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The Newspaper of Corporate Finance
Financial Week
crain
December 17, 2007

Department of Justice has a big new stick

A little-known securities fraud provision of Sarbanes-Oxley may be coming into play—and it carries a sentence of up to 25 years in prison

By Michael A. Asaro and Charles D. Riely

CONGRESS ENACTED THE SARBANES-OXLEY Act five years ago this past summer in response to a parade of corporate scandals—beginning with the Enron debacle—that rocked the very foundation of the U.S. financial markets. Among SarbOx's many provisions was Section 1348, a new criminal securities fraud statute that carries a penalty of up to 25 years in prison. It's been a relatively little-used club in the government's anti-corruption arsenal. But that could change over the next five years. Here's what you need to know about it.

Congress created Section 1348 despite the decades-long existence of a multitude of other criminal laws that had seen regular use in this area, including Section 10(b) of the Securities Exchange Act of 1934 and its implementing regulation, Rule 10b-5, which already prohibited fraud "in connection with the purchase or sale of any security." Section 1348 was designed to address what Congress perceived as a need for a "more general and less technical" statute that would be "more accessible to investigators and prosecutors" than existing antifraud laws. The 25-year prison term was also expected to give prosecutors a powerful tool in the fight against corporate corruption.

Yet in the five years that have passed since the enactment of Sarb-Ox, the Department of Justice has reported only 50 or so Section 1348 prosecutions. There appear to be three basic reasons for Section 1348's limited use during the first five years of its existence.

First, many of the corporate scandals that have come to light during this period involved conduct that either completely or partially predated Section 1348. SarbOx's ex post facto clause prohibited prosecutors from relying on Section 1348 to bring charges involving conduct that ended before the effective date and complicated efforts to bring Section 1348 charges for conduct that straddled the effective date.

SECTION 1348 CHARGES HAVE RECENTLY BEEN FILED IN CONNECTICUT, GEORGIA AND PUERTO RICO.

Second, the use of any new criminal statute not yet subjected to judicial scrutiny carries risks for the government, including the risk that a court might choose to interpret Section 1348 in a manner incompatible with its prosecution theory. This risk would only be heightened in white-collar cases, which are often already burdened by complex issues of fact.

Third, in addition to adopting Section 1348, SarbOx drastically increased the maximum penalties for violations of the pre-existing mail and wire fraud statutes (which had been five years) and Rule 10b-5 securities fraud (which had been 10 years) to 20 years in prison. This marginalized the impact of Section 1348's 25-year punishment. In many instances, prosecutors may have simply reasoned that the difference between a maximum sentence of 20 and 25 years in jail per fraud count did not justify the risks inherent in relying on a completely new and untested criminal law, especially because the sentencing guidelines, which play a dominant role in the calculation of federal sentences, do not differentiate between convictions under the various fraud statutes.

Despite Section 1348's lackluster history, it is unlikely that the provision will be relegated to obscurity forever. As time passes, new and ongoing frauds that entirely postdate Section 1348's enactment will undoubtedly come to light. The passage of time is therefore rapidly eliminating the ex post facto concerns that may have deterred prosecutors from applying Section 1348 in the past.

In addition, some prosecutors have already begun to pursue cases under Section 1348. For example, the U.S. Attorney's Office for the Eastern District of New York has been charging Section 1348 fairly regularly since its enactment, and Section 1348 charges have also recently been filed by federal prosecutors in Connecticut, Georgia and Puerto Rico. As cases from these and other districts work their way through the courts, a more robust body of Section 1348 case law is bound to develop.

With the main impediments to bringing Section 1348 quickly evaporating, prosecutors may opt to use it more often. While the contours of Section 1348 have not yet been fully developed, prosecutors may argue that the new statute is broader than existing statutes.

Moreover, under Section 1349, which was passed at the same time as Section 1348, defendants convicted of conspiracy to commit Section 1348 securities fraud "shall be subject to the same penalties as those prescribed for the [substantive] offense"—namely, 25 years in prison. This is significantly higher than the five-year sentence a defendant could face under 18 U.S.C. 371, the traditional conspiracy statute, which would apply to conspiracy to commit securities fraud in violation of Section 10(b) and Rule 10b-5.

In the end, only time will tell whether prosecutors will use Section 1348 more extensively. The next five years should show whether this provision is utilized as the additional weapon against corporate corruption, as Congress envisioned, or if instead the statute will be relegated to obscurity forever.

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