Securities Roundtable

EXECUTIVE SUMMARY

The high-profile unraveling of Bernard Madoff's $50 billion Ponzi scheme will likely lead to significant policy and practice changes by the U.S. Securities and Exchange Commission (SEC), as well as litigation filed by investors against those who potentially failed to do their due diligence on Madoff's funds. Additionally, securities litigation attorneys note that the financial crisis led to an uptick in securities lawsuits in 2008 against firms in the financial sector, as well as an increase in litigation following mergers and acquisitions.

Our panel of experts from Northern and Southern California discuss these trends, as well as anticipated policy changes under the Obama administration. They are Helen B. Kim of Katten Muchin Rosenman; Richard M. Heimann of Lieff Cabraser Heimann & Bernstein; Sean T. Prosser of Morrison & Foerster; and Jim Kramer and Daniel J. Tyukody of Orrick, Herrington & Sutcliffe. The roundtable was held at the Westin San Francisco Market Street, moderated by freelance writer Bernice Yeung, and reported for Barkley Court Reporters by Krishanna DeRita.

MODERATOR: What policy changes and shifts in SEC enforcement do you anticipate seeing under the Obama administration?

KRAMER: We are going to see a number of changes in response to recent criticism regarding the SEC and its enforcement efforts. In particular, I expect that the SEC's enforcement chief, Linda Thomsen will be replaced with someone with close ties to the U.S. Attorney's office—someone who will coordinate closely with that office. I also expect that Mary Schapiro, the chairman of the SEC will push hard to lift the requirement that there be full commission authority before opening new investigations. We will also see legislation proposed that will address perceived loopholes in the current regulatory scheme, including providing for private rights of action to enforce certain provisions of Sarbanes-Oxley.

KIM: I agree that the SEC will seek to close a number of loopholes. For example, in the Madoff situation, there were major internal control failures that I would hope would be closed in the near future. One is that Madoff did not have an independent custodian for the assets entrusted to him, which enabled him to issue all account statements and checks. The second problem is that his so-called auditing firm was not even registered with the Public Company Accounting Oversight Board (PCAOB). It actually claimed an exemption—ironically because it claimed it was not auditing anyone.

And then you have Financial Industry Regulatory Authority (FINRA) saying that it wasn't its responsibility to catch Madoff because it was examining the books of the Madoff broker-dealer entity, not the investment adviser. We need to close up those loopholes so that each regulatory organization can't point the finger at the other.

In terms of the SEC's policies, the commission had historically conducted compliance investigations during the first year of registration for all new investment advisors. Madoff slipped through the cracks, perhaps because the SEC, with its limited resources, had to pick and choose which advisors to examine. There should be a reexamination of that policy, perhaps by setting a certain monetary threshold, which could have helped the agency catch the fraud much earlier.

PROSSER: Because of Madoff, there is likely going to be a wholesale reexamination and overhaul of the process by which the SEC receives, evaluates, and investigates complaints. Complaints against Madoff were lodged in the SEC's Boston, New York and Miami offices but because there is not sufficient coordination between offices, it appears that independent decisions were made without sufficient understanding of the context or complaint history, and credible complaints were not pursued adequately. The complaint follow-up procedure is old and ineffective. There needs to be a new system with better oversight.

TYUKODY: I think we'll see some omnibus legislation, and we could see a radical realignment of the enforcement agencies, including a rethinking of the roles of the SEC and banking regulatory enforcement, potentially with all of them being brought under one roof into some sort of super agency. This would certainly create a very different enforcement regime than we're used to.

We are also likely to see an effort to bring alleged aiders and abettors—which would affect third parties such as accountants and attorneys—brought back into the private litigation securities law fabric with attempts to legislatively overrule the central holdings of *Central Bank* and *Stoneridge*. Certainly, there's going to be a fight on this issue, because the accounting firms, in particular, are going to strongly oppose such efforts.

HEIMANN: On that note, it strikes me as odd and politically motivated that aiders and abettors are

ROUNDTABLE

exposed to SEC action under current law, but are not liable under private actions.

There are two additional areas I would like to see addressed, although I don't know how realistic it is to think that Congress, even in the wake of this last election, would take them up. One is the pleading standards in civil actions, which, from a plaintiff practitioner's point of view, is a real problem. I see a number of cases where there is strong evidence of fraud, but I can't get to them because I don't have the information I need to adequately plead the case.

Another area I'd like to see addressed is the notion of loss causation and the way it's being dealt with in the wake of the U.S. Supreme Court decision in *Dura*. It is difficult to know, quite frankly, whether or not you have a good case of loss causation under *Dura* or not, and it would be useful if there were uniformity as to what is actually meant by loss causation.

KRAMER: In terms of additional changes under the Obama administration, I expect to see legislation giving the plaintiffs bar the ability to pursue claims under Section 304 of Sarbanes Oxley for executive compensation clawbacks.

Most commentators would say that the private plaintiffs bar plays an important function in regulating the securities markets. Given the current economic environment and the fact that the SEC continues to be resource-constrained, I expect to see legislative changes that will make it easier for plaintiffs to assert claims on behalf of investors.

PROSSER: With administration changes, we often see a push to increase the SEC's budget and staffing, but this time, there seems to be some real fuel behind it. There's also increasing pressure on the SEC to bring bigger cases more quickly, instead of the piddly cases you often see them wasting resources on. In fact, we've recently seen the SEC staff push to resolve the older cases because they are anticipating a wave of bigger cases at the insistence of the new SEC chairperson.

MODERATOR: What are the takeaway lessons from Madoff case?

TYUKODY: Madoff reflects the importance of due diligence. There were a number of independent funds that investigated Madoff and they concluded that it was too good to be true. So the litigation action on the Madoff front is going to be in the area of investment advisors who put people into Madoff's funds and who claimed that they did extensive due diligence on Madoff. In retrospect, they probably did not. Meanwhile, Madoff's insurers are likely to say that since it was fraud, they will not cover the losses, so the plaintiffs are going to have to go to the secondary line of people who arguably breached their fiduciary duties by putting people into these funds without doing sufficient due diligence.

KIM: There could be a whole new area of law created. With Madoff, you had two types of investors: direct investors, which our traditional legal schemes covers pretty well, and indirect investors who invested in the so-called feeder funds that invested in Madoff. The culpability and the exposure of those feeder funds is an area that's going to undergo significant change because, to date, they have not been the subject much judicial scrutiny.

HEIMANN: And aside from the three main domestic feeder funds, well over half of the funds invested with Madoff were by foreign investors. So there's going to be an enormous push by some American lawyers to bring cases on behalf of those investors in U.S. courts. I suspect the foreign investors will be defending mightily on the jurisdictional issues.

On a related note, one of the main foreign feeder funds was called Optimal, owned by the Spanish bank Santander, which we are actively investigating as the subject of litigation. And I am fascinated by one of the risk disclosures contained in the offering documents for a fund that invested in Madoff. It states that Optimal is investing all of its investors' funds with a "U.S. broker dealer" that's otherwise unnamed and then goes on to state that the "information supplied by the broker-dealer may be inaccurate or even fraudulent. The investment manager and the administrator are entitled to rely on such information provided they do so in good faith and they are not required to undertake any due diligence to confirm the accuracy thereof."

KIM: That is fascinating. Particularly with respect to the indirect investors, their remedy will depend upon the feeder fund's documentation and the laws under which those funds were created. So if it is an offshore entity that's the feeder fund, it will depend very much upon the law governing those funds and we are going to see wide range of possible remedies.

PARTICIPANTS

HELEN B. KIM is a partner in Katten Muchin Rosenman's Securities Litigation Practice Group in New York and Los Angeles. She represents directors, officers, and principal shareholders of public and private companies in complex commercial litigation, with particular emphasis on the defense of securities and other class actions, shareholder derivative suits, and regulatory investigations. In 2008, the *Daily Journal* named her to its list of Top 75 Women Litigators in California. Ms. Kim also serves as co-editor of the ABA Litigation Section's Securities Litigation Journal.
helen.kim@kattenlaw.com

RICHARD M. HEIMANN oversees Lieff Cabraser Heimann & Bernstein's securities practice. He possesses substantial trial experience, both as a public defender and a prosecutor, and then in private practice devoted to complex commercial and financial litigation. Mr. Heimann obtained one of the largest jury awards in the country in 2002 in the trial of a securities fraud class action in Federal Court in San Francisco. He has written and lectured on accountant liability, and taught effective techniques for the deposition and trial cross-examination in securities actions.
rheimann@lchb.com

ROUNDTABLE

PARTICIPANTS

SEAN T. PROSSER is a partner in Morrison & Foerster's San Diego office. Mr. Prosser, a former SEC enforcement attorney, defends companies and their officers and directors, as well as public accounting firms, in shareholder class action, derivative and corporate control lawsuits, and in enforcement investigations and proceedings by the SEC, FINRA, CFTC, stock exchanges, and state securities regulators. Mr. Prosser also frequently represents companies, board committees, and individuals in connection with internal investigations.
sprosser@mofo.com

JIM KRAMER is a partner in Orrick's Securities Litigation and Regulatory Enforcement Group. His practice focuses on representing companies and individuals in securities class actions, derivative actions, M&A related litigation, SEC enforcement proceedings, and other complex commercial litigation. Recent litigation results include obtaining a ruling completely favorable to NVIDIA Corporation in a complex M&A/creditor's rights dispute, and dismissals of securities class actions at the pleading stage for clients Micrus Endovascular and Ikanos Communications. Mr. Kramer was named among America's leading litigation attorneys by *Benchmark: Litigation*.
jkramer@orrick.com

KRAMER: The major take-away from Madoff will be the legislative changes it brings about. Policymakers will reverse engineer what caused the SEC to miss Madoff despite the purported existence of numerous "red flags." The results will be legislative changes designed to insure the situation does not repeat itself.

TYUKODY: The Madoff case could also wind up impacting Errors & Omissions (E&O) policies because it's going to be the insurers for the funds of funds that are going to be on the hook for the negligence of their insureds, as opposed those who insured Madoff directly.

HEIMANN: I expect the three major U.S. feeder funds, if held responsible to their investors, will ultimately go into bankruptcy themselves. As a plaintiff, it's going to be difficult to decide whom to seek to hold accountable, given the enormity of the losses and the limited resources of some of the more obvious targets.

The third source of potential recovery is the auditors, such as the Big Four accounting firms. It's a curious situation. Typically, the auditor of the feeder fund would have no responsibility to engage in any audit procedures on the money manager to whom the fund feeds, but in this case, a minimal amount of due diligence would have revealed that the auditor for Madoff was a fly-by-night operation. Under those circumstances, a fair case can be made that the auditor for the feeder fund could not simply sit by and accept the audit reports from that sort of firm.

TYUKODY: I also wonder why the SEC does not use more sophisticated statistical analysis. Funds that did not invest in Madoff ran statistical analyses and concluded that the statistical probability of Madoff's fund generating such consistent returns in both up and down markets was less than 1 percent.

One of the things we might see with the Obama administration is an embracing of more sophisticated statistical tools. It seems to be a much more computer-savvy administration, and it would not surprise me if we saw that skill set applied toward a more statistical based analysis of fraud.

PROSSER: I also think the SEC must better prioritize its investigations. Currently, each attorney in each SEC office can go to his or her boss to get approval to open an inquiry. They could just read something in the newspaper, get a hunch, and open an inquiry where only minimal dollars might be at stake. That investigation might take years to conclude while at the same time, fraud involving tens of millions of dollars—or more, as we've seen in the Madoff case—might go undetected because the commission has not done a sophisticated analysis to set and carry out investigation priorities. There needs to be a change in the overall approach so the SEC does not spend its time and resources on small cases just because they're easier to pursue or because the target may not have the resources to defend itself.

KRAMER: Ultimately, if you were to predict the change that ought to happen in terms of the regulatory scheme, one way to go about it would be to look at what happened with Madoff, pick out the top ten things that went wrong, and those are likely the areas where—at least initially—we'll see additional regulation.

MODERATOR: How has the financial crisis affected the types and the number of suits that are being filed? What additional litigation trends are you seeing?

KIM: It's clear that the number of cases has increased dramatically. According to National Economic Research Associates (NERA), there were 131 securities class actions filed in 2006, 195 in 2007 and 255 in 2008. Last year, nearly 50 percent of these cases were filed against firms in the financial sector.

PROSSER: Very few of these cases have been resolved at this point; most are wending their way through the courts. There have been just a few settlements and some motions to dismiss granted. However, to the extent that cases have been dismissed, there's been leave to amend granted so the ultimate impact of the cases remains to be seen.

TYUKODY: The Southern District of New York certainly got very busy with 95 filings last year. But I don't know that we are going to see a whole lot of new law coming out of them. My guess is that they will wind up getting settled.

HEIMANN: It will be interesting to watch the Bank of America/Merrill Lynch cases. Both 10(b)5 cases and 14(a) proxy cases have been filed, and in some cases, the complaints include both claims.

ROUNDTABLE

They have involved issues ranging from due diligence to when Bank of America became aware of Merrill's fourth-quarter losses.

TYUKODY: The role of the government is going to be interesting to look at in these cases. By most accounts, the Treasury and the Federal Reserve pushed Bank of America to close the deal, notwithstanding the subsequent revelations of the extent of Merrill's losses. Of course, the fact that they got sued doesn't tell us much about the merits, as nowadays, if there is a merger, there will be a lawsuit. The acquirer will be sued for paying too much, or the acquired will be sued because the acquirer paid too little. What's dangerous about those cases is that plaintiffs immediately seek an injunction against the deal and get very quick discovery. So you get back into that trap that the U.S. Private Securities Litigation Reform Act of 1995 tried to avoid, which is a case that may not have merit will get into the courts, and through discovery, there's some mucking around with the documents to see if anything is in there. There's great potential for abuse.

KRAMER: I do think, though, that the courts are continuing to get more sophisticated in terms of narrowing the scope of the discovery you get in that situation. Further, the recent *Gantler* decision from the Delaware Supreme Court limit the application of shareholder ratification in certain situations, including merger and acquisition (M&A) transactions. Prior to *Gantler*, this was an important tool of the defense bar. As the market stabilizes, I expect we will see an increased level of M&A activity and given the *Gantler* decision, I wouldn't be surprised to see an uptick in the number of cases challenging M&A transactions.

PROSSER: Merger litigation is on the upswing. With the stock market now seeming to stabilize somewhat at low prices, a lot of companies are targets for companies with cash. Plaintiffs' counsel are trying to be creative to thwart those transactions. For example, we have seen plaintiffs try to support an "unfair price" argument with the theory that the board of directors should have just waited for the stock market to rebound before agreeing to sell the company. That simply is not realistic or even legally proper.

KRAMER: However, I have had a number of M&A cases where the suit gets filed, but we've sat down with the plaintiffs lawyers and it's led to voluntary dismissals. At the end of the day, plaintiffs are not interested in spending money on a case where they don't think there will be a recovery for the shareholders.

TYUKODY: There would seem to be an issue regarding resource constraints on the plaintiffs bar because there is going to be so much involved with the financial crisis and with suits against the four major banks, which are going to require immense resources.

KIM: It is also a question of assessment of who is going to be left standing at the end of the day. As Dan [Tyukody] just pointed out, there are only four major investment banks left. If you look at the statistics, one would have thought that the second half of 2008 would have resulted in a huge spike in litigation because of the growing financial crisis, but according to Cornerstone Research, that did not happen. That may be due to a wait-and-see position by the plaintiffs bar regarding how this financial crisis is going to shake out since there's no point in pursuing cases if there isn't a source of recovery at the end of the day.

HEIMANN: Undoubtedly true. Then there is the added complication of the government's involvement in all of this. For example, there were a couple of cases working their way through the courts against AIG prior to the government's intervention, and I question whether or not the government, which now owns 80 to 100 percent of AIG as the shareholder, is going to allow any sort of substantial recovery against that company.

The thought I would conclude with is that we are not done with the financial crisis yet. ■

PARTICIPANTS

DANIEL J. TYUKODY is the partner in charge of Orrick's Securities Litigation Group in Los Angeles. His practice focuses on defending underwriters, issuers, and officers and directors in securities class and derivative actions, SEC proceedings, and in conducting internal investigations. As lead trial counsel, he obtained a complete defense verdict in May 2005 in one of the few securities class actions tried to verdict since 1995. Lawdragon named him one of the "500 Leading Lawyers in America" and one of the "Top 100 Securities Litigators."
dtyukody@orrick.com