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U.S. DISTRICT COURT
EASTERN DISTRICT
OF NEW YORK

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UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

HURLEY, J.

LINDSAY, M.J.

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

FALCONSTOR SOFTWARE, INC.,

Defendant.

12 Civ. ____ ()

COMPLAINT

Plaintiff Securities and Exchange Commission (“Commission”), for its Complaint against Defendant FalconStor Software, Inc. (“FalconStor,” “the Company,” or “Defendant”), alleges as follows:

SUMMARY

1. This action arises out of a commercial bribery scheme at FalconStor, a public company specializing in electronic data protection and storage technology. In connection with that scheme, FalconStor, acting primarily through the Company’s co-founder and then-chief executive officer, president and chairman (the “CEO”), made materially misleading statements

on earnings calls and in earnings releases, failed to accurately record the expenses associated with the bribes on its books and records, and failed to devise or implement a system of effective internal accounting controls to detect or prevent the bribes, which violated state law and were inconsistent with the Company's policies, and granted stock and options in unregistered, non-exempt transactions. FalconStor thus violated the issuer books and records and internal controls provisions, the offering registration provisions, and certain antifraud provisions of the federal securities laws.

2. From October 2007 through July 2010 ("the relevant period"), the CEO, who is now deceased, directed certain FalconStor personnel to pay bribes to employees of JPMorgan Chase Bank, National Association ("JPMC"), a subsidiary of JPMorgan Chase & Co., a financial services holding company, in order to obtain and retain JPMC's business. In total, FalconStor spent approximately \$430,000 to bribe, or attempt to bribe, several JPMC executives during the relevant period. The bribes given and offered to the JPMC executives (and relatives of those executives) included grants of FalconStor options and restricted stock, direct cash payments, gift cards, payments of golf club fees, and lavish entertainment, including gambling.

3. Shortly after the bribery scheme began, FalconStor secured a direct, multi-million dollar contract with JPMC, which then became one of FalconStor's largest customers and a major source of FalconStor's revenue during the relevant period.

4. On quarterly earnings calls with securities analysts and others and in two earnings releases filed with the Commission on Forms 8-K, the CEO touted FalconStor's large direct contract with JPMC as a vindication of the quality and desirability of FalconStor's products and a harbinger of the growth of the direct distribution portion of FalconStor's business, which was

then largely dependent on sales through third-party resellers and distributors. FalconStor never disclosed that JPMC's business resulted, in whole or in part, from the inducements that it was lavishing on JPMC's employees. FalconStor therefore made materially misleading statements about the true nature of its business relationship with JPMC and the potential market for FalconStor's products.

5. FalconStor failed to accurately record the expenses associated with the bribes on its books and records, and failed to devise or implement a system of effective internal accounting controls to detect or prevent the bribes, which violated state law and, were contrary to FalconStor's code of conduct.

6. In addition, because the options and restricted stock granted to executives of JPMC – or more precisely, the wife, son, and brother of the executives – were not granted as compensation for *bona fide* services rendered to FalconStor and thus not covered by the Form S-8 registration statement in effect for the Company's Incentive Stock Plan, FalconStor violated the registration provisions of the federal securities laws.

VIOLATIONS

7. By virtue of the foregoing conduct and as alleged further herein, Defendant FalconStor, singly or in concert, directly or indirectly, violated Sections 5(a), 5(c), 17(a)(2) and 17(a)(3) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §§ 77e(a), 77e(c), 77q(a)(2) and 77q(a)(3)], and Sections 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B)].

8. Unless Defendant FalconStor is permanently restrained and enjoined, it will again engage in the acts, practices, and courses of business set forth in this Complaint, or in acts and practices of similar type and object.

JURISDICTION AND VENUE

9. The Commission brings this action pursuant to the authority conferred by Section 20 of the Securities Act [15 U.S.C. § 77t] and Section 21(d) of the Exchange Act [15 U.S.C. § 78u(d)]. The Commission seeks a final judgment (i) permanently restraining and enjoining FalconStor from violating Sections 5(a), 5(c), 17(a)(2) and 17(a)(3) of the Securities Act [15 U.S.C. §§ 77e(a), 77e(c), 77q(a)(2) & 77q(a)(3)], and Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B)]; and (ii) imposing civil money penalties on FalconStor pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] and Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)].

10. This Court has jurisdiction over this action pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)] and Section 27 of the Exchange Act [15 U.S.C. § 78aa]. Defendant, either directly or indirectly, has made use of the means or instrumentalities of interstate commerce, of the mails, the facilities of national securities exchanges, and/or the means or instruments of transportation or communication in interstate commerce in connection with the acts, practices, and courses of business alleged herein.

11. Venue lies in the Eastern District of New York pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)] and Section 27 of the Exchange Act [15 U.S.C. § 78aa]. FalconStor is and was at all relevant times, headquartered in Melville, New York. Many of the

acts, practices and courses of business alleged herein took place at, or were directed from, FalconStor's headquarters.

DEFENDANT

12. **FalconStor** is a Delaware corporation headquartered in Melville, New York. The Company also maintains offices in California, Europe, Asia, and Australia. FalconStor's common stock is registered with the Commission pursuant to Section 12(b) of the Securities Act and trades on the NASDAQ under the symbol FALC. FalconStor files annual and periodic reports with the Commission pursuant to Section 13(a) of the Exchange Act. From the second quarter of 2008 through the first quarter of 2009, FalconStor issued nearly four million stock options and approximately one million shares of restricted stock pursuant to the Company's Incentive Stock Plan.

FACTUAL BACKGROUND

The Origins of the Bribery Scheme

13. FalconStor develops, manufactures, and sells electronic data protection and storage solutions, including virtual tape library technology, and provides related maintenance, implementation and engineering services in the United States and internationally. FalconStor's technology allows customers to condense large quantities of computer data. FalconStor sells its products primarily through original equipment manufacturers ("OEMs"), value-added resellers, and other resellers and distributors. In reaction to industry consolidation, however, during the relevant period, FalconStor was trying to reduce its reliance on OEM and reseller and distributor relationships by expanding its direct customer base, sometimes referred to as the "enterprise channel."

14. In March 2007, JPMC became an indirect customer of FalconStor through an OEM contract. Thereafter, Salesman X was the Company's designated sales contact for JPMC.

15. Executive 1 of JPMC ("Executive 1") was an information technology executive known for his expertise in the field of data storage. As a result of his position and perceived expertise, Executive 1 was the primary decision maker when it came to JPMC's selection of data storage technology, a fact that became apparent to FalconStor's CEO, Salesman X, and others at FalconStor during the process leading to the awarding of the OEM contract. Executive 1 worked out of JPMC's global technology infrastructure division, located in Columbus, Ohio.

16. In September 2007, as JPMC issued another purchase order for additional FalconStor products through the OEM contract, FalconStor and JPMC began exploring a direct business relationship.

The Bribery Scheme Begins

17. With the prospect of a direct contract on the horizon, FalconStor's CEO sought to cement FalconStor's relationship with JPMC by offering enticements to Executive 1. Accordingly, in October 2007, at the CEO's direction, Salesman X traveled to Hong Kong to entertain Executive 1 and several other employees of JPMC, who were going to be there for other business. The entertainment consisted of a lavish dinner in Hong Kong followed by a night of drinking, gambling, and other entertainment at various casinos and resorts in Macau, a helicopter or speed boat ride away.

18. At about this time, the CEO and Salesman X took steps to ensure that Executive 1 knew that he would be further rewarded for his support of FalconStor. Among other things, shortly after the night's entertainment in Hong Kong and Macau, the CEO offered Executive 1

the opportunity to become a director of a Chinese data storage software company that was a joint venture partner of FalconStor's. Executive 1 understood that he would be compensated for serving as a director. Executive 1 never received this benefit, however, because he concluded that he would likely not obtain the necessary approvals from JPMC to serve as a director of the Chinese company. (JPMC's code of conduct prohibited employees from engaging in outside business activities or accepting gifts from current, or certain prospective customers, suppliers, or other parties doing business with JPMC, without written approval of specified high-level executives.)

The March 2008 Contract and the CEO's Public Statements Concerning It

19. Shortly after these inducements, in March 2008, the direct relationship between FalconStor and JPMC commenced, with the execution of a direct \$5 million contract for the sale of data storage software licenses and related services.

20. On an April 24, 2008 earnings call, the CEO extolled the March 2008 contract with JPMC as a "major victory," telling listeners that FalconStor's software had been "selected by a major Fortune 50 financial services firm as the corporate standard to optimize the operating efficiency of the tape backup infrastructure around the world." The CEO added that FalconStor's selection by the "Fortune 50 account" showed FalconStor's "demonstrated viability to engage with the [account]" and the account's comfort in dealing directly with FalconStor, as opposed to through an OEM. In its earnings release dated April 24, 2008, which was filed with the Commission on Form 8-K, FalconStor also quoted the CEO on the significance of "[t]he decision by a Fortune 15 global financial services firm" to select FalconStor's technology.

21. The CEO's public statements about the contract with JPMC on April 28, 2008 were materially misleading because they held out JPMC's selection of FalconStor's product as evidence of the quality and desirability of FalconStor's technology to substantial direct purchasers at a time when the market was concerned about the Company's reliance on OEM distribution, but omitted the fact that FalconStor was bribing key employees of JPMC to obtain the company's business.

The 2008 Bribes and Third & Fourth Quarter 2008 Earnings Calls

22. After securing the direct contract with JPMC, the CEO and Salesman X continued to ply select employees of JPMC with inducements. In May 2008, Salesman X gave a second employee of JPMC ("Executive 2"), a \$500 gift certificate. In addition, the CEO and Salesman X arranged a grant of 1,000 FalconStor options (valued at \$925) to a third employee of JPMC ("Executive 3"), ostensibly pursuant to the FalconStor Incentive Stock Plan, which was registered with the Commission on Form S-8 (the "S-8 Stock Plan"). At the request of Executive 3, the options were granted to his sixteen-year-old son. Executive 2 and Executive 3 were important to FalconStor because they each played integral roles in the issuance of IT-related purchase orders at JPMC and thus were able to assist FalconStor in making its quotes more competitive.

23. Later in 2008, the CEO again touted the new relationship with JPMC on a quarterly earnings call. On the call held on October 28, 2008, announcing the Company's third quarter results, the CEO stated:

... FalconStor's product line is built to meet the requirement of enterprise data [inaudible] with scalable performance and capacity. Consider this case in point. A Fortune 10 customer has standardized and deployed over 100 nodes of virtual tape library, VTL, with deduplication across several data centers in the past nine months.

The “Fortune 10” customer was JPMC, which FalconStor had previously publicly identified as a major customer.

24. The CEO returned to this theme in the February 5, 2009, fourth quarter earnings call, touting FalconStor’s capacity for a direct contractual relationship and the validation of FalconStor’s technology by JPMC, which at the time was FalconStor’s most substantial and recognizable non-OEM customer. The CEO’s statements about the validation of its technology were repeated in the Company’s earnings release of the same date, which was filed with the Commission on Form 8-K.

25. The CEO’s statements about its business with JPMC on the third and fourth quarter 2008 earnings calls and in the fourth quarter earnings release were materially misleading because they held out the relationship with JPMC as evidence of the quality and desirability of FalconStor’s technology to substantial direct purchasers at a time when the market was concerned about the Company’s reliance on OEM distribution, but omitted the fact that FalconStor was bribing key employees of JPMC to retain and expand the Company’s business.

The 2009 Bribes and the Second Quarter 2009 Earnings Call

26. In the spring of 2009, as JPMC began to consider products offered by FalconStor’s competitors, FalconStor’s CEO found a variety of ways to further ingratiate FalconStor with Executive 1 and Executive 2.

27. First, the CEO arranged to provide 25,000 FalconStor stock options (valued at \$35,425) to Executive 1’s brother. To accomplish this, the CEO endorsed the recommendation of another FalconStor executive, who played a role in managing the relationship with JPMC and was familiar with Executive 1, to designate Executive 1’s brother as an advisor who would provide *bona fide* services to the Company. The CEO then provided that recommendation, along

with his own recommendation that Executive 1's brother be granted the stock options under the S-8 Stock Plan, to the Company's Compensation Committee. The CEO did so even though he knew that Executive 1's brother would not be rendering any *bona fide* services to FalconStor.

28. Second, the CEO facilitated the purchase of Executive 1's house in Ohio, which Executive 1 was trying to sell in a difficult real estate market. The CEO did this by arranging for a \$40,000 relocation allowance for a FalconStor employee who was relocating to Columbus, Ohio, where Executive 1's house was located. The \$40,000 relocation allowance enabled the relocating employee first to rent Executive 1's house and then make the requisite down payment needed to purchase the house. The \$40,000 relocation allowance was excessive, unprecedented, and designed to benefit Executive 1.

29. Third, in or about May 2009, the CEO and Salesman X offered Executive 1 approximately \$100,000 to stake Executive 1's gambling in Las Vegas in order to induce Executive 1 to support additional JPMC business for FalconStor, which Executive 1 and Salesman X were then negotiating.

30. To make the money available to Executive 1, the CEO arranged for Salesman X to be paid an unusually large "bonus," in the amount of \$240,000, approximately \$100,000 of which the CEO directed Salesman X to deposit in a Las Vegas casino account for Executive 1's use. At the CEO's direction, Salesman X then opened an account in Salesman X's name at a Las Vegas casino that was linked to, and collateralized by, a bank account into which Salesman X deposited the approximately \$100,000 that was intended for Executive 1's gambling. Thereafter, Salesman X repeatedly offered to accompany Executive 1 to Las Vegas so that Executive 1 could access the funds and gamble, but Executive 1 never did so.

31. In addition, in April 2009, Salesman X paid \$3,295 for Executive 2's membership fees at a local golf club. FalconStor's CEO approved the payment, which was reimbursed using Company funds.

32. On June 26, 2009, FalconStor and JPMC executed a \$6 million contract. The contract represented 22.3% of FalconStor's total reported revenue for the second quarter of 2009.

33. Although up to this point, the CEO had arranged for FalconStor to secretly give approximately \$163,000 in bribes to key employees of JPMC, and had offered to give one of them another \$100,000, the CEO continued to tout JPMC's business as proof of the quality and desirability of FalconStor's products and validation of its strategy to grow its non-OEM business. On a July 28, 2009 earnings call, the CEO stated "[i]n Q2, a major Fortune account after realizing a substantial return on investment for our totally open [Virtual Tape Library ("VTL")] deduplication system last year placed a multi-million-dollar order to double the scope and capacity of this VTL deduplication implementation around the world." The CEO added that JPMC "represents the largest deployment of data deduplication technology anywhere in the world. It is (inaudible) about FalconStor's credibility and the technological leadership in the space. . . ."

34. The CEO did not disclose on this earnings call or otherwise that before and during this period, FalconStor was bribing key executives of JPMC, which in the second quarter of 2009 was one of the Company's three largest customers and its most high profile non-OEM relationship.

The Relationship with JPMC Winds Down and the Bribery Scheme Is Revealed

35. After securing the June 2009 contract, the CEO continued to direct or approve bribes to employees of JPMC in the hopes of obtaining additional business, or simply to retain the business. In late 2009 and early 2010, the frequency and amounts of the bribes increased.

36. In addition to cash and large amounts of gift cards, the bribes given during this period included grants, ostensibly pursuant to the Company's Incentive Stock Plan, of 5,000 stock options (valued at \$8,360) to Executive 3's wife and 20,000 shares (or \$58,400 worth) of restricted stock to Executive 1's brother.

37. Ultimately, however, the bribes ceased to have the desired effect. In 2010, JPMC technology personnel, including some senior executives who had long dissented from Executive 1's views on the technical merits of FalconStor's products, became concerned about FalconStor's technology. In addition, risk management personnel at JPMC expressed concerns about the Company's financial health. As a result, FalconStor's revenues from JPMC declined significantly. In 2010, FalconStor's revenues from JPMC totaled approximately \$1.7 million, down from approximately \$7.7 million in 2009, and were derived solely from professional services and maintenance.

38. In total, during the relevant period, FalconStor earned approximately \$13.5 million in gross revenues on contracts with JPMC.

39. On September 29, 2010, FalconStor issued a press release disclosing the CEO's admission that he had been involved with improper payments to a customer, and his resignation. Following the September 29th announcement, the price of FalconStor's stock declined 22.4%.

The Impact of the Bribery Scheme on FalconStor's Books and Records

40. The giving and offering of bribes to JPMC's personnel violated applicable state law and was inconsistent with FalconStor's policies, JPMC's policies, and the express terms of

the contract between FalconStor and JPMC.

41. Under New York state law, it is, and was throughout the relevant period, a crime to “confer[], or offer[] or agree[] to confer, any benefit upon any employee, agent or fiduciary without the consent of the latter’s employer or principal, with intent to influence his conduct in relation to his employer’s or principal’s affairs.” New York Penal Law Sections 180.00, 180.03. With limited exceptions, JPMC’s Code of Conduct prohibited employees from accepting gifts (including entertainment and hospitality) from any customer, supplier, or other party doing, or seeking to do, business with the firm. The Code strictly prohibited employees from accepting gifts of securities, cash, or gift cards from suppliers or other parties doing business with the firm, unless approved by certain compliance personnel and high level management. During the relevant period, FalconStor’s Code of Conduct directed that any entertainment or gifts given or received “must be in compliance with law, must not violate the giver’s and/or the receiver’s policies on the matter, and must be consistent with local custom and practice.” The master agreement governing the contracts between FalconStor and JPMC contained an anti-inducements clause, pursuant to which FalconStor represented and agreed that it “has not provided, and will not provide, to any [JPMC] employee or contractor any gift, gratuity, service or other inducement or favor to influence or reward that employee or contractor in connection with any [contract for specific goods or services].”

42. As a result of the giving and offering of the bribes described above and actions by the CEO and others to conceal the true purpose of the expense of those bribes, FalconStor’s books and records were inaccurate.

43. For example, the grants of restricted stock and options to the relatives of Executive 1 and Executive 3 resulted in the creation of books and records inaccurately characterizing Executive 1's brother and Executive 3's wife and sixteen-year-old son as consultants or advisors to FalconStor who had provided or would provide *bona fide* services to FalconStor, when in fact they had not provided any *bona fide* services to FalconStor and were not in a position to do so.

44. In addition, some of the expenses were disguised as compensation expenses on the Company's books and records. For example, the expense of the \$35,000 in traveler's checks the CEO arranged for Salesman X to have to entertain JPMC personnel in Hong Kong and Macau was disguised as a performance bonus to a FalconStor executive who served as a conduit for the transmittal of the funds. Similarly, the approximately \$100,000 offered to Executive 1 for gambling was disguised as a bonus to Salesman X, resulting in the inaccurate recording of the approximately \$100,000 payment as a compensation expense.

45. Finally, the expenses of many of the bribes offered or given were reflected on the Company's books and records as sales promotion expenses or, to a lesser extent, entertainment expenses. Characterizing these expenses as entertainment or sales promotion expenses rendered the books and records inaccurate because the expenses were actually bribes that violated New York state law and FalconStor's and JPMC's policies, as well as the express terms of the contract between FalconStor and JPMC, and thus were not legitimate expenses.

FIRST CLAIM FOR RELIEF
Violations of Sections 5(a) and (c) of the Securities Act
(Unregistered Sales of Securities)

46. The Commission realleges and incorporates by reference herein each and every allegation contained in paragraphs 1 through 45 above.

47. FalconStor's grants of options and restricted stock to the relatives of employees of JPMC described above were "sales" as defined by Section 2(a)(3) of the Securities Act [15 U.S.C. § 77b(a)(3)].

48. The grants of options and restricted stock to the relatives of employees of JPMC described above were not covered by the S-8 Stock Plan, because the grants were not made to persons who provided *bona fide* services to FalconStor. Consequently, there was no registration statement in place for the grants of options and restricted stock and no exemption from registration applies.

49. By selling unregistered securities, FalconStor violated Sections 5(a) and 5(c) of the Securities Act [15 U.S.C. §§ 77e(a) and 77e(c)].

SECOND CLAIM FOR RELIEF

Violations of Sections 17(a)(2) and 17(a)(3) Securities Act (Anti-Fraud Violations)

50. The Commission realleges and incorporates by reference herein each and every allegation contained in paragraphs 1 through 45, above.

51. The CEO's misleading statements about the relationship with JPMC in the earnings releases issued in April 2008 and February 2009 were filed on Forms 8-K and incorporated by reference in the registration statement for the Company's Incentive Stock Plan in effect at the time.

52. The CEO's misleading statements inflated the price of FalconStor's stock, which declined by over 22% following the Company's disclosure that the CEO had been involved in improper payments and had resigned. As a result, the Company obtained property by means of those statements, because it received the services of employees, consultants, and advisors who

rendered *bona fide* services to the Company – and thus properly received FalconStor restricted stock and options pursuant to the Company’s Incentive Stock Plan – for fewer shares (or less other compensation) than it would otherwise have had to grant them, if the stock had been valued at its true worth. As a result, the Company also defrauded those same employees, consultants, and advisors.

53. FalconStor, in the offer or sale of securities, by the use of means or instruments of interstate commerce or by the mails, directly or indirectly (a) obtained money or property by means of untrue statements of a material fact or omissions of a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and (b) engaged in transactions, practices or courses of business which operated as a fraud or deceit upon purchasers of securities.

54. FalconStor’s CEO knew of the facts and circumstances concerning the bribes given and offered to Executives 1, 2, and 3 and other employees of JPMC and therefore knew or should have known that his failure to disclose that information rendered his public statements about FalconStor’s contracts with JPMC filed on Forms 8-K and incorporated into the Company’s S-8 registration statement misleading to purchasers of FalconStor securities.

55. By reason of the foregoing, FalconStor violated Sections 17(a)(2) and (3) of the Securities Act [15 U.S.C. §§ 77q(a)(2) and 77q(a)(3)].

THIRD CLAIM FOR RELIEF

Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act (Books-and-Records and Internal Control Violations)

56. The Commission realleges and incorporates by reference herein each and every allegation contained in paragraphs 1 through 45, above.

57. As described above, FalconStor failed to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflected the transactions and dispositions of its assets, and failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions: (i) are executed in accordance with management's general or specific authorization; and (ii) are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets. Accordingly, FalconStor violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B)].

PRAYER FOR RELIEF

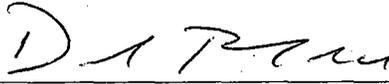
WHEREFORE, the Commission respectfully requests that this Court:

1. Enter a Final Judgment:
 - a. permanently restraining and enjoining FalconStor from violating Sections 5(a), 5(c), 17(a)(2), and 17(a)(3) of the Securities Act [15 U.S.C. §§ 77e(a), 77e(c), 77q(a)(2) and 77q(a)(3)] and Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B)]; and

b. ordering FalconStor to pay a civil monetary penalty pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] and Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)]; and

2. Grant such other and further relief as the Court deems appropriate.

Dated: June 27, 2012
New York, New York

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