognized also that it had yet more leverage as a result of Judge Rakoff’s rejection of the first settlement, and that it was no longer strictly tied to precedent in arriving at a higher civil penalty number. Canellos explained in the following exchange:

Q: Did you also think that you could use the fact that the judge had thrown out the first settlement as . . . leverage in . . . settlement discussions with Bank of America to get a very favorable settlement for the SEC, maybe even better than you could get if you want by saying, look, we can agree to this but the judge can throw that out too so it’s going to have to be something significantly more than the previous one?

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A: Sorry to say, I'll give you a yes and no to that. I do think to some extent our settlement dynamic consisted of like a collaboration with an opponent with a third party silently sitting at the table, and that was the judge, and I think we all knew that no matter what we came up with we had this overriding concern of what would and wouldn't be acceptable to the judge and that that presented a strong litigation dynamic. **There was a big force of influencing settlement discussions.** But I would also say that I think we could have pretty much dictated the terms of settlement that we thought were fair within reason . . . **So we, when it came to dollar amounts, my view was always I think we should come up with the fair and right number, and then we just dictate it and it will be paid.** . . . I think we had huge leverage even without Judge Rakoff, **with him, overwhelming leverage.**

Canellos Testimony Tr. at pgs. 32-33 (emphasis added). In his February 22, 2010 Opinion and Order, Judge Rakoff expressed a view that the proposed civil penalty amount was too low, even as he recognized that it was nearly five times the amount originally proposed:

The part of the proposed settlement that presents the greatest difficulty is, however, the penalty package, which essentially consists of a \$150 million fine. Though that amount is considerably greater than the \$33 million that the Court rejected in the prior proposed settlement of the Undisclosed Bonuses case, it is still very modest in light of the fact that it now covers both cases – that is, all the nondisclosures that were material to the proposed merger with Merrill, a merger that may yet turn out well but that could have been a Bank-destroying disaster if the U.S. taxpayer had not saved the day. From this perspective, the amount of the fine appears paltry.

Exhibit 59 at p. 11. Judge Rakoff also noted that, although the parties to the settlement proposed a Fair Fund distribution to BofA “legacy” shareholders injured by BofA’s alleged fraud, “the effect is very modest, amounting perhaps to no more than a few pennies per share.” *Id.* at pgs. 12-13.

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### **C. The Court Expressed Continued Concern that no Individuals Were Charged**

As expressed in his September 14, 2009 Memorandum Order, a significant concern of Judge Rakoff regarding the first proposed settlement was his belief that, “since the fine is imposed, not on the individuals putatively responsible, but on the shareholders, it is worse than pointless: it further victimizes the victims.” Exhibit 26 at p. 11. Judge Rakoff reiterated this concern in his February 22, 2010 Opinion and Order, stating:

An even more fundamental problem [than the fine amount], however, is that a fine assessed against the Bank, taken by itself, penalizes the shareholders for what was, in effect if not in intent, a fraud by management on the shareholders. This was among the major reasons the Court rejected the earlier proposed settlement. . . . Where management deceives its own shareholders, a fine most directly serves its deterrent purposes if it is assessed against the persons responsible for the deception. If such persons acted out of negligence, rather than bad faith, that should be a mitigating factor, but not a reason to have the shareholder victims pay the fine instead.

Exhibit 59 at pgs. 11-12. As discussed earlier in this report, the second team performed a focused and thorough analysis of whether a case could be made against individuals, in contrast to the first team. Moreover, the second team was not confused about whether individuals could directly violate Exchange Act Section 14(a) and Exchange Act Rule 14a-9 thereunder.

Judge Rakoff ultimately approved the second proposed settlement while continuing to voice the following concerns:

In short, the proposed settlement, while considerably improved over the vacuous proposal made last August in connection with the Undisclosed Bonuses case, is far from ideal. Its greatest virtue is that it is premised on a much better developed statement of the underlying facts and inferences drawn therefrom, which, while disputed by the Attorney General in another forum, have been carefully scrutinized by the Court here and found not to be irrational. Its greatest defect is that it advocates very modest punitive, compensatory, and remedial measures that are neither directed at the specific individuals responsible for the nondisclosures nor appear likely to have more than a very modest impact on corporate practices or victim compensation. While better than nothing, this is half-baked

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justice at best. . . . this Court, while shaking its head, grants the S.E.C.'s motion and approves the proposed Consent Judgment . . . .

*Id.* at pgs. 13-15. Finally, Judge Rakoff did acknowledge that, although the NYAG “reached a more sinister interpretation of what happened” in deciding to charge two individuals in connection with BofA’s alleged fraudulent nondisclosure, the Court found that “after a careful review of voluminous materials,” the SEC acted reasonably in reaching a different conclusion when proposing its settlement with BofA. *Id.* at pgs. 4, 8.

Overall, the OIG has found that the second BofA team put forth considerable effort to both litigate the case and then craft a settlement proposal that was appropriate and suitable to the charges brought and also acceptable to Judge Rakoff. To accomplish this, the second team, among other things: (1) coordinated with Corporation Finance to devise a set of remedial measures in an effort to address concerns over the standard “obey-the-law injunction” proposed at first; (2) brought a second case on facts that were insufficiently developed at the time of the first proposed settlement and, <sup>DP, AC, LE</sup> [REDACTED] <sub>DP, AC, LE</sub> used that second case as an avenue to seek a civil penalty from BofA nearly five times higher than the one originally sought; (3) recognized the increased leverage provided by Judge Rakoff’s earlier rejection during negotiations, and replaced a strict adherence to case precedent with a “take-it-or-leave it” offer to BofA, which the company ultimately took; (4) paid particular attention to the issue of charging individuals and considered the issue thoroughly and free of confusion about the applicable law; and (5) provided Judge Rakoff with an extensive Statement of Facts in an effort to alleviate concerns about the insufficient factual record created by the aforementioned “obey-the-law” injunction, while also proposing a Fair Fund distribution to harmed “legacy” BofA shareholders.

After these aforementioned steps were taken by the second team, Judge Rakoff accepted the second proposed settlement; although he continued to voice some of the same concerns as with the first proposed settlement. He also acknowledged that the SEC’s view of the case was reasonable, although the NYAG perceived the case differently under the same facts.

## **VI. AGENCY COOPERATION IN THE BOFA INVESTIGATION**

On February 22, 2010, Judge Rakoff approved a settlement between the SEC and BofA in which BofA agreed, among other things, to pay \$150 million in civil penalties. *See generally* Exhibit 59. The SEC’s settlement did not include any charges against individuals. *Id.* On the same day that the SEC filed a motion seeking court approval of its proposed settlement with BofA, the NYAG and SIGTARP announced that the NYAG had filed charges against BofA and two of its executives, “Kenneth Lewis and Joe Price for violations of the Martin Act, the Executive Law and common law . . . [following] a year-long investigation.” E-mail from Carlene Brown to David Kotz, dated August 13, 2010, attaching NYAG’s written responses to questions from the SEC’s Inspector General (“NYAG’s August 13, 2010 Responses”), attached hereto as Exhibit 20, at p. 5.

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Congress asked the OIG to investigate why the SEC proposed a penalty against BofA in which the shareholders, who were the victims of the Bank's alleged misconduct, would pay the penalty for the alleged misconduct rather than the individuals who engaged in the misconduct. As part of its consideration of why no individuals were charged and made to pay a penalty, the OIG examined the factors that affected the SEC's charging decision. During this examination, the OIG considered whether cooperation among law enforcement agencies affected the SEC's decision or ability to charge individuals. The OIG has found that the NYAG declined to coordinate with the SEC. While the OIG did not conclude, based on the available evidence, that greater coordination and cooperation among law enforcement agencies would have altered the SEC's final charging decision, the OIG did find that improved cooperation and coordination likely would have more efficiently utilized governmental resources and sped up the investigation by reducing duplication of investigative efforts.

#### **A. Multiple Law Enforcement Agencies Were Involved in the BofA Investigation**

At the time that the SEC began investigating issues related to the merger between BofA and Merrill, several other law enforcement agencies were conducting related investigations. These law enforcement agencies included the United States Attorney's Offices for the Southern District of New York and the Western District of North Carolina, the NYAG, and SIGTARP. See E-mail dated July 2, 2009 from [ENF Supv 3] to [M Atty 1] and attached draft Action Memorandum, attached hereto as Exhibit 60; [ENF Supv 4] Testimony Tr. at pgs. 27-28.

The United States Attorney's Offices have authority to bring criminal cases on behalf of the federal government. See <http://www.sec.gov/about/whatwedo.shtml>. Because the SEC has only civil enforcement authority, the SEC and the United States Attorney's Offices often coordinate investigations where there is a potential criminal violation. See <http://www.justice.gov/usao/index.html>; [ENF Supv 4] Testimony Tr. at pgs. 26-28.

The NYAG has hybrid authority to bring both civil and criminal securities cases on behalf of the people of the state of New York. [ENF Atty 2] Testimony Tr. at p. 27. Under the Martin Act, a New York state statute, the NYAG has broad powers "to enjoin and prosecute conduct that is deemed detrimental to the investing public without a showing of the elements of intent or scienter." See Frank C. Razzano, *The Martin Act: An Overview*, 1 J. Bus & Tech. L. 125 (2006), attached hereto as Exhibit 61, at p. 125. Notably, the Martin Act "outlaws certain practices deemed detrimental to the public without requiring proof of intentional or negligent conduct. It does not even require proof that anyone was, in fact, defrauded." *Id.*

According to Special Inspector General Neil Barofsky, SIGTARP's "statutory mandate is to provide oversight to conduct, coordinate and direct audits and investigations of any action taken under EESA with several exceptions." Barofsky

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Testimony Tr. at p. 8. SIGTARP, therefore, has “the jurisdiction to conduct criminal and civil investigations” of the purchase, management and sale of assets under the Troubled Asset Relief Program. *Id.* at p. 9; <http://www.sig tarp.gov/>. However, SIGTARP does not have independent enforcement authority. E-mail from ENF Supv 3 to Rosenfeld dated May 7, 2009, attached hereto as Exhibit 62. As Barofsky explained, “[w]e don’t have the capacity to actually bring cases. . . . [O]ur basic role is we’re fact gatherers.” Barofsky Testimony Tr. at p. 9. Thus, in cases in which SIGTARP believes an individual or entity has violated the law, it must persuade another law enforcement agency to file charges.

## **B. Law Enforcement Agencies Varied in their Level of Coordination with the SEC**

### **1. The United States Attorney’s Offices Coordinated with the SEC**

The United States Attorney’s Offices, which included the Southern District of New York and the Western District of North Carolina, and the SEC made significant efforts to coordinate their investigations. *See, e.g.,* ENF Supv 4 Testimony Tr. at pgs. 27-28. According to an SEC trial attorney assigned to the BofA matter, “[W]e have always had a good relationship with the Southern District. We’re both federal agencies and we get along.” ENF Supv 5 Testimony Tr. at p. 137. An SEC Assistant Director working on the BofA investigation stated that the SEC kept the United States Attorney’s Office for the Southern District of New York apprised of developments in the investigation and trusted the federal prosecutors to safeguard this information: “The Southern District of New York was generally kept up-to-date as far as to [what] our plans were. And we were comfortable sharing our confidential thoughts about our plans and prospects that [we] would bring the case.” ENF Supv 4 Testimony Tr. at pgs. 35-36. A PII on the investigation had a similar view of the relationship: “[T]he Southern District . . . was a cooperative relationship, sharing views, sharing thoughts, participating in the process, not excluding us from witness interviews, DP Testimony Tr. at p. 48.

### **2. The NYAG Declined to Coordinate Fully with the SEC**

Attempts between the SEC and the NYAG to coordinate the BofA investigation were less successful. *Id.* at pgs. 46-47. In contrast to the collaborative relationship between the SEC and the United States Attorney’s Office for the Southern District of New York, there has historically been tension in the relationship between the SEC and the NYAG. *See* Rosenfeld Testimony Tr. at pgs. 27-28, 82-84; ENF Supv 5 Testimony Tr. at p. 133; ENF Atty 2 Testimony Tr. at p. 27; Canellos Testimony Tr. at pgs. 52-53; and ENF Atty 1 Testimony Tr. at pgs. 46-47. The Regional Director of NYRO stated that “there are a number of other cases [in addition to the BofA investigation] where we had extremely difficult relationships with the New York AG.” Canellos Testimony Tr. at pgs. 52-53. According to the Branch Chief on the BofA investigation, working with the NYAG has been “difficult” and that “[a]ny time I work with the AG’s office, there are odd dynamics.” ENF Supv 3 Testimony Tr. at pgs. 30, 32.

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SEC attorneys expressed that the NYAG has had a history of undermining the SEC in order to upstage them, such as by racing to file charges before the SEC in cases in which they have agreed to work together and by making statements to the press about ongoing investigations. See ENF Supv 1 Testimony Tr. at pgs. 65-66; Rosenfeld Testimony Tr. at p. 82; ENF Atty 2 Testimony Tr. at pgs. 28-30; and ENF Atty 1 Testimony Tr. at pgs. 45-46.<sup>15</sup> As one trial attorney stated, "I think there was a certain level of distrust and fear of being undermined." ENF Supv 1 Testimony Tr. at p. 66.

Despite the distrust, the SEC and the NYAG had worked together on investigations prior to the BofA matter. See Rosenfeld Testimony Tr. at p. 28; ENF Supv 4 Testimony Tr. at p. 36. The Director of Enforcement stated that cooperation between the SEC and the NYAG "can ebb and flow." Khuzami Testimony Tr. at p. 106. The NYAG described its cooperation with the SEC as "proceed[ing] on a case-by-case basis." Exhibit 20 at p. 1. According to the NYAG, in some cases coordination between the agencies included "the NYAG and SEC taking joint testimony, dividing witnesses between the agencies and sharing the respective testimony transcripts, and otherwise sharing investigative materials, transcripts and work product." *Id.*

Prior to investigating the merger between Merrill and BofA, the SEC and the NYAG had been coordinating an investigation involving Merrill. Rosenfeld Testimony Tr. at pgs. 25-26. The NYAG explained that it "became involved in the investigation of [BofA] as part of an inquiry into executive compensation at Wall Street firms including Merrill Lynch and [BofA]." Exhibit 20 at p. 2. The NYAG stated further that "[i]n May 2009 [the NYAG] and the SEC exchanged access request and grant letters." *Id.*

However, according to SEC attorneys, once the NYAG learned that the SEC was coordinating its investigation with the United States Attorney's Office for the Southern District of New York, the NYAG would no longer coordinate with the SEC and "cut us off" from their investigation. See Rosenfeld Testimony Tr. at p. 25; ENF Supv 4 Testimony Tr. at p. 152; and Khuzami Testimony Tr. at p. 107. The Associate Regional Director for NYRO Enforcement stated that "as a general matter [the NYAG] will not work with us if we are working with another law enforcement agency. . . . [T]hey had told us at various times that if we were working with other criminal authorities, they won't work with us and share information with us." Rosenfeld Testimony Tr. at pgs. 23-24.

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<sup>15</sup> An SEC staff attorney related the following incident that occurred during an auction rate securities investigation upon which the SEC and NYAG were coordinating: "We went to negotiate the auction rate agreement, which was done hand in hand with the AG, with the team from Merrill; that was done in the AG's office, with NYAG Atty. But what he essentially did was, he put us in a room, then suddenly walked out on some pretense, got the Merrill people out of the room, moved them to another room and negotiated a settlement with them to announce immediately, before we would be able to announce it; and he left us in the room for maybe half an hour, 45 minutes, with someone to watch over us. Eventually we just left, because there wasn't anybody to talk to us." See ENF Atty 1 Testimony Tr. at pgs. 45-46. See also ENF Supv 3 Testimony Tr. at pgs. 28-29 (relating the same incident). The NYAG denied awareness of any instances in which, after agreeing to coordinate, the NYAG or the SEC resolved a matter with a defendant without notifying the other agency. Exhibit 20 at p. 3.

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In an e-mail to a [REDACTED] M Atty 1 [REDACTED], the [REDACTED] ENF Supv 3 [REDACTED] on the BofA investigation explained that because the SEC was coordinating with the federal prosecutor, the NYAG would not work with them:

Yes, DOJ (SDNY and WDNC specifically) are investigating. We are coordinating our investigation with theirs and, as a practical matter, that means the NYAG will not coordinate with us (the NYAG told us so). They do not play well together.

Exhibit 60 at p. 1.

SEC lawyers expressed the view that, although the NYAG provided some cooperation with the SEC during the BofA investigation, the NYAG failed to cooperate fully. [REDACTED] ENF Supv 4 [REDACTED] Testimony Tr. at p. 28. According to SEC attorneys, the NYAG refused to share information and to provide certain witness transcripts requested by the SEC prior to the SEC's first and second proposed settlements. See [REDACTED] ENF Supv 1 [REDACTED] Testimony Tr. at p. 68; Khuzami Testimony Tr. at p. 105; Rosenfeld Testimony Tr. at pgs. 22, 26-27; [REDACTED] ENF Atty 3 [REDACTED] Testimony Tr. at p. 60; and [REDACTED] ENF Supv 4 [REDACTED] Testimony Tr. at p. 34. The [REDACTED] ENF Supv 3 [REDACTED] on the investigation stated that "I think we got one or two transcripts. We certainly never got all we asked for." [REDACTED] ENF Supv 3 [REDACTED] Testimony Tr. at p. 20. In a memorandum to the SEC [REDACTED] ENF Supv 4 [REDACTED] on the BofA investigation, the [REDACTED] ENF Supv 3 [REDACTED] wrote the following regarding "Coordination Issues with the New York Attorney General's Office:"

Pros

- Publicly referred findings concerning Bank of America's corporate governance and disclosure practices to the SEC and offered "to assist further in any way."

Cons

- Notwithstanding their offer to assist the SEC in "any way," to date they have been unwilling to provide us with the transcripts of testimony they have taken during the course of their investigation other than the Lewis and Thain testimony transcripts.

E-mail from [REDACTED] ENF Supv 3 [REDACTED] to [REDACTED] ENF Supv 4 [REDACTED] dated May 14, 2009 and attached memorandum, attached hereto as Exhibit 63, at p. 4.

Similarly, one trial attorney assigned to the BofA case stated that the NYAG seemed reluctant to share information with the SEC:

[The NYAG] gave us a certain number of transcripts, but not all of the transcripts. As we – as the case developed later on, to the point where it was clear that we were going to be bringing charges and they were going to be bringing



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charges there was a definite reluctance on the part of the AG's office to provide information.

ENF Supv 1 Testimony Tr. at p. 68.

A staff attorney on the case provided a similar view in his OIG testimony of the NYAG's cooperation with the SEC:

I think there was a lot of effort on our side, a lot, certainly after the case was litigated, to cooperate with them. We asked for transcripts. They were very – again, underhanded about it. They only gave us very few of those, not everything. When we asked for more, they said no. When they gave us a transcript, they would send us – for example . . . a transcript that they finally agreed to give. . . . They gave us initially 2 and then 4, and I think we ended up with 6, but not everything. [An Assistant NYAG] sent us a transcript that was a printed out printout of an electronic document of 400 pages. We asked for the electronic version, they needed to get authority for it – so we could search it. And we never got it. So they were a little – it was not a cooperative relationship.

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And so I think there was a tension that, if I had to bet, it probably originated with that office. And that tension sort of became, again, an issue, when we had the second action that we brought. It is not a healthy relationship. I hope it will improve in the future . . . .”

ENF Atty 1 Testimony Tr. at pgs. 46-48.

The NYAG explained why certain transcripts were not provided to the SEC in connection with the BofA investigation. The NYAG stated that “[i]n May 2009, the SEC requested copies of certain investigative materials from this office” and in response to the request “our office provided certain transcripts to the SEC.” Exhibit 20 at p. 2. The NYAG also stated that “in February 2010, the SEC requested five transcripts generated by our office” and “[i]n response to its second request, our office responded by letter dated February 16, 2010.” *Id.* The letter from the NYAG stated that the SEC requested transcripts of five individuals and that the NYAG would not provide the transcripts. *See* Letter from <sup>NYAG Atty</sup> to George Canellos, dated February 16, 2010, attached hereto as Exhibit 64, at p. 1. In the February 16, 2010 letter, the NYAG stated its reasoning for not sharing the transcripts with the SEC:

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At this time, we are concerned about the impact partial disclosure could have on our litigation at a time when the parties in our contested proceeding have yet to respond to the complaint or negotiate a confidentiality order. We are also concerned about the possible impact disclosure of these materials could have on our ongoing investigations of other individuals. Accordingly, we cannot in a manner consistent with our prosecutorial obligations turn over piecemeal evidence at this time.

*Id.* at pgs. 1-2.

The NYAG's refusal to produce witness transcripts to the SEC meant that the SEC did not obtain testimony for certain witnesses. According to the Regional Director of NYRO, unlike the SEC, the NYAG's Office follows a practice of not providing witnesses with a transcript of their testimony. *See Canellos Testimony Tr.* at pgs. 55-56. Therefore, while the NYAG had "the ability to gain access to [SEC] testimony potentially because we provide anyone who's testified before us with a transcript of their testimony, and they in turn could provide that transcript . . . to the New York AG's Office . . . in response to a subpoena," the SEC did not have that same ability. *Id.* Because Judge Rakoff had limited the number of depositions that the SEC could take, the SEC could not always remedy the NYAG's refusal to produce transcripts by deposing the same witness. *Id.* at p. 56. Consequently, in making its charging decisions, there were certain witnesses whose testimony the SEC was not able to obtain, requiring the staff to rely instead on attorney proffers that were "not as good as a transcript." *Id.*

There were also concerns expressed about the SEC not sharing information with the NYAG as well. The NYAG stated that the "office requested copies of certain investigative materials from the SEC," but "did not receive investigative materials from the SEC in this case." Exhibit 20 at pgs. 2-3. The NYAG did not provide the OIG with specific details as to what materials they requested or what reason the SEC provided for not producing the materials. *Id.* at p. 3.

An SEC staff attorney on the investigation rejected the possibility that the SEC did anything to precipitate the type of treatment it received from the NYAG in the following exchange:

- Q: Did you see anything the SEC did in the relationship with the NYAG that may have precipitated some of what the NYAG did in return.
- A: No; absolutely not. In fact, I will tell you that the relationship with the AG had a lot of focal points, and almost all of them could be characterized as us pressing to be cooperative with them, to give them, and to get something in return. And it was always a

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very sort of tactical attempt on their side to not make that happen, to still try and get something from us.

ENF Atty 1 [REDACTED] Testimony Tr. at p. 49.

While the SEC attorneys asserted that there were no requests for information from the NYAG to which the SEC failed to respond, they did admit that the SEC did not “discuss the facts that we had uncovered” with the NYAG. ENF Supv 1 [REDACTED] Testimony Tr. at p. 68. The SEC attorneys’ distrust of the NYAG kept them from speaking to the NYAG “in confidence about our investigative plans.” ENF Supv 4 [REDACTED] Testimony Tr. at p. 35. The Assistant Director on the BofA investigation explained that there “was a concern at senior levels” that if the NYAG knew that the SEC was about to file charges, the NYAG would race to file a case against BofA ahead of the SEC:

I know the closer we got to thinking when we were going to be able to file a case against Bank of America[,] which towards the end, there was a concern that there might be a leak and that if our plans were reported in the press, that the New York Attorney General’s Office might then be prompted to go ahead and do something before we were able to bring a case. And that was a concern at senior levels.

*Id.* at pgs. 32-33.

The Assistant Director recalled that NYAG Atty [REDACTED] 16 PII [REDACTED] PII [REDACTED] at the NYAG, “expressed the desire to meet with us to talk about our investigation generally, because we were not coordinating with them.” See PII [REDACTED]; ENF Supv 4 [REDACTED] Testimony Tr. at pgs. 34-35. Accordingly, “[g]eneral marching orders [from] on high were to try to keep the distance and don’t engage in any contacts with them that would, that might entail revealing where we were in our investigation, such as in that, that Rob [Khuzami] and other folks didn’t want us to do.” ENF Supv 4 [REDACTED] Testimony Tr. at p. 35. ENF Supv 4 [REDACTED] added, “I think my general recollection is that the request for [a] meeting was viewed as their desire to find out where we were. And folks up the chain had [a] desire to not be put in a position where they could try to obtain that confidential information from us.” *Id.* at p. 37.

<sup>16</sup> According to Commission staff, NYAG Atty [REDACTED] and David Rosenfeld – a NYRO Enforcement Associate Director – had a tense relationship that worsened an already dysfunctional relationship between the NYAG and the SEC. See ENF Supv 5 [REDACTED] Testimony Tr. at p. 137; Canellos Testimony Tr. at p. 54; ENF Atty 1 [REDACTED] Testimony Tr. at pgs. 45-46; and ENF Supv 3 [REDACTED] Testimony Tr. at p. 21. Other staff members had a good relationship with NYAG Atty [REDACTED]. See, e.g., ENF Supv 5 [REDACTED] Testimony Tr. at p. 137. According to testimony, decisions not to share documents and information appeared to take place at the Attorney General level and not at the NYAG Atty [REDACTED] level, so it is unclear what effect Rosenfeld’s relationship with NYAG Atty [REDACTED] had on cooperation between the agencies. *Id.* at pgs. 138-139.

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The Regional Director for NYRO stated that he spoke to [REDACTED] NYAG Atty about the BofA investigation, and that [REDACTED] NYAG Atty expressed that the SEC had not communicated adequately with the NYAG about its intention to announce a settlement with BofA:

[REDACTED] NYAG Atty felt as though when the original case was charged he didn't have adequate warning and that the charge was brought notwithstanding the fact that the New York AG's Office had [an] interest in the case and that the SEC in his view was trying to seize the limelight or seize the lead in an investigation that he was interested in, and that essentially what he was saying was we didn't really coordinate with them and so why should we coordinate with you. We tried to repair that rift.

Canellos Testimony Tr. at p. 53.

In a written statement to the OIG, the NYAG rejected the assertion that it or the SEC was "concerned with getting a media headline on the [BofA] case" or that the agencies were competing to be the first "to file a case against [BofA]." Exhibit 20 at pgs. 3-4. While the OIG did not uncover any specific evidence that the NYAG was motivated by the media, we did find that distrust between the offices resulted in a lack of coordination in the BofA investigation.

### **C. Lack of Complete Coordination Did Not Materially Affect the SEC's Decision Not to Charge Individuals**

The SEC attorneys who were involved in the investigation asserted that if the NYAG had coordinated fully and produced all of the requested transcripts, the SEC still would not have charged individuals at BofA with wrongdoing. The SEC attorneys expressed that they were able to ascertain what evidence the NYAG had developed and did not feel that the NYAG was in possession of facts that would have led the SEC to charge individuals. [REDACTED] ENF Supv 1 Testimony Tr. at pgs. 70-71.

The New York Regional Director stated that in those cases in which they were unable to take a witness's testimony and the NYAG would not produce the transcript, the SEC "would take proffers from the attorneys who were present at the NYAG's testimony." Canellos Testimony Tr. at p. 56. The Regional Director felt that from the proffers the SEC "had pretty good information on what every witness we examined would testify to but not as good as a transcript." *Id.* According to the Regional Director, the attorneys who provided the proffers "have a strong disincentive to proffer to us anything that's inaccurate because ultimately the transcript [i]s going to come to light and if they've misdescribed what their client testified to, they're going to have a problem." *Id.*

The Director of Enforcement stated that although one "would have preferred to have had" the requested transcripts, he felt that the SEC had "fully investigated" the

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“heartland of the case.” Khuzami Testimony Tr. at pgs. 105-106. The Enforcement Director felt at “the end of the day . . . we developed . . . a very significant, detailed, factual presentation to Judge Rakoff. So we were able to do what we needed to do.” *Id.* at p. 106.

Likewise, a staff attorney on the investigation felt that receiving the witness transcripts from the NYAG would have been helpful, but would not have changed the SEC's final analysis of the case:

[The NYAG] are involved or not involved, it has no impact on our subpoena power or ability to get information. We do what we think we need to look into. If they want to look into other things, it's their prerogative. I don't think they can prevent us from getting information. . . . Investigative effort is independent.

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I've gone through those transcripts, the ones they've given us, very carefully. They were not very good for us. . . . Look, would it be helpful to have a transcript of someone before coming in for testimony? Yes, it could be. Does it hinder you if you don't get it? No; we just need to be as thorough as we can. . . . If we had gotten the transcripts they may have had some utility, but I think that utility would have been ultimately nullified by our taking of testimony or our interviews or our analysis of the evidence; which I think was, is and was, superior in the way we approached things.

ENF Atty 1

Testimony Tr. at pgs. 52-53.

The Associate Director on the BofA matter also stated that the SEC has “the same resources to develop information that [the NYAG does]. So we weren't concerned that they were developing things that we couldn't develop.” Rosenfeld Testimony Tr. at p. 26. In addition, a staff attorney who was working on the investigation stated that she “believe[d] we were operating basically from the same set of facts” because the complaint that the NYAG filed against individuals in the BofA matter did not contain facts of which the SEC was unaware. ENF Atty 3 Testimony Tr. at pgs. 68-69. Finally, the Assistant Director stated that he did not think that the facts that the NYAG had would have changed their final analysis, but he could not be certain:

Surely, [coordination with the NYAG] would help that kind of stuff sooner, faster, easier, don't have to spend time asking for it more than once. But at the end of the day, was there a fact in any of their investigative materials that we [had] later

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because we didn't have access to their investigative materials that [would have] made a difference. I didn't recall any such fact]. I don't know.

ENF Supv 4 Testimony Tr. at pgs. 153-54.

#### **D. SIGTARP Coordinated Closely with the NYAG**

As discussed above, when SIGTARP believes a violation of the law has occurred, it must find another law enforcement agency to bring an action because SIGTARP does not have enforcement power. As characterized by one SEC staff attorney, SIGTARP is “basically shopping for a client.” ENF Atty 1 Testimony Tr. at p. 41. In the BofA investigation, SIGTARP worked with the NYAG, the SEC, and others. Specifically, the Special Inspector General explained that SIGTARP “had sort of two separate investigations going on. I mean the same investigation with two separate partners, and one partner was the New York State Attorney General and the second” was with the SEC and others. Barofsky Testimony Tr. at p. 15.

The law enforcement agency with whom SIGTARP was most closely aligned was the NYAG. By “work[ing] very closely” with the NYAG, SIGTARP was limited in the information it could share with the SEC. Barofsky Testimony Tr. at pgs. 14-15. At the request of its law enforcement partners, including the SEC and the NYAG, SIGTARP imposed an information silo. The Special Inspector General described SIGTARP's procedure for sharing information among agencies:

What we did do, where we did have a wall for information was very early on we made it very clear to both sides . . . [that] for information that was gathered by them, you know, our partners, for example, if the New York Attorney General conducted a witness interview and a transcript was generated, that we would not share. So if we received – anything that came down to us, we would keep in different silos. Anything that we obtained, we would spread to everyone.

*Id.* at pgs. 24-25. Thus, if the same SIGTARP agent interviewed a witness with the SEC one day and then went to interview the same witness with the NYAG the following day, the SIGTARP agent was not allowed to share with “one side about what happened in the interview with the other.” *Id.* at p. 25. Alternatively, the SIGTARP agent would refer the law enforcement partner that requested the information to the law enforcement partner that had compiled or created it. *Id.* at p. 26.

The Special Inspector General explained that in the New York area competition among law enforcement agencies is not unusual:

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We have a number of different state and local and federal agencies all looking at the same information. . . . And in the past I think there have been concerns about potential leaks of information. I think there's been concerns about lack of coordination of, you know, one agency bringing charges before another. I think there's been a lot of very, very well publicized problems. When I came to the office in 2000 and in the late '90s, there were a series of very, very public and frankly ugly disputes between the U.S. Attorney's Office [for the] Southern District of New York and the Manhattan District Attorney's Office, and I think that there is a carryover of that . . . It was not unusual at all in the New York area. I don't know if it's typical in other areas, but in the New York area, there's a lot of – there's a lot of, frankly, a lot of competition.

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I don't think there was any specific rivalry that I would say [existed] between New York AG and the SEC as much as that was the general tenor of investigations, white collar, sophisticated white collar investigations in New York City.

*Id.* at pgs. 29-30.

The SEC and SIGTARP did collaborate to some extent on the BofA investigation. SIGTARP “repeated a number of times that they want to work alongside the SEC.” Exhibit 62. Furthermore, “SIGTARP was definitely a regular participant at the witness hearings and we had fairly regular communications with them as well.” ENF Supv 4 Testimony Tr. at p. 29. In addition, the SEC did not have the same concerns with SIGTARP that they had with the NYAG, such as SIGTARP talking to witnesses without giving the SEC an opportunity to participate. *Id.* at pgs. 30-31.

However, SEC attorneys on the BofA investigation did express some frustration about SIGTARP's decision not to share information among law enforcement agencies. Attorneys working on the investigation found the relationship with SIGTARP to be “frustrating,” in part because SIGTARP attended testimony with the NYAG and received information that they would not share with the SEC. ENF Atty 1 Testimony Tr. at pgs. 43-44, 59; ENF Supv 3 Testimony Tr. at pgs. 26-27.

Concerns over SIGTARP sharing SEC investigative findings with the NYAG also kept the SEC from coordinating more fully with SIGTARP. Top Enforcement officials at NYRO told the SEC attorneys working on the case not to share the SEC's “plans or theories” with SIGTARP. E-mail from ENF Supv 3 to ENF Atty 1 dated May 7, 2009, attached hereto as Exhibit 65. Due to the information competition between the SEC and

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the NYAG, the SEC attempted to learn what SIGTARP's "theories [were] without our weighing in on the issue." *Id.*

The collaboration between SIGTARP and the SEC was not as critical to the BofA investigation because they were focused on different legal theories. The Special Inspector General stated that its primary focus involved the use of TARP funds and representations made to the Federal Reserve. *See Barofsky Testimony Tr. at p. 14.*

According to the Special Inspector General, the SEC was initially focused on legal theories distinct from SIGTARP's. The SEC's first proposed settlement dealt with disclosure of an "agreed upon bonus pool" and "that part of the case was not really a focus of our investigation." *Id.* at p. 18. The Regional Director of NYRO shared the view that SIGTARP and the SEC were primarily pursuing separate theories, stating that SIGTARP's "investigation to some extent overlapped with our investigation, but it also focused very much on communications relating to securing TARP money from the government as opposed – as distinct from proxy disclosure." Canellos Testimony Tr. at p. 59.

Top Enforcement officials viewed the success of the collaboration with SIGTARP differently from the attorneys working on the investigation. The Regional Director of NYRO did not believe there were any collaborative issues with SIGTARP. *Id.* at p. 60. In contrast, the view of other attorneys on the investigation was that "it was not a very productive relationship. . . . They would promise evidence, wouldn't give it; suggest phone calls to discuss, they'd never get back to you" and noted that they had difficulty initially obtaining certain documents from SIGTARP. ENF Atty 1 Testimony Tr. at p. 50; ENF Supv 3 Testimony Tr. at pgs. 17-18.

Although SIGTARP's inaction "initially . . . slowed [the SEC] down and caused "some frustrations," the SEC attorneys did not feel that it "hampered the investigation" because the SEC eventually "got the document[s] in our own way" and SIGTARP ultimately produced "the key documents, which were very important to us." *See* ENF Supv 3 Testimony Tr. at pgs. 17-18, 33; ENF Atty 1 Testimony Tr. at pgs. 56-58. The ENF Supv 3 working on the investigation described the delay as "just an annoying wrinkle." ENF Supv 3 Testimony Tr. at p. 33.

The Special Inspector General identified two potential coordination issues. First, as discussed above, SIGTARP did not share with the SEC transcripts of witness interviews conducted by the NYAG but, instead, referred the SEC to the NYAG for copies of such transcripts. Barofsky Testimony Tr. at 26. Second, SIGTARP was unable to share with the SEC financial institution examination materials that it had obtained from the Federal Reserve. September 27, 2010 e-mail from Bryan Saddler, Chief Counsel, SIGTARP to OIG Staff 1, attached as an Addendum to Barofsky Testimony Tr. (Exhibit 19). These materials were subject to the examination privilege, and SIGTARP was covered by the privilege. Accordingly, to preserve the privilege, SIGTARP referred the SEC to the Federal Reserve and provided advice with



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respect to the Federal Reserve's procedures for requesting access to privileged materials. *Id.*

#### **E. The NYAG Rejected Joining the SEC's Settlement with BofA**

The Director of Enforcement and the Regional Director of NYRO communicated with the NYAG about a potential global settlement in which the SEC and the NYAG would jointly announce a settlement with BofA. *See* Khuzami Testimony Tr. at pgs. 107-108; Rosenfeld Testimony Tr. at p. 75. BofA had expressed concern that, if they settled with the SEC prior to settling with the NYAG, the NYAG "might not take kindly to it." Rosenfeld Testimony Tr. at p. 75. According to Enforcement staff, the SEC approached the NYAG about a potential joint settlement. ENF Atty 3 Testimony Tr. at p. 59. According to an SEC trial attorney, the NYAG ultimately rejected the idea of a global settlement

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Testimony Tr. at p. 100. While the NYAG acknowledged that "[i]n the days prior to filing our Complaint, our office had discussions with the SEC about the possibility of a global resolution," the NYAG chose not to detail the reasons why a global settlement did not occur. Exhibit 20 at p. 4.

#### **F. The SEC Viewed the Evidence Against Individuals Differently from Other Law Enforcement Agencies**

Although differences between the operative statutes that the NYAG and the SEC were utilizing may have influenced the agencies' charging decision, attorneys on the investigation also felt that the agencies viewed the evidence differently. Khuzami Testimony Tr. at pgs. 108-109. The Regional Director of NYRO believed that the NYAG's decision to charge individuals may have been influenced by the Martin Act, but that he "think[s] primarily they're evaluating evidence on their own and making different decisions." Canellos Testimony Tr. at pgs. 57-58. Similarly, an SEC Assistant Director stated that the SEC

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While acknowledging that the NYAG was able to bring claims under a broader law than those available to the SEC, the Special Inspector General took no position on whether he thought the NYAG was able to bring a case against individuals because of the Martin Act or because the NYAG and SIGTARP interpreted the facts differently from the SEC:

It's a very difficult question to answer because, again, our job is to present the facts. And, you know, we're still investigating. We're still looking at it. And there are . . . different legal standards for each of the different entities that we were working with. . . . [M]y basic understanding is, that the Martin Act is the broadest of the various potential tools for civil and criminal liability. [Federal criminal liability] has the highest threshold. . . . And my

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understanding[,] which may be incorrect[,] is that the SEC would be in between those. So . . . my understanding is that that was a factor.

Barofsky Testimony Tr. at pgs. 44-45.

The Special Inspector General stated further that he “didn’t have a position with respect to the SEC case because, frankly . . . the intricacies of the SEC’s . . . laws and regulations that the SEC enforces, the dynamics within the SEC with the Commission having to get an approval, what their goals were to accomplish . . . are all decisions within the . . . jurisdiction and decisionmaking of the SEC.” *Id.* at p. 44.

The Special Inspector General emphasized that SIGTARP is focused on charging individuals: “Well, we obviously wanted to see individuals charged. That is our position, very generally speaking.” *Id.* at p. 41. Moreover, “generally speaking, the individuals should be charged by someone somehow somewhere.” *Id.* at p. 44. Additionally, “our approach is always laying out the facts and the specific acts that were committed by certain individuals. . . . [I]ndividuals are always what drives any type of action.” *Id.* at p. 46.

The Special Inspector General felt that the SEC’s settlement with BofA, coupled with the NYAG and SIGTARP’s filing of charges against individuals, meant that the law enforcement agencies “were going to achieve complementary goals.” *Id.* at p. 42. In his view, the SEC would “obtain a cash settlement and some important [governance] changes for Bank of America” and “individuals were going to be held accountable through the New York State action.” *Id.* at pgs. 41-42.

#### **G. Increased Coordination and Cooperation Among Agencies Would Have More Efficiently Utilized Government Resources**

There was testimony that greater coordination and cooperation among law enforcement agencies would have more efficiently utilized government resources by reducing duplication of investigative efforts. The Regional Director of NYRO acknowledged that “there’s been a lot of people disturbed by the lack of coordination between state regulators generally and federal regulators.” Canellos Testimony Tr. at p. 52. He stated that both the SEC and the NYAG would have benefitted from sharing witness transcripts and would have avoided duplicative efforts in the following exchange:

Q: So I mean in some ways it could have potentially been more helpful for the SEC if they had seen what the New York AG’s Office had done and seen what they obtained?

A: Absolutely, we would have benefitted and they would benefit from our transcripts too. **We took testimony from many dozens of the same people,**

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**which is kind of outrageous.** I mean two regulators a few feet away taking redundant testimony of the same people. I mean that's not a very acceptable situation. I think which is one of the reasons why I have been trying to work closely to build bridges with the New York AG's office.

*Id.* at pgs. 54-55 (emphasis added).

The Special Inspector General acknowledged also that the involvement of multiple law enforcement agencies in an investigation may lead to duplicative effort, stating, "There was absolutely duplication of effort in this case." Barofsky Testimony Tr. at p. 31. For example, there were numerous times when the same individuals would be interviewed separately by different agencies. *Id.* However, he asserted also that the different goals of each agency may make duplication of investigative steps necessary, and explained that there were reasons to support law enforcement agencies taking separate witness interviews, such as agencies gearing their interviews toward different goals. *Id.* at pgs. 31-32. In particular, the Martin Act is "very broad and can cover a lot of conduct" whereas SIGTARP was also "looking at some very specific federal criminal securities law. The SEC has their own set of civil securities laws. So the interviews may have a different focus." *Id.* at p. 32. The Special Inspector General concluded, however, that even where agencies have different law enforcement goals, it is a good idea for both the state prosecutor and the SEC to know the facts that were elicited by each side. *Id.* at p. 33.

The NYRO Regional Director stated that due to the "tough relations" in cases prior to his joining the SEC in June 2009 and the redundancies caused by regulators failing to work together, he has made attempts to improve the SEC's relationship with the NYAG and "to try to find a better basis for cooperation." Canellos Testimony Tr. at p. 54.

As part of its consideration of why no individuals were charged and made to pay a penalty, the OIG examined whether cooperation among law enforcement agencies affected the SEC's decision or ability to charge individuals. The OIG's investigation did not uncover evidence that better cooperation and coordination during the BofA investigation would have altered the SEC's final charging decision. However, the OIG did find that the NYAG declined to cooperate fully with the SEC. The OIG also found that the SEC was reluctant to share information with the NYAG and SIGTARP due to concerns that the NYAG would leak information to the press or otherwise use the information from the SEC for its own gain. The OIG found further that greater coordination and collaboration among law enforcement agencies would have more efficiently utilized government resources and sped up the investigation by reducing duplication of witness interviews and other investigative efforts.

Therefore, the OIG recommends that Enforcement: (1) continue the efforts undertaken by NYRO's Regional Director to increase cooperation and coordination

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among law enforcement agencies; (2) as part of these efforts, review the level of coordination and cooperation on current investigations and assess where improved coordination would conserve government resources; (3) in the early planning stages of investigations, assess whether other law enforcement agencies are already participating in or should be made aware of the subject investigation; and (4) encourage staff, where appropriate, to establish and maintain effective communication with those who are assisting in investigations and to inform supervisory personnel when they are not receiving cooperation.

## **VII. CONFLICTS OF INTEREST IN THE ENFORCEMENT ACTION AGAINST BOFA AND OTHER POTENTIAL TARP RECIPIENTS**

In an August 6, 2009 letter both to the OIG and SIGTARP, Congressman Cummings referenced an attached August 4, 2009 *Washington Post* article raising the following conflict of interest issues that could potentially arise from Enforcement actions against entities who, like BofA, received TARP funds from the federal government:

- (1) the enforcement action may harm the firm's viability, and threaten systemic risk to the financial industry;
- (2) the fines levied would essentially be paid with taxpayer funds;
- (3) the fines would harm the shareholder investment in the firm, when the shareholder is the U.S. taxpayer; and
- (4) the role played by Federal Reserve or Treasury officials in the actions upon which fines were issued may have been significant to the occurrence of the violation but cannot be investigated by the SEC.

Exhibit 1 at pgs. 1-2.

Congressman Cummings asked the OIG and SIGTARP, respectively, to "investigate the extent to which the enumerated scenarios above existed in the case of *SEC v. Bank of America*, as well as the potential for future instances of the above conflicts . . ." *Id.* at p. 2. Because of SIGTARP's ongoing investigation of BofA, the OIG agreed to conduct the requested investigation by letter dated August 20, 2009 (Exhibit 2), and did not find evidence that any conflict of interest existed on the part of Enforcement: (1) during Enforcement's investigation of BofA; or (2) in making its charging decisions with respect to BofA and any individuals. The OIG also has found that, in anticipation of the BofA action and future actions where civil penalties will be sought against TARP recipients, Enforcement developed a policy designed specifically to provide settlement guidance for such situations.

The OIG did find that Corporation Finance's decision to recommend a WKSI waiver to BofA in connection with the first proposed settlement, notwithstanding that BofA did not meet the criteria traditionally applied by Corporation Finance for a WKSI

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waiver, was an example of the SEC considering a TARP firm's viability and the potential systemic risk to the financial industry in connection with the SEC's Enforcement action against BofA. We do note that since Judge Rakoff rejected the first proposed settlement with BofA, the WKSI waiver was never issued; however, we have found that special consideration was given to BofA because of its unique status as a TARP recipient and the nation's uncertain economic future.

**A. BofA Received TARP Funds Prior to the SEC's Enforcement Action**

As asserted in Congress's August 6, 2009 request for an investigation (Exhibit 1), BofA was a recipient of TARP funds at the time of the SEC's first enforcement action against the bank. According to Enforcement's July 20, 2009 Action Memorandum to the Commission:

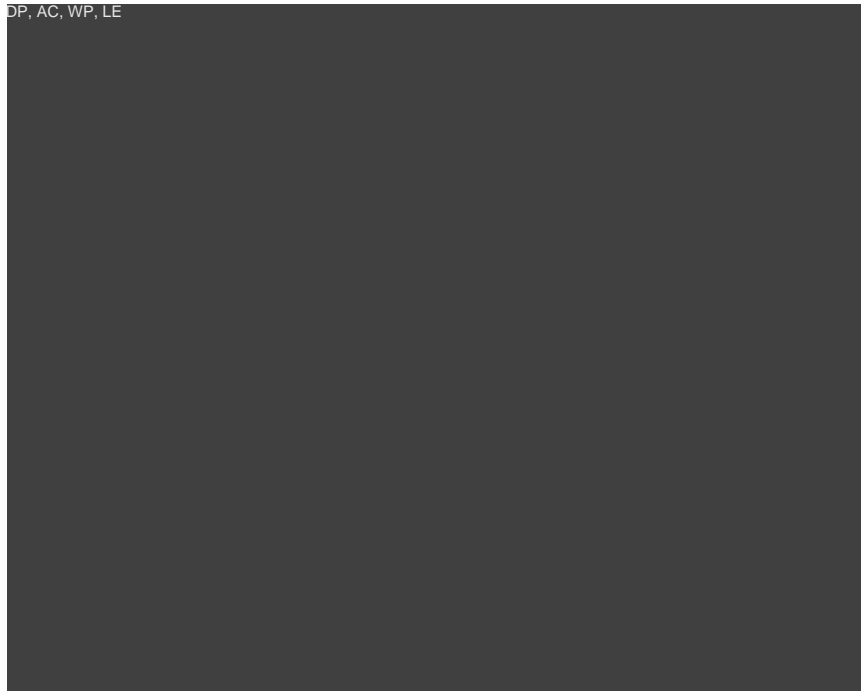


Exhibit 21 at p. 14, n. 13. In the first proposed settlement on August 3, 2009, the SEC and BofA agreed that, among other things, BofA would pay a \$33 million civil monetary penalty. Exhibit 22 at p. 1. After Judge Rakoff's rejection of the first proposed settlement on September 14, 2009, the SEC and BofA agreed to re-settle the matter for a civil monetary penalty of \$150 million, plus additional remedial relief, on February 4, 2010. Exhibit 34 at p. 1. Judge Rakoff then approved the second proposed settlement on February 22, 2010. The OIG recognizes the significant concerns expressed by Congress surrounding the SEC's enforcement action against BofA, particularly in light of its status as a TARP recipient. These concerns are addressed immediately below.

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## 1. Enforcement Actions May Harm a Firm's Viability and Threaten Systemic Risk to the Financial Industry

During the course of its investigation, the OIG took the sworn, under-oath testimony of Director of Enforcement Robert Khuzami, during which this office asked him about the specific concerns raised in the August 6, 2009 Congressional request for an investigation. With respect to the concern that an action against a TARP recipient such as BofA may harm a firm's viability or, more broadly, may threaten systemic risk to the financial industry, Khuzami first explained that just because an entity is labeled a "TARP recipient" doesn't necessarily mean that it is in financial distress:

[B]ut TARP is a lot of different things, first of all. Right? Some parts of the TARP program are actual cash loans. There's lots of other parts of the program that deal with backstops or getting collateral. And so – and I think this is reflected in the written [TARP] policy. And some of it is designed less to help an institution, as you may recall in fact some of them got the money and didn't even really want it, as it is to provide liquidity to a system. So right out of the box there's a notion that just because someone's labeled a TARP recipient doesn't necessarily mean they're in financial distress or that just bringing an action will therefore somehow harm them.

Khuzami Testimony Tr. at p. 124. He then explained in the following exchange that it would be unusual for an SEC enforcement action to be the deciding factor in whether a financial institution, such as BofA, would fail:

[Y]ou know, if the notion is a TARP recipient is fragile and an enforcement action will tip them over the edge, I suppose that there's some conceivable set of circumstances out there where that might happen, but it's by no means every case. And I think it'd be – even in the worst of the credit crisis, I'm not sure that would have made, you know, the difference and had that result. So that's something to think about. But I think it'd be pretty rare and unusual.

Q: And it wasn't a matter that arose in the Bank of America case?

A: No.

*Id.* at p. 125. Finally, Khuzami acknowledged in the following exchange that it is not Enforcement's policy to assume that every TARP recipient is an entity in distress:

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Q: And so is it fair to say that the enforcement division would potentially consider whether an entity is in distress, vis-a-vis penalties in an enforcement action, but wouldn't necessarily assume that every TARP recipient was an entity in distress?

A: Yes.

*Id.*

Khuzami's acknowledgment that Enforcement does not assume that every TARP recipient is an entity in distress is consistent with the Division's newly-developed policy that provides guidance for situations where civil penalties are contemplated against TARP recipients. As will be discussed in greater detail below, Enforcement developed a policy designed specifically to provide settlement guidance for the Division when TARP recipients are involved. July 29, 2009 TARP Policy Memorandum (and attached July 29, 2009 e-mail from ENF Atty 4 to the BofA team), attached hereto as Exhibit 66. The three key components of Enforcement's TARP policy expand on Khuzami's stated premise that every TARP recipient is not necessarily in financial distress, and are as follows:

LEP, DP, AC, LE  
LEP, DP, AC, LE  
LEP, DP, AC, LE

Based upon Khuzami's testimony and Enforcement's written TARP policy and the evidence accumulated in our investigation, we have concluded that BofA's status as a TARP recipient played no role in the determination of the appropriate civil penalty to be assessed against BofA or the amount for which Enforcement agreed to settle.

However, the OIG has found that there is evidence that BofA's status as a TARP recipient was a factor in a different aspect of the first proposed settlement recommendation to the Commission on July 30, 2009. As this report discussed in Section III.G.1 above, Corporation Finance's decision not to oppose BofA's request for a WKSI waiver was, at least in part, based on BofA's status as a TARP recipient. The OIG found that the traditional criteria for determining WKSI waiver requests were not applied to BofA as under these traditional criteria, BofA would not have been entitled to the WKSI waiver. Nonetheless, Corporation Finance agreed to recommend that BofA receive a conditional WKSI waiver based upon the specific concern that in this economic environment denying BofA a WKSI waiver could have an adverse impact on BofA and the entire market. Because the first settlement under which the WKSI waiver was proposed was rejected by the Court, the WKSI waiver was never actually issued; nonetheless, the OIG has found that the favorable consideration BofA received likely would not have occurred but for the company's unique status as a TARP recipient and the nation's uncertain economic future.

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## 2. The Fines Levied Would Essentially Be Paid With Taxpayer Funds

In response to Congress's concern that civil monetary penalties imposed on TARP recipients would be paid with taxpayer funds, Khuzami responded in the following exchange:

Q: Okay. What about a potential conflict that the fines levied would essentially be paid with taxpayer funds?

A: You know, I guess fundamentally they still have to pay back all the money. So like the example \$50 million in TARP money, a \$20 million penalty, they still have to pay \$50 million back. I guess theoretically what's lost is the beneficial effect of whatever that \$20 [million] was supposed to accomplish.

Q: Right.

A: It would theoretically be lost, because it went to [the] shareholder or the Treasury rather than whatever they were supposed to do with it.

Q: Right.

A: But that depends on whatever they were supposed to do with it. So again, it's not the kind of thing that is – that is an inherent result of being a TARP recipient.

Khuzami Testimony Tr. at p. 126. In Khuzami's view, the civil penalty affects only the bank's intended use for the money, not the taxpayer, because the TARP recipient is obligated to pay back the taxpayer regardless of how the civil penalty would have been used. *Id.* For Enforcement, therefore, the relevant issue is always the financial condition of the TARP recipient. When asked about the BofA situation specifically, Khuzami responded under questioning as follows:

Q: Okay. And that was a matter that you thought would or was a concern in the Bank of America case?

A: No. You know, by the time that case was brought they were – they were a TARP recipient, but things were in much better shape.



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Q: And as far as the analysis that your office conducted as to the circumstance in place in the Bank of America case you didn't see [a financially fragile] situation arising?

A: In fact, I don't –

Q: Is that no? You didn't see that?

A: We did not. That's right. I don't even think Bank of America made – maybe the most surprising thing is Bank of America never came in and said, we're a TARP recipient; we're in distress; please reduce the penalty. We almost expected that argument, but in fact – you have to confirm this with the New York people – I don't think they ever raised the argument.

*Id.* at pgs. 126-127.

The OIG has found no evidence of conflicts of interest with respect to the issue of whether fines levied from an enforcement action against BofA, or any TARP recipient, would essentially be paid with taxpayer funds.

### **3. The Fines Would Harm the Shareholder Investment in the Firm, When the Shareholder is the U.S. Taxpayer**

In response to the concern that a civil monetary penalty would harm a taxpayer because he or she is the shareholder when a TARP recipient is sued, Khuzami explained that the only harm that would potentially occur is that the civil penalty would go to the government instead of whatever use the TARP recipient originally had for it:

You know, the government is the shareholder and the government's getting the money back, so again it's not a notion that they would be hurt. I think the theoretical harm is that whatever you're trying to achieve with the TARP money would not be achieved. If you wanted them to take that TARP money and go out and hire people and instead, you know, sent that money to the Treasury, then maybe the people that you wanted to get jobs theoretically couldn't have [gotten] them. But money's also very fungible, and so the assumption they couldn't have done both is not at all clear.

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*Id.* at pgs. 128-129. This, in Khuzami's view, is not taxpayer harm but, rather, a speculative, theoretical harm in the form of a lost potential business opportunity. Moreover, Khuzami was specific about the original BofA settlement in the following exchange:

Q: So you didn't determine that the \$33 million potential settlement amount in the first settlement would harm the shareholder investment in the firm, [affecting] the U.S. taxpayer?

A: That's right. Again, Bank of America never – nor did they make that claim.

*Id.* at p. 129. In sum, the OIG has found no evidence of conflicts of interest with respect to the issue of whether fines levied from an enforcement action against BofA, or any TARP recipient, would harm shareholder investment in the firm when the shareholder is the U.S. taxpayer.

#### **4. The SEC Cannot Investigate Federal Reserve or Treasury Officials Who May Have Had Substantial Roles in the Alleged Wrongdoing**

With respect to the final concern expressed by Congress, Khuzami stated that this situation did not apply to the BofA investigation because the SEC never brought a TARP case against BofA, as evidenced by the following exchange:

Q: All right. The role played by Federal Reserve or Treasury officials in the actions upon which fines were issued may have been significant to the occurrence of the violation but cannot be investigated by the SEC. I guess the idea is that an entity like Bank of America really didn't engage in the improper action; it was something that was forced [upon] them by [the] Federal Reserve or Treasury, and so you're potentially punishing Bank of America when really the [offender] is the Federal Reserve.

A: Well, that would be if you're bringing a TARP fraud related action. So an institution says, "I don't want the money." The Treasury says, "[Y]ou got to take the money." And then they turn around and they somehow get sued for some of the circumstances surrounding the TARP money they got. But we never brought a TARP case.

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Q: The Bank of America case did not raise those issues?

A: Did not raise those issues.

DP, WP, PII

DP, WP, PII

*Id.* at p. 130.

Moreover, Khuzami testified under oath that Enforcement

DP, PII, WP

DP, PII, WP

Thus, the assertion that the SEC cannot investigate either Federal Reserve or Treasury officials is contrary to Khuzami's sworn testimony that such conduct was investigated in connection with the BofA/Merrill merger, and the OIG has seen no evidence to suggest that the SEC cannot, in fact, conduct such investigations. Overall, this office has found no evidence of conflicts of interest here, and has found no substantiation of the assertion that Enforcement would be unable to investigate either Treasury or Federal Reserve officials where warranted.

#### **B. Enforcement Developed a TARP Policy to Provide Guidance on Seeking Civil Penalties from TARP Recipients, Including BofA**

In anticipation of BofA and future actions where civil penalties will be sought against TARP recipients, Enforcement developed a policy designed specifically to provide settlement guidance for such situations. On July 29, 2009, the day before the Commission meeting that approved Enforcement's first proposed settlement with BofA, Enforcement circulated to the Commission an Information Memorandum titled *Considerations When Imposing Monetary Relief on TARP Recipients* ("TARP Policy Memorandum"). Exhibit 66. Developed by Khuzami, then-Chief Counsel Joan McKown and other members of Enforcement's Office of Chief Counsel, with guidance from the SEC's Office of General Counsel, the TARP Policy Memorandum's stated purpose was to describe "the Enforcement Division's policy guidance concerning settlement recommendations that involve the imposition of monetary relief against an entity that has received, or soon will receive, emergency financial assistance, in the form of funds under the Troubled Asset Relief Program, as currently structured." *Id.* at p. 1.

As stated above, Enforcement's TARP policy was developed in anticipation of the BofA matter, and others like it, where TARP recipients would be subject to civil monetary penalties. In a July 27, 2009 e-mail to the Office of General Counsel and others (including Khuzami) attaching a draft of the TARP Policy Memorandum, [REDACTED] from Enforcement's Office of Chief Counsel explained the purpose of the TARP Policy Memorandum was to:

ENF Atty 4

[Lay] out the Division's policy on whether and when to consider an entity's receipt of TARP funds when recommending monetary sanctions against them. We'd

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like to send a memo up to the Commission in advance of the Commission's consideration on Thursday of Bank of America's settlement offer (that action memo includes a brief analysis of the penalty in light of the bank's receipt of TARP funds).

July 28, 2009 e-mail from Khuzami to Mark Cahn (Office of General Counsel) and others (e-mail chain contains July 27, 2009 e-mail from <sup>ENF Atty 4</sup> to the Office of General counsel quoted above), attached hereto as Exhibit 67, at p. 1.

According to the TARP Policy Memorandum, Enforcement has taken the following view of TARP recipients:



Exhibit 66 at p. 2 (emphasis added). In explaining her understanding of the SEC's new TARP policy, <sup>ENF Atty 4</sup> similarly testified:

- Q: And then you say, "Please insure the TARP analysis is in line with the Enforcement spending recommendations to the Commission on that issue." What was that concern there?
- A: Enforcement was trying to draft an information memo to the Commission about how they would treat recipients of TARP money, and I think that the ultimate analysis in that information memo that went up to the Commission was that **TARP recipients wouldn't get any additional consideration just by virtue of having received TARP funds. In fact, they should be treated in all fairness like every other issuer who may have**

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**violated the law, regardless of the received TARP funds.**

ENF Atty 4 Testimony Tr. at p. 33 (emphasis added). ENF Supv 2  
provided a similar account of what she believed to be the nature of Enforcement's new TARP policy:

- Q: What was the nature of [the TARP] policy?
- A: We evaluated whether or not – what, if any, effect the receipt of TARP funds should have on the Commission's view of whether or not to accept money settlement from a TARP recipient.
- Q: And what did you determine, did it have any effect?
- A: Ultimately, we determined that **the pure receipt of TARP funds should not be a determining factor.** However, there were some circumstances where that may be an indicator that they were in dire financial straits. And if that's the case, then **we should treat them as we do any other settling party that is in dire financial straits.**
- Q: Okay, so you determined it was only relevant to the extent that it may have indicated dire financial straits. But otherwise, the fact that they were a recipient of TARP funds shouldn't make a difference?
- A: I don't know if I would go so far as to say it is only relevant because we were concerned about the effect on where taxpayers are putting their money. But ultimately we determined that for the Commission, the factors that should be considered are the traditional factors of whether or not the party has sufficient funds to enter into the settlement.

ENF Supv 2 Testimony Tr. at pgs. 17-18 (emphasis added).

In support of its position that TARP recipients are to be treated like every other subject of Enforcement actions, the TARP Policy Memorandum made the following additional point about Congressional intent:

DP, WP, AC, LEP

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DP, WP, AC, LEP



Exhibit 66 at p. 2. Overall, the OIG has found that, in anticipation of bringing actions against actual and potential TARP recipients (including, but not limited to, BofA), Enforcement conferred internally and with the Office of General Counsel to develop a TARP policy for future guidance in this area. Considering factors ranging from standard Enforcement policy to perceived Congressional intent, the TARP policy now adopted by the SEC is clear in its pronouncement that TARP recipients are to be treated like any other subject of an enforcement action, and that financial viability, not TARP status, is to be the controlling factor:

LEP, DP, WP, AC, LE



In summary, the OIG has found that Enforcement considered the issue of whether TARP recipients should be treated differently than any other proposed defendant or respondent in enforcement actions where a civil penalty is sought, and determined that financial viability, not TARP status, should be the controlling factor. Enforcement's recently-enacted TARP policy also provides guidance on how much weight should be given to an entity's TARP status when determining an appropriate civil penalty – concluding that TARP status should be only one of many factors to consider in Enforcement's civil penalty analysis. Enforcement also considered Congressional intent

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when formulating the policy, and was unaware of any evidence that Congress intended for TARP recipients be spared the same treatment that non-TARP recipients receive for misconduct against injured shareholders.

Finally, the OIG has found that although Enforcement has established an official policy that TARP status is not, without more, determinative of whether an entity should be assessed a civil penalty and, if so, for what amount; there is evidence that BofA's status as a TARP recipient was a substantial factor in the first proposed settlement recommendation to the Commission on July 30, 2009. As this report discussed in Section III.G.1. above, Corporation Finance's decision not to oppose BofA's request for a WKSI waiver was, at least in part, based on BofA's status as a TARP recipient. There was, furthermore, a certain degree of deference given to BofA due to: (1) the perilous economic situation the nation was facing at the time; and (2) a desire by Corporation Finance not to interfere with BofA's access to the market and ability to compete with other financial institutions. This is significant because BofA did not meet the criteria traditionally applied by Corporation Finance when determining, under its Commission-delegated authority, whether to grant a WKSI waiver to an applicant. Because the first settlement under which the WKSI waiver was proposed was rejected by the Court, the WKSI waiver was never actually issued; however, the OIG nonetheless has found that the favorable consideration BofA received likely would not have occurred but for the company's unique status as a TARP recipient and the nation's uncertain economic future.

### **Conclusion and Recommendations**

As stated earlier in this report, the Commission's Canon of Ethics obligates Enforcement staff to continuously and diligently investigate instances of securities fraud. It is imperative that Enforcement staff vigorously enforce compliance with the law, and that it does so impartially and free from influence by a person's rank, position, prestige or other impermissible factor. The OIG has not found evidence that SEC staff violated the Commission's Canon of Ethics or acted in an improper fashion in connection with the two proposed settlements with BofA on August 3, 2009 and February 4, 2010, respectively. Furthermore, the OIG has not found evidence of conflicts of interest with respect to the concerns that formed the basis of the August 6, 2009 Congressional letter to the OIG and SIGTARP requesting this investigation. Additionally, the OIG has found that, when deciding whether to impose a civil penalty against TARP recipients, Enforcement has established a policy whereby the TARP status of a proposed defendant or respondent will be but one of many factors to be considered. As with non-TARP recipients, Enforcement will consider a company's financial viability most important.

The OIG also has found that BofA's status as a TARP recipient did impact the company's treatment during SEC staff's first settlement recommendation to the Commission. Specifically, because of the nation's perilous economic situation at the time and the desire by certain SEC staff not to interfere with BofA's ability to compete with other financial institutions, BofA was initially recommended for a waiver that it likely would not have been granted under ordinary circumstances. Although the waiver was never issued, there was an appearance of favorable consideration in the departure

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from traditionally applied criteria, and an absence of clear, consistent procedures for waiver consideration by the Commission. Finally, the OIG has found that there were instances during the BofA investigation where different law enforcement agencies, including the SEC, did not cooperate at the most effective level, resulting in lost time and unnecessary duplication of effort. In light of the foregoing, the OIG recommends that the Division of Corporation Finance:

- (1) Create clear criteria for making waiver determinations;
- (2) Disseminate the guidance both internally and externally; and
- (3) In cases where the waiver decision departs from the stated criteria, articulate in a written decision or order the rationale for its departure.

The OIG recommends also that the Division of Enforcement:

- (4) Continue the efforts undertaken by NYRO's Regional Director to increase cooperation and coordination among law enforcement agencies;
- (5) As part of these efforts, review the level of coordination and cooperation on current investigations and assess where improved coordination would conserve government resources;
- (6) At the early planning stages of investigations, assess whether other law enforcement agencies are already participating in or should be made aware of the subject investigation; and
- (7) Encourage staff, where appropriate, to establish and maintain effective communication with those who are assisting in investigations and to inform supervisory personnel when they are not receiving cooperation.



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A copy of this report is being provided to the Chairman, the Deputy Chief of Staff to the Chairman, the Director of Enforcement, the Director of Corporation Finance, the General Counsel and the Regional Director for the New York Regional Office.

Submitted: OIG Staff 2  Date: 9/30/2010

OIG Staff 1  Date: 9/30/2010

Concur: OIG Staff 3  Date: 9/30/2010

Approved: H. David Kotz  Date: 9/30/2010  
H. David Kotz