UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. WORLDCOM, INC., Defendant.	: Civ No. 02-CV-4963 (JSR)

SUBMISSION OF THE SECURITIES AND EXCHANGE COMMISSION ADDRESSING THE ISSUES IDENTIFIED IN THE COURT'S MAY 19, 2003 ORDER CONCERNING THE PROPOSED SETTLEMENT OF THE COMMISSION'S MONETARY CLAIMS AGAINST WORLDCOM

Peter H. Bresnan (PB 9168)
Arthur S. Lowry (AL 9541)
Lawrence A. West
Gerald W. Hodgkins
Securities and Exchange Commission
450 Fifth St., N.W., Mail Stop 911
Washington, D.C. 20549-0911
(202) 942-4788

Counsel for Plaintiff Securities and Exchange Commission

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

Cases

Statutes and Other Authorities

Plaintiff Securities and Exchange Commission (the "Commission" or the "SEC") respectfully makes this submission to address the four issues raised by the Court in its May 19, 2003 Order with respect to the proposed settlement of the Commission's claims for monetary relief against defendant WorldCom, Inc. This submission also addresses the broader issue of whether the settlement is an appropriate resolution of the Commission's monetary claims.

INTRODUCTION

The largest financial fraud in history merits the largest civil penalty ever imposed in an SEC action. The Commission's proposed settlement with WorldCom would result in the largest judgment in the 69 years the Commission has been in existence and a civil penalty far greater than any penalty ever previously imposed in an SEC action. In our view, this record $500 million civil penalty payment -- particularly when viewed in conjunction with the other relief the Court has already imposed against WorldCom -- is sufficiently tough to deter future violations of the federal securities laws. At the same time, the proposed settlement is measured and balanced. It takes account of WorldCom's extensive cooperation with the Commission's investigation of financial fraud at WorldCom. It also seeks to ensure that WorldCom's creditors are not unfairly disadvantaged. In addition, we respectfully submit that the proposed settlement is appropriate because it greatly reduces litigation risks that would otherwise jeopardize any recovery by the Commission – and, ultimately, by the victims of WorldCom's devastating fraud.

BACKGROUND

The Commission filed its initial Complaint in this matter on June 26, 2002, the day after WorldCom announced that it intended to restate its financial results for all four quarters of 2001 and the first quarter of 2002. The initial Complaint charged that WorldCom had inflated its income by approximately $3.8 billion and had engaged in an unlawful scheme in violation of

certain antifraud and reporting provisions of the federal securities laws, including Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 (the "Exchange Act") and Exchange Act Rules 10b-5, 13a-1, 13a-13 and 12b-20. The Complaint sought injunctive relief, the appointment of a corporate monitor and a civil penalty. On July 3, 2002, former Commission Chairman Richard Breeden was appointed by the Court to act as the Corporate Monitor.

On November 1, 2002, the Commission filed its First Amended Complaint, adding claims that WorldCom violated the antifraud prohibitions of Section 17(a) of the Securities Act of 1933 (the "Securities Act") in connection with several securities offerings made during the period WorldCom's financial statements were falsely inflated, and also violated the internal controls and books and records provisions of the securities laws, Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. The First Amended Complaint also broadened the time period covered by the Commission's charges to allege that WorldCom misled investors from at least as early as 1999 through the first quarter of 2002, and further stated that the Company acknowledged that during that period, as a result of undisclosed and improper accounting, WorldCom materially overstated the income it reported in its financial statements by approximately $9 billion.

In addition, the Commission has brought civil actions against four former employees of WorldCom. The Commission filed civil actions against former WorldCom Controller David F. Myers on September 26, 2002; former WorldCom Director of General Accounting Buford "Buddy" Yates, Jr., on October 7, 2002; and Betty L. Vinson and Troy M. Normand, former accountants in WorldCom's General Accounting Department, on October 10, 2002. All four defendants consented to Judgments enjoining them from future violations of the federal securities laws, and, in the case of Myers and Yates, prohibiting them from serving as an officer or director of any public company. In addition, Myers, Yates and Vinson agreed to be suspended from

appearing or practicing before the Commission as accountants. The civil actions against the four individuals are still pending as to monetary relief.

On November 26, 2002, the Court entered a Judgment of Permanent Injunction against WorldCom (the "November Judgment") that embodied a partial settlement of the claims in this lawsuit. The November Judgment imposed all of the equitable relief sought by the Commission in its First Amended Complaint, as well as additional equitable relief not specifically sought in the First Amended Complaint. In particular, the November Judgment (1) imposed the full injunctive relief sought by the Commission, (2) ordered an extensive review of the Company's corporate governance systems, policies, plans, and practices, (3) ordered an extensive review of the Company's internal accounting control structure and policies, and (4) ordered that WorldCom provide training and education to certain officers and employees to minimize the possibility of future violations of the federal securities laws.

The November Judgment left the question of what civil penalty, if any, would be imposed against WorldCom to be decided by the Court at a later date. In addition, the Court ordered that at any hearing to consider the appropriateness of civil penalties against WorldCom:

> "WorldCom will be precluded from arguing that it did not violate the federal securities laws in the manner described in the First Amended Complaint herein and, solely for the purposes of such hearing, the allegations of the First Amended Complaint shall be accepted as and deemed true by the Court."

(November Judgment at par. VI).

The Commission's demand for a civil penalty was made pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] and Section 21(d) of the Exchange Act [15 U.S.C. § 78u(d)]. Those statutes provide that penalties are to be determined "in light of the facts and circumstances" and provide for three tiers of penalties. The third, and highest, tier of penalties provides that the amount of civil penalty against a corporate entity for each violation of the federal securities laws

shall not exceed the higher of (I) $600,000 or (II) the "gross amount of pecuniary gain to such defendant as a result of the violation." Id.; see also 17 C.F.R. Pt. 201, Subpt. E.

On May 19, 2002, the parties submitted a proposed settlement of the Commission's monetary claims. The proposed Judgment would find WorldCom liable to pay a civil penalty of $1.51 billion. The proposed Judgment further provides that in the event WorldCom is either reorganized or liquidated under Chapter 11 of the Bankruptcy Code, WorldCom's liability under the Judgment shall be satisfied by a payment by WorldCom, Inc. and its affiliated debtors of $500 million. The proposed Judgment also provides for a nominal amount of disgorgement to be paid by WorldCom. The inclusion of that nominal disgorgement figure would allow the $500 million penalty payment to be distributed to victims of the fraud pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002.

I. THE UNPRECEDENTED SANCTIONS OBTAINED AGAINST WORLDCOM IN THIS CASE ARE SUFFICIENT TO DETER FUTURE VIOLATIONS OF THE FEDERAL SECURITIES LAWS

A. The Proposed Civil Penalty Judgment Would Be the Largest in Any SEC Case

A Judgment for $1.51 billion would rank as the largest Judgment in SEC history. As such, the Judgment would be larger than those imposed against Drexel Burnham Lambert and junk-bond king Michael Milken in the late 1980s, larger than the judgment against Salomon Brothers in 1992 for its role in the Treasury auction scandal and larger than the judgments obtained against Prudential Securities Inc. in 1993 and Paine Webber Group Inc. in 1996 involving fraud in the sale of limited partnership interests. The amount of the Judgment would also be larger than the proposed Judgments announced this past April against 10 major Wall Street firms for failing to ensure that the research they provided their customers was independent and unbiased by investment banking interests.

The proposed penalty would also far exceed any civil penalty previously obtained in an SEC case. Prior to this settlement, the largest civil penalty ever imposed was the $150 million penalty Citigroup's Salomon Smith Barney agreed to pay in April 2003 in connection with the analyst conflicts-of-interest matter. The only other penalty the Commission has ever obtained in excess of $100 million was the $122 million penalty imposed against Salomon Brothers in connection with the Treasury auction scandal.

But the true strength of the proposed settlement is best gauged by comparing the civil penalty here with the penalties imposed by the SEC against other public companies in financial fraud cases. The Commission has historically been reluctant to impose civil penalties on public companies because of the negative impact such a penalty can have on shareholders who have already been victimized by the conduct being penalized.[1] Due to this concern, the Commission has sought and obtained civil penalties against public companies in financial fraud cases on only a handful of occasions.

In its April 2002 complaint in SEC v. Xerox Corporation, Civil Action No. 02-272789 (DLC) (S.D.N.Y. 2002), the Commission alleged that Xerox engaged in a wide-ranging four-year scheme to defraud investors that involved improper acceleration of the company's recognition of

---

1 Section 21(d) of the Exchange Act permits the SEC to seek penalties against "any person" and explicitly distinguishes between amounts for which natural persons and other persons, *i.e.*, corporations, may be liable. The legislative history of the penalty provisions speaks directly to the issue of penalties against corporate issuers. The Senate Report states as follows:

> "The Committee believes that the civil money penalty provisions should be applicable to corporate issuers, and the legislation permits penalties against issuers. However, because the costs of such penalties may be passed on to shareholders, the Committee intends that a penalty be sought when the violation results in an improper benefit to shareholders. In cases in which shareholders are the principal victims of the violations, the Committee expects that the SEC, when, appropriate, will seek penalties from the individual offenders acting for a corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations. The court may also consider the extent to which the passage of time has resulted in shareholder turnover.

S. Rep. No. 337, 101st Cong., 2d Sess. 2 (1990) at 17.

revenue of over $3 billion and an improper increase in its pre-tax earnings of approximately $1.5 billion. In settling the case, Xerox agreed to pay a civil penalty of $10 million, which is the largest penalty imposed to date in an SEC action against an entity other than a broker-dealer regulated by the Commission. In announcing the settlement of the case, the Commission took pains to make clear that the penalty was imposed, in large part, as a sanction for Xerox's failure to fully cooperate with the Commission's investigation.

In its September 2002 complaint in SEC v. Dynegy Inc.,H-02-3623 (S.D. Tex. 2002), the Commission alleged that Dynegy improperly accounted for a $300 million financing transaction involving special purpose entities and overstated its energy-trading activity as a result of pre-arranged "round-trip" sales. Dynegy agreed to pay a $3 million civil penalty as part of the settlement of the case. The $3 million penalty against Dynegy is the second largest penalty ever imposed by the Commission against a public company in a financial fraud case. Again, in its public comments on the settlement, the Commission emphasized that imposition of the penalty reflected the Commission's dissatisfaction with Dynegy's lack of full cooperation in the Commission's investigation.

The proposed Judgment against WorldCom of $1.51 billion would impose a penalty that is 151 times greater than the penalty in Xerox. Even when viewed in relation to the $500 million amount that is to be paid to the SEC through WorldCom's bankruptcy, the penalty dwarfs the Xerox penalty by 50 times. Moreover, the penalties against Xerox and Dynegy were to a large degree influenced by the fact that those companies had failed to cooperate fully with the Commission's investigations regarding those companies. Here, in contrast, WorldCom's cooperation with the Commission's investigation since June 25, 2002 has been both extensive and meaningful. In addition, both Xerox and Dynegy were solvent companies whose ability to pay the

penalties imposed was not in question, whereas WorldCom is in bankruptcy and is unable to satisfy the claims of all of its creditors.

B. A Very Substantial Penalty is Warranted by the Undisputed Facts

A large civil penalty is appropriate due to the nature and extent of WorldCom's fraud. The Commission agrees with the view expressed by the Court in its May 19, 2003 Order that it will be beneficial for the Court and the public to receive more information regarding the details of WorldCom's fraud. A great deal of detail regarding the facts at issue has already been provided publicly in the Commission's First Amended Complaint in this matter and the Commission's Complaints filed against David Myers, Buford Yates, Betty Vinson and Troy Normand, WorldCom's sworn statement in response to the Commission's request for information pursuant to Section 21(a)(1) of the Exchange Act, the criminal indictments and informations against Scott Sullivan, Mr. Myers, Mr. Yates, Ms. Vinson and Mr. Normand, the statements made by certain of these defendants during plea allocutions, and the first report of former U.S. Attorney General Richard Thornburgh, who was appointed Examiner in the bankruptcy proceeding involving WorldCom Inc. and its affiliated debtors that is pending before the Honorable Arthur J. Gonzalez in the U.S. Bankruptcy Court for the Southern District of New York (the "Bankruptcy Proceeding"). Furthermore, a wealth of additional factual detail concerning the fraud will be furnished early next week when the report of WorldCom's Special Investigative Committee and the second Report of the Bankruptcy Examiner are filed with the Courts and made public. Counsel for both the Commission and WorldCom reviewed the report of WorldCom's Special Investigative Committee several weeks ago and its contents and conclusions were well known to the parties at the time they entered into the proposed settlement.

If the Commission's claim for a civil penalty were to be litigated -- rather than settled -- the

report of WorldCom's Special Investigative Committee would form an important part of the factual foundation for the Commission's contentions regarding various factors relevant to setting an appropriate penalty. When penalties have been litigated, courts in this Circuit have considered the following factors in making penalty determinations:

> "(1) the egregiousness of the defendant's conduct; (2) the degree of the defendant's scienter; (3) whether the conduct created substantial losses or the risk of substantial losses to other persons; (4) whether the conduct was isolated or recurrent; and (5) whether the penalty should be reduced in light of the defendant's demonstrated current and future financial condition."

See, e.g., SEC v. Kane, 2003 WL 1741293 (S.D.N.Y. Apr. 1, 2003); SEC v. Credit Bancorp, Ltd., 2002 U.S. Dist. LEXIS 20597 (S.D.N.Y. Oct. 29, 2002). The report of WorldCom's Special Investigative Committee supports the notion that a very substantial civil penalty is warranted in this case because WorldCom's fraud was egregious, involved a high level of scienter, was perpetrated by members of WorldCom's senior management and required the acquiescence of dozens of WorldCom employees to remain undetected for more than three years. Moreover, the report describes inadequacies in WorldCom's internal controls, failures of its systems of corporate governance and WorldCom's corrupt corporate culture. For all these reasons, if this case were to be litigated, the report of WorldCom's Special Investigative Committee, as well as the reports of the Bankruptcy Examiner, would be important in establishing that any penalty sought by the Commission was justified. In the Commission's view, those reports strongly suggest that a penalty as large as the one that would be imposed by the proposed Judgment is fully warranted.[2]

C. The Broad Array of Sanctions Imposed on WorldCom is Sufficient to Deter Future Financial Fraud

Although the civil penalty contained in the proposed Judgment is, by itself, sufficiently

2 Because liability is uncontested with respect to the issue of what civil penalty is appropriate and because the parties have agreed to settle the case, the Commission respectfully suggests that an in-court evidentiary hearing at which the reports of the Bankruptcy Examiner and the Special Investigative Committee might be introduced as evidence is not necessary.

large to serve as an effective deterrent against future financial fraud, the adequacy of the civil penalty cannot be judged in a vacuum. Instead, it must be viewed in conjunction with the other extremely important remedies the Court has already imposed in this matter. First, the Court appointed a Corporate Monitor with broad oversight responsibility with respect to all compensation paid by WorldCom, and authority to prevent the destruction of documents. Second, as noted above, in its November Judgment, the Court (1) enjoined WorldCom from violating every statutory provision at issue in this proceeding, (2) ordered the Corporate Monitor to conduct an extensive review of the company's corporate governance systems, policies, plans, and practices, (3) ordered an independent consultant to perform an extensive review of the company's internal accounting control structure and policies, and (4) ordered WorldCom to provide training and education to certain officers and employees to minimize the possibility of future violations of the federal securities laws.

The combination of the Monitorship and the broad array of significant and innovative equitable sanctions already imposed constitute an unprecedented -- though in the Commission's view a wholly justified -- degree of oversight and involvement by a court in the affairs of a public company. The Corporate Monitor has an office at WorldCom's headquarters, has been present at all or virtually all meetings of WorldCom's Board of Directors for the past 11 months, has been intimately involved in WorldCom's efforts to improve its corporate governance and its internal controls and to provide education to its employees with respect to their obligations under the federal securities laws, and was intimately involved in the negotiation and approval of the employment contract of WorldCom's new Chief Executive Officer, Michael Capellas. Since this lawsuit and Mr. Breeden's Monitorship began, WorldCom has not only a new CEO and CFO, but an entirely new Board of Directors, and has ensured that all of the officers and employees

implicated in the misconduct described in the report of WorldCom's Special Investigative Committee no longer work for the Company. Thanks in no small part to the unstinting work of Mr. Breeden, WorldCom appears to have made substantial progress in transforming itself from one of the ultimate symbols of corporate corruption into a good corporate citizen.

In its May 19 Order, the Court required the parties to report on the status of the reviews of corporate governance and internal controls required by the Court's November Judgment. Under the schedule set forth in the November Judgment, Mr. Breeden's report on corporate governance is due no later than August 1, 2003. Notwithstanding the fact that Mr. Breeden's report has not yet been completed, it is clear that Mr. Breeden has been extremely active in reviewing and reformulating WorldCom's corporate governance systems, and that WorldCom's new management has been receptive to his efforts. In addition, the Commission understands that Mr. Breeden expects to complete his report towards the end of June 2003.

As the parties informed the Court at an earlier hearing, the review and report on internal controls required by the November Judgment has not been completed. At the time the parties entered into the partial settlement reflected in the November Judgment, they anticipated that the internal controls report would be completed within 6 months. Following the entry of the November Judgment, WorldCom sought to identify candidates to serve as the internal controls consultant that were acceptable to the Commission. This process proved to be more difficult than the parties originally anticipated and took longer than the 30 days provided for in the Judgment. The parties also engaged in extended discussions with regard to the scope of the work to be performed by the consultant, which culminated in the submission of a proposal to the Commission in early March 2003 under which consultants would have reviewed the design of WorldCom's significant internal controls structure and policies. During this same time period, WorldCom's

independent external auditor, KPMG LLP ("KPMG"), was engaged in work in connection with audits of the Company's financial statements for 2000, 2001 and 2002. In the course of that work, KPMG reviewed the Company's existing internal accounting controls and identified certain material weaknesses (as defined in generally accepted auditing standards) as well as other deficiencies in WorldCom's internal controls.

In March 2003, while the Commission staff was reviewing the consultant's proposal, the staff was informed, in general terms, of KPMG's observations with respect to internal controls. At that point, following discussions with the Corporate Monitor, both parties determined that it made no sense to hire and pay consultants to review the design of internal controls systems that were not operating effectively. Instead, the parties agreed that WorldCom should fix the internal control weaknesses and deficiencies identified by its internal auditor before a review of the effectiveness of the Company's system of internal controls is undertaken. On June 3, 2003, KPMG issued a detailed report to WorldCom's management outlining its observations regarding the material weaknesses and other deficiencies in the Company's internal accounting control structure and policies and procedures. To make sure that the Company's internal controls problems are remedied, the parties expect to jointly submit in the near future an application for a modification of paragraph VIII of the November Judgment.

Paragraph IX of the November Judgment requires WorldCom to provide reasonable training and education to certain of its officers and employees to minimize the possibility of future violations of the federal securities laws. Such training is mandatory for a period of three years for WorldCom officers and employees involved in its corporate level accounting and financial reporting functions; for those officers and employees involved in financial reporting at WorldCom's major divisions and subsidiaries (including, specifically, those officers and

employees responsible for closing the books in their area of responsibility at the end of a quarterly or annual reporting period); and for senior operational officers at WorldCom's corporate, divisional and subsidiary levels. A detailed agenda for the training program was submitted to both the Corporate Monitor and the Commission, and was approved by the Commission staff. The first training session was held last week, and the training and education program remains on track.

Although the reports required by the November Judgment with respect to corporate governance and internal controls have yet to be completed, the Court's entry of the proposed Judgment would in no way affect WorldCom's obligations to complete such reports. Indeed, if WorldCom were to fail to comply with its obligations with respect to corporate governance and internal controls, it would be in contempt of court, and appropriate additional sanctions could be imposed. But the record to date indicates that WorldCom appears to be committed to improving both its systems of corporate governance and internal controls, and that it has already taken major steps towards implementing the substantial changes in those systems that are needed. In the Commission's view, the ongoing work to improve WorldCom's corporate governance and internal controls poses no impediment to the Court's entry of the proposed Judgment.

D. The Primary Purpose of the Commission's Penalty Claim is to Deter Fraud

Some have criticized the proposed settlement on the ground that it fails to provide sufficient recompense to the investors who lost approximately $200 billion by investing in WorldCom securities. Such arguments are misplaced for several reasons. First, WorldCom simply does not have $200 billion. Its value as a going concern has been estimated at between $12 and $15 billion by WorldCom's financial advisors, and its liquidation value at approximately $4 billion. Second, the Commission does not have a claim on which it could recover $200 billion. The Commission's claim is not one for restitution of losses suffered by investors, but instead one

for a statutory penalty that is limited by the "gross pecuniary gain" to WorldCom as a result of the fraud, which is a small fraction of $200 billion. As a result, the Commission could recover only a portion of the amount lost by investors even if the Court were to award the Commission the maximum recovery attainable on its penalty claim. Third, not all of the $200 billion lost by investors was lost as a result of WorldCom's fraud. Indeed, most of WorldCom's market capitalization was lost before shareholders had any knowledge of the fraud. The price of WorldCom common stock had fallen from a high of $60 per share to a mere 83 cents by June 25, 2002, before WorldCom publicly admitted that its financials were misstated.[3] Fourth, the primary reason the Commission asserted a penalty claim in this case was to deter future financial frauds – not to compensate injured investors. While the Fair Fund provision of the Sarbanes-Oxley Act has the effect of allowing the Commission to distribute funds collected from civil penalty judgments to victims, the primary purpose for which the Commission seeks penalties remains deterrence, not investor restitution.

The unprecedented civil penalty that would be imposed by the proposed Judgment, particularly when viewed in conjunction with the extraordinary equitable relief already imposed by the Court, is clearly sufficient to accomplish the primary purpose of the penalty statutes: deterring future financial fraud by WorldCom, and by other companies that might be tempted to follow WorldCom's example.

II. THE PROPOSED SETTLEMENT PROPERLY BALANCES THE NEED FOR DETERRENCE WITH COMPETING CONSIDERATIONS

In the Commission's view, the goals of punishing misbehavior and deterring future

3 By noting that the stock price had fallen to 83 cents before the full extent of the fraud was revealed, we do not mean to suggest that there were not other events that could have led market participants to conclude at a date prior to June 25, 2002 that a fraud was possible. We also do not mean to suggest that shareholders' damages in private actions should be capped at 83 cents per share. The question of the proper measure of shareholder losses is a complex one, as to which economists would likely have differing views. In our view, however, the measure of securityholders' losses that are due to the fraud is substantially less than $200 billion.

misconduct are not the only considerations germane to the question of what civil penalty is appropriate in this matter. In deciding to settle this case in accordance with the proposed Judgment, the Commission took account of WorldCom's extensive cooperation with the Commission's investigation. In addition, the proposed settlement seeks to ensure that WorldCom creditors are not unfairly disadvantaged by the relief the Commission obtains.

A. WorldCom's Cooperation Was Considered in Determining the Appropriate Penalty

WorldCom's cooperation with the Commission investigation since June 25, 2002 has been extensive and meaningful. WorldCom produced hundreds of thousands of documents to the Commission's staff, as well as many audiotapes, videotapes and CD ROMs, and has voluntarily made approximately one hundred witnesses available to the Commission staff for extended interviews. In addition to such cooperation with the Commission, WorldCom has made both documents and witnesses available to the criminal authorities investigating the fraud at WorldCom, to the Special Investigative Committee and its counsel, and to the Bankruptcy Examiner and its counsel. Moreover, after the Commission filed suit, the Company acceded to the appointment of a Corporate Monitor, and has cooperated in the Monitor's efforts to transform WorldCom's corporate governance. In addition, the fact that the Company invested many millions of dollars in the effort that led to the report of WorldCom's Special Investigative Committee, and supported the effort of the Committee to investigate and report upon the fraud at WorldCom, demonstrates that WorldCom has in fact shown meaningful cooperation with the Commission's investigation. The fact that WorldCom no longer employs any of the employees that were identified as involved in the fraud by the Special Investigative Committee's report, and consented to the equitable relief contained in the November Judgment, demonstrates further cooperation by the Company.

If the Commission were to insist that the highest possible civil penalty be imposed against

WorldCom despite its record of cooperation, other companies would likely conclude they have little or nothing to gain by cooperating with the government. Due to the limited resources available to the Commission, encouraging and obtaining early, extensive and meaningful cooperation in SEC investigations is critical to the successful accomplishment of the agency's mission. If the Court were to second-guess the agency's determination that the proposed civil penalty is appropriate and conclude that the proposed penalty is too low,[4] other companies might well conclude that they have little incentive to either cooperate or settle with the Commission. The Commission respectfully suggests that such a result would be highly detrimental to the agency's efforts to restore investor confidence in the capital markets.

B. The Interests of WorldCom's Creditors Were Considered in Determining the Appropriate Penalty

The proposed settlement also seeks to ensure that WorldCom creditors are not unfairly disadvantaged by the relief obtained by the Commission. Any recovery by the Commission on its civil penalty claim will necessarily come at the expense of WorldCom's creditors. While the Commission believes it is appropriate to obtain a civil penalty from WorldCom -- and to return the funds it obtains to victims of WorldCom's fraud -- the Commission does not wish to unfairly diminish the recoveries of creditors who were not participants in the fraud. At the same time, the Commission understands that many of WorldCom's current creditors were not victims of the fraud. Instead, many persons made conscious decisions to become creditors of WorldCom after the fraud came to light, and after the Commission sued WorldCom and advanced its claim for a civil penalty, by purchasing WorldCom debt securities. Many of these creditors have already

4 Circuit Courts have observed that deference is to be given to judgments made by the SEC and other governmental agencies in determining to settle litigation. See SEC v. Randolph, 736 F.2d 525, 529 (9th Cir. 1984) (reversing district court's refusal to approve consent judgment) ("courts should pay deference to the judgment of the government agency that has negotiated and proposed the judgment"); see also United States v. Cannons Engineering Corp., 899 F.2d 79, 84 (1st Cir. 1990) (affirming district court's order approving CERCLA consent decree)("In the first place, it is the policy of the law to encourage settlements. . . . That policy has particular force where, as here, a government actor committed to the protection of the public interest has pulled the laboring oar in constructing the proposed settlement).

profited, or stand to profit, from their investments in WorldCom. In the Commission's view, such creditors who bought on notice of both WorldCom's fraud and the Commission's penalty claim have little cause to complain about the proposed penalty Judgment or about the Commission's desire to ensure that victims of the fraud receive modest recoveries through a distribution pursuant to the Fair Fund provision of the Sarbanes-Oxley Act. Nonetheless, the Commission has weighed the interests of creditors in determining the appropriate civil penalty in this case, so as not to disadvantage them unfairly.

C. Putting WorldCom into Liquidation Would Harm the People the SEC is Committed to Protect

Some competitors of WorldCom contend that the Commission should seek a penalty large enough to force WorldCom into liquidation. Their arguments are misguided. As a going concern, WorldCom is apparently worth between $12 and 15 billion, according to WorldCom's financial advisors. If the company emerges from bankruptcy and our proposed settlement is approved, virtually all of that going-concern value will go to creditors and victimized investors. If the company were liquidated, its assets would apparently yield about $4 billion, according to the Company's financial advisors. It is thus clear that it will be much better for creditors and victimized investors if the company reorganizes instead of being liquidated. Reorganization is also better for the company's 55,000 employees, who would lose their jobs in the event of a liquidation. Moreover, even if the SEC wanted to put WorldCom into liquidation, it could not. Even if the SEC were awarded a multi-billion dollar penalty, such a Judgment would not push WorldCom into liquidation. The company's assets are already far outstripped by the claims of creditors – but that is not causing a liquidation. A larger SEC claim would merely dilute the claims of other creditors. In short, the liquidation of WorldCom would harm creditors, investor victims and WorldCom's employees, while benefiting only WorldCom's competitors.

Some have argued that recovery should be sought from the individual WorldCom officers who engaged in the fraud, rather than the Company. We believe that both courses of action are appropriate. In addition to this action against WorldCom, the Commission has to date brought suit against four former WorldCom officers, and our investigation of fraud at WorldCom is continuing. In any event, the former officers of WorldCom who participated in the fraud, based on the evidence uncovered thus far, as a group do not have the means to pay a Judgment anywhere close to $500 million. Moreover, nothing in the proposed settlement prevents any aggrieved party from pursuing its own litigation against any party it chooses.

III. THE PROPOSED SETTLEMENT IS APPROPRIATE IN LIGHT OF SIGNIFICANT LITIGATION RISKS

The proposed settlement greatly reduces litigation risks that would otherwise jeopardize any recovery by the Commission, and by the victims of WorldCom's fraud who stand to receive distributions of the funds collected. First and foremost, there is no assurance that absent this settlement, this Court would enter a Judgment as high as $1.51 billion. The parties do not know what civil penalty, if any, the Court would impose if this matter were to be litigated. Thus, one clear benefit of the settlement to the Commission is that it reduces the uncertainty that is attendant to any judicial determination.

The Commission's recovery on its penalty claim is not unlimited, but is instead circumscribed by the limits on recovery set forth in the statute. If this case were to be litigated, the upper limit on the Commission's penalty claim would be determined by the gross amount of WorldCom's pecuniary gain as a result of its violations. See Exchange Act Section 21(d)(3)(B)(iii). There can be no certainty that the Court would agree with the Commission's analysis of what items comprise the "gross pecuniary gain" to WorldCom, how those gains should be measured, or the extent to which those gains were the result of the Company's violations. The

proof at a contested civil penalty hearing would feature the testimony of economists retained as expert witnesses by both the Commission and WorldCom. There can be no assurance as to how the Court would resolve the "battle of experts" that would inevitably ensue.

In addition, when civil penalties are litigated, courts have broad discretion in determining what civil penalties are appropriate. As previously stated, the penalty statutes provide that penalties are to be set "in light of the facts and circumstances." Thus, if this matter were to be litigated, the Court might conclude that the facts and circumstances (including the facts and circumstances relating to WorldCom's cooperation and the interests of creditors that were discussed in the preceding section of this brief) justify a penalty that the Commission would consider too low. In short, if the Commission's civil penalty claim were to be litigated, there is a risk that the Commission might obtain less than it would recover through the proposed settlement. Moreover, settlement reduces the risks of an appeal, and delays attendant thereto.

If the Commission's civil penalty claim were to be litigated, the risks faced by the Commission would not be limited to those it would face in federal district court. Even if the Commission were to succeed through litigation in obtaining a Judgment for a civil penalty from this Court, in order to obtain payment on any such Judgment, the Commission would be required to file a claim in the Bankruptcy Proceeding. The Commission is confident that its claim as a judgment creditor would be categorized as a general unsecured claim in the Bankruptcy Proceeding. The Commission is also confident that its claim would receive the same treatment as and be paid pro rata with the claims of other general unsecured creditors. However, there is a risk, which cannot be characterized as insubstantial, that the Bankruptcy Court would subordinate the Commission's claim to the claims of other creditors.

It is a virtual certainty that if the Commission's civil penalty claim were not settled, and the

Commission were required to seek satisfaction of its judgment in the Bankruptcy Proceedings, certain creditors would seek to subordinate the Commission's claim under Sections 510(b) and 510(c) of the Bankruptcy Code. Section 510(b) of the Code provides that a claim for rescission or damages arising from the purchase or sale of a security is subordinated to claims or interests senior to or equal to the claim. By virtue of this provision, securities fraud claims of securities purchasers are routinely subordinated. Creditors can be expected to argue that Section 510(b) should apply to the Commission's claim for civil penalties on the theory that the purpose and effect of the SEC's bringing such a claim is to funnel money to defrauded investors who would otherwise not be entitled to payment due to the operation of Section 510(b). The Commission believes that its claim would not likely be subordinated under Section 510(b) for several reasons, not the least of which is that the Commission's statutory claim for a civil penalty is not one for either restitution or damages, as Section 510(b) requires. Moreover, if the Commission chose to direct the penalty funds to the U.S. Treasury, creditors would not even have a theoretical basis to seek subordination under 510(b). The Commission's choice to distribute the penalty to victims of the fraud rather than to the Treasury does not change the character of the Commission's claim, or otherwise convert the Commission's claim into one subject to subordination. Nonetheless, the issue has never been litigated, and how the Bankruptcy Court would resolve the issue is not free from doubt.

Creditors would likewise seek to subordinate the Commission's claim under Section 510(c) of the Bankruptcy Code, which provides that a court "may under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim." The doctrine of equitable subordination permits a court to subordinate a particular claim if the creditor has acted inequitably in obtaining or enforcing its claim, to the detriment of other creditors. The Commission believes that WorldCom's creditors would be unlikely to succeed in any attempt to

subordinate the Commission's claim based upon an argument that it is unfair to pay the penalty claim in parity with claims of creditors who sustained economic losses. First, the creditors would be unable to establish that the Commission engaged in inequitable conduct. Second, in two recent cases the Supreme Court has rejected the subordination of Internal Revenue Service penalty claims based upon the alleged general unfairness of satisfying a penalty claim before satisfying claims of creditors who sustained pecuniary losses in their dealings with the debtor. United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996); United States v. Noland, 517 U.S. 535 (1996). Nonetheless, the question of whether a Commission claim for a civil penalty could be equitably subordinated has never been decided by any court. Although the Commission believes its arguments on the question would in all likelihood succeed, this question is also not free from doubt. In short, if this case were not settled, the Commission would face significant litigation risks not only in this Court, but in the Bankruptcy Court as well.

The proposed settlement would not subvert the bankruptcy process, as some critics have charged. The Commission is a creditor and, as such, is entitled to assert its rights in bankruptcy court. The settlement effectively accords the Commission the bankruptcy treatment to which the Commission believes it is entitled. Moreover, creditors would fare no worse under the settlement than they would if the Commission decided to direct WorldCom's penalty payment to the U.S. Treasury.

The proposed settlement is subject to the approval of the Bankruptcy Court. The parties anticipate that a hearing to consider approval of the settlement will be held pursuant to Federal Rule of Bankruptcy Procedure 9019. By structuring the settlement to provide that approval of the settlement will be considered pursuant to Rule 9019, the parties minimized the risk that the distribution of $500 million to victims of WorldCom's fraud would be jeopardized by unforeseen

developments in the Bankruptcy Proceeding. Settlement avoids litigation concerning issues such as how the Commission's claim should be classified, and what treatment and priority the claim should receive. In addition, the proposed settlement would assure that the Commission's claim would be paid in full regardless of the resolution of the complex issues to be addressed in connection with the confirmation of WorldCom's bankruptcy plan, including issues relating to whether the assets of the various WorldCom debtors should be subject to substantive consolidation.

The Commission believes that it has negotiated a good tough settlement. The Commission does not want to gamble away the $500 million penalty it intends to distribute to investors. Instead, the Commission believes that reducing the litigation risks posed by the novel and complex issues involved in this lawsuit through settlement is sound and sensible.

IV. THE PLAN TO DISTRIBUTE THE PENALTY PROPOSED BY THE COMMISSION IS FAIR AND REASONABLE

A. The Fair Funds Provision of the Sarbanes-Oxley Act Permits Distribution of the Penalty to WorldCom's Victims

Prior to the passage of the Sarbanes-Oxley Act of 2002, civil penalties assessed for violations of the securities laws were paid to the United States Treasury. Section 308(a) of that Act created an alternative treatment for civil penalties, allowing the Commission to move a court to add a civil penalty to a disgorgement distribution fund to benefit victims of securities law violations. To compensate victims of the fraud, the Commission has chosen the alternative treatment here.[5] Consistent with the Court's May 19, 2002 Order, the Commission's proposed distribution plan is outlined in the Appendix to this submission.

---

5 . Although the Sarbanes-Oxley Act was enacted after the fraud alleged in this action occurred, Section 308(a) of the Act may properly be used to distribute the penalty obtained under the terms of the proposed settlement. Section 308(a) is, in essence, a purely procedural rule (which permits the disposition of civil penalties obtained under other statutes to victims instead of being paid directly to the Treasury), and does not affect any rights or obligations of WorldCom,

B. The Commission's Proposed Plan to Distribute WorldCom's Penalty To Investors Injured By WorldCom's Fraud Is Fair and Reasonable

In fashioning any distribution plan, the Commission necessarily has to draw lines among potential claimants, as it is the rare case in which the amount recovered by disgorgement or (now) by a penalty could compensate all victims of the fraud. In recognition of the difficulty of the task, among other things, Courts give the Commission significant discretion to set the parameters of a distribution plan. See SEC v. Wang, 944 F.2d 80 (2d Cir. 1991); SEC v. Levine, 881 F.2d 1165 (2d Cir. 1989). A Court's review of a plan proposed by the Commission is limited to whether the plan is fair and reasonable. Wang, 944 F.2d at 85 ("once the district court satisfies itself that the distribution of proceeds in a proposed SEC disgorgement plan is fair and reasonable, its review is at an end"). The fact that a plan excludes certain potential claimants or limits certain losses does not render a proposed plan inequitable, as long as there are reasons underlying such decisions.

For example, in Wang, the Second Circuit affirmed the district court's rejection of challenges to a SEC distribution plan by option traders who contended that the plan both unfairly excluded some option traders and also unfairly limited the recovery of others. After noting that the choices made by the Commission in designing the plan were reasonable in that they, among other things, conserved the limited pool of funds to distribute to investors by minimizing administrative expenses that would be incurred by making other choices, the Second Circuit underscored the deference given to the inevitable line-drawing the SEC must make in nearly every distribution plan:

---

increase its liability for the fraud, or impose any new duties on the company. Accordingly, the use of Section 308(a) in this case is appropriate. See Landgraf v. USI Film Products, 511 U.S. 244, 275 (1993) ("changes in procedural rules may often be applied in suits arising before their enactment without raising concerns about retroactivity"); id. at 280 (retroactivity concerns arise if new law "impairs rights a party had when he acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed").

> "As [appellant] concedes, had the Commission chosen to expand the definition [of eligible claims], the costs of administration would have increased because the SEC would have been required to process a greater number of claims, and the pool of money available for distribution to victims would have been reduced . . . It is important to keep in mind though that the primary purpose of disgorgement is not to compensate investors . . . but to ensure that those guilty of securities fraud are not unjustly enriched. This kind of line-drawing – which inevitably leaves out some potential claimants – is, unless commanded otherwise by the terms of a consent decree, appropriately left to the expertise of the SEC in the first instance."

Wang, 944 F.2d at 87-88 (emphasis supplied); accord SEC v. Levine, 881 F.2d 1165, 1182 (2d Cir. 1989) (under consent judgments, SEC had primary authority to determine eligibility of claimants under disgorgement distribution plan); SEC v. Scherer, 1996 WL 689350 (S.D.N.Y. 1996) ("[T]he Commission has discretion in fashioning distribution plans like the disgorgement fund in this case"); SEC v. Finacor Anstalt, 1991 WL 173327 (S.D.N.Y. 1991) (rejecting challenge to SEC's proposed disgorgement distribution plan; holding that the "equities weigh in favor of limiting payment at this time to the claimants suffering the greatest injury").

The Commission submits that the proposed distribution plan is both fair and reasonable. Its guiding principle is to ensure that the limited funds available for distribution are paid to those shareholders with the greatest losses, rather than those who have already profited or have lost substantially less than others. The plan also directs the fund's proceeds to those whose losses are most directly related to the fraudulent accounting practices alleged in the Commission's lawsuit, i.e., purchasers who bought when the securities' price was inflated by the fraudulent accounting, and held until the revelation of that fraud reduced the value of their investment. At the same time, it excludes those who were responsible for the fraud and those who were in a position to detect or prevent the fraud. It also attempts to ensure that the limited funds available for distribution are not disbursed to those who have made net profits in their WorldCom investments, or who have already recovered a proportionally larger measure of their investment through sales, or who stand to

achieve such a recovery through distributions made in the Bankruptcy Proceeding. The plan also attempts to adjust the amount of eligible claims in proportion to the escalation of WorldCom's fraud over time.

The Commission submits that the plan outlined above makes fair and reasonable choices in attempting to identify those claimants most injured by WorldCom's fraud, to exclude claimants who may bear some responsibility for the fraud, to conserve the limited funds available for distribution by making reasonable choices among otherwise eligible claimants and by quantifying the losses resulting from the fraud, and by doing all this in a relatively simple fashion designed to minimize administrative expenses associated with the plan. The proposed plan, when formally submitted to the Court, should therefore be approved.

CONCLUSION

For all the forgoing reasons, the Commission respectfully requests that the Court enter the proposed Judgment.

Dated: June 6, 2003

Respectfully submitted,

Robert B. Blackburn (RB 1545)
Local Counsel for Plaintiff
Securities and Exchange Commission
Woolworth Building, 13th Floor
233 Broadway
New York, New York 10279
(646) 428-1610
(646) 428-1980 (fax)

Peter H. Bresnan (PB 9168)
Arthur S. Lowry (AL 9541)
Lawrence A. West
Gerald W. Hodgkins

Counsel for the Plaintiff
Securities and Exchange Commission
450 Fifth St., N.W., Mail Stop 911
Washington, D.C. 20549-0911
(202) 942-4788 (Bresnan)
(202) 942-9581 (Fax)

APPENDIX

OUTLINE OF THE SEC'S PROPOSED DISTRIBUTION PLAN

A. Selection of a Distribution Agent to Administer the Claims and Distribution Process

A Distribution Agent would be appointed by the Court to oversee the claims and distribution process. Once appointed, the Distribution Agent would be charged with administering the claims process, and entrusted to ensure that after payment of taxes, and approved costs, fees and expenses, the funds remaining would be distributed to the eligible victims of WorldCom fraud in accordance with the criteria in the distribution plan approved by the Court.

B. Eligible Claimants

Except as described below, an eligible claimant would be any person or entity that:

- Purchased any debt or equity security of WorldCom, Inc. or any of its affiliated debtors between April 29, 1999 and June 25, 2002, and
- Held that security continuously from the date of purchase until the market closed on June 25, 2002.

The following persons or entities would not be eligible claimants and would be excluded from participating in the distribution of the penalty:

- Any past or present director or officer of WorldCom or any of its past or present subsidiaries (or any of their assigns, heirs, distributes, spouses, parents, or children, or any entity they control);
- Any employee of WorldCom who has been terminated for cause by WorldCom's management in connection with the fraud, or was otherwise terminated or resigned in connection with the investigations conducted by the Commission, the Special Investigative Committee of WorldCom's Board of Directors, or the WorldCom Bankruptcy Examiner (or any of their assigns, heirs, distributes, spouses, parents, or children, or any entity they control);
- Any employee, officer or director of WorldCom who has been charged criminally in connection with the accounting fraud at WorldCom (or any of their assigns, heirs, distributes, spouses, parents, or children, or any entity they control);

- Any defendant in any class action lawsuit related to the fraud (or any of their assigns, heirs, distributes, spouses, parents, or children, or any entity they control), unless found not liable in all such civil suits;

- Any person who assigned that person's right to obtain a recovery in the Commission's lawsuit against WorldCom;

- Any person who made a net profit on that person's combined purchases and sales of all WorldCom securities, and

- With respect to any particular security, any security holder (a) who will receive a higher payout from WorldCom's bankruptcy estate with respect to such security than that received by WorldCom general unsecured creditors for their claims or (b) who sold such security after June 25, 2002 at a price which allowed the seller to recoup a percentage of the purchase price that is higher than the percentage recovery general unsecured creditors will receive.[6]

The Distribution Agent would have discretion to determine whether each claimant falls within any of these exclusions.

C. Eligible Loss Amounts

Each eligible claimant (as defined according to the criteria described above) would be required to submit a claim form, designed by the Distribution Agent in accordance with the plan, to substantiate his or her (or its) claimed losses. Each eligible claimant would receive a pro rata share of the loss of all eligible claimants based on the claimant's eligible loss amount.

All of the company's securities lost a significant percentage of their value in response to the company's June 25, 2002 announcement. For example, the WorldCom Group tracking stock, which had closed at $0.83 on the day of the announcement, closed at $0.06 per share on the day trading resumed -- a price decline of approximately 92.73 percent. Other WorldCom securities similarly suffered price declines as a result of the fraud announcement, though price declines for

6 The Commission notes that the above definition of eligible claimant would include, among others, present and former WorldCom employees who purchased WorldCom stock during the period of the fraud -- including those who purchased through WorldCom's 401(k) plan – and who continued to hold that WorldCom stock until the close of the market on June 25, 2002. However, employees who fall into an excluded category would not be "eligible claimants."

debt issues were not as severe as those suffered by equity.[7]

The Commission's proposed distribution plan provides for a formula to compute each investor's recoverable loss that takes into account the increase over time of WorldCom's financial misstatements.[8] Using this formula, the effect of the fraud on each issue of WorldCom securities at a particular point in time will be estimated based on the reaction of that issue's price to the company's June 25, 2002 announcement. For all reporting periods for which the company's cumulative misstatements of line costs equal or exceed $3.852 billion (the misstatement amount announced on June 25, 2002), the price inflation from the fraud – i.e., the measure of loss from the fraud – will equal the percentage decline in that issue's price in response to the June 25, 2002 announcement of the fraud. For periods where the company's cumulative misstatements are less than $3.852 billion, the measure of loss will be reduced proportionally.

Based on currently available data,[9] the following chart shows the increase over time in the misstatements in line costs as a percentage of the announced total misstated line costs on June 25, 2002:

---

7 Available data indicates that prices for WorldCom bonds declined, depending upon issue, from approximately 80% to 68% in response to the company's June 25, 2002 announcement, with an average decline for the group of approximately 74%.

8 This computation recognizes that the prices paid for WorldCom securities early in the fraud period more closely reflected the correct price of the security, and the price paid later in the fraud was increasingly inflated from the fraud. If WorldCom had revealed the true state of its finances in early 1999 and 2000, instead of making the relatively smaller misstatements it made in those time periods, it is unlikely that such revelations would have had as dramatic an impact on the value of the company's securities as the June 25, 2002 announcement did. Put another way, because the announcement of $3.852 billion in improperly adjusted line costs resulted in a 92.73% decrease in the value of WorldCom stock, the plan assumes that announcement of a misstatement of approximately $100 million in line costs during the second quarter of 1999 would have had a proportionally smaller impact on the stock's value.

9 The data with respect to quarterly line cost misstatements comes from the Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom, Inc., which will be filed with the Court on June 9, 2003.

Periods	Extent of Misstated Line Costs[10]
4/29/1999 – 10/27/1999	1.61%
10/28/1999 – 2/9/2000	5.24%
2/10/2000 – 4/26/2000	15.52%
4/27/2000 – 7/26/2000	28.32%
7/27/2000 – 10/25/2000	46.05%
10/26/2000 – 2/7/2001	67.65%
2/8/2001 – 4/25/2001	90.03%
4/26/2001 – 6/25/2002	100%

Thus, for example, a shareholder who purchased WorldCom shares at any time after April 26, 2001, when the cumulative amount of the misstated line costs equaled or exceeded the amount of the announced misstatement on June 25, 2002, would have an eligible loss amount based upon 100% of the market reaction to the announcement of the fraud, or 92.73% of the price paid (because the stock price declined 92.73% in reaction to the announcement). The eligible loss amounts of shareholders who purchased in earlier time periods would be reduced in proportion to the extent of the line cost misstatements up to that period.[11] The extent of the misstated line costs percentage reflected in the above chart would be applied to the percentage loss suffered by each WorldCom security in reaction to the June 25, 2002 announcement.

After each eligible claimant's loss is adjusted in light of the extent to which the fraud had progressed at the time of the claimant's purchase, the Commission's proposed plan provides that the resulting claims would be satisfied from WorldCom's penalty pro rata, in accordance with the SEC's usual practice. See SEC v. Credit Bancorp, Ltd., 290 F.3d 80, 88-89 (2d Cir. 2002).

10 Defined as the cumulative improper adjustments to line costs as a percent of the improper adjustments disclosed on June 25, 2002.

11 Thus, for example, for a shareholder purchasing WorldCom shares between July 27 and October 25, 2000, where the cumulative misstatement of line costs was 46.05% of the amount announced on June 25, 2002, the loss due to the fraud would be 46.05% of the price impact on June 25, 2002 (92.73%), or about 42.7% of the price paid (46.05% X 92.73%).